Economic Uncertainties

Address to IVY, New York, July 27, 2017.

By **William R. Rhodes**

President and CEO of William R. Rhodes Global Advisors, LLC and author of
Banker to the World: Lessons from the Front Lines of Global Finance

Introduction

It is a pleasure for me to join you this evening.

The world economy faces serious challenges, especially as the political landscape of the developed industrial nations is being transformed by rising nationalism, populism and protectionism. This is starkly highlighted by the election here of Donald Trump and the U.K.'s Brexit decision.

For several years, I have been arguing that it is important to understand what I call the "middle-class revolt syndrome," which has fueled the rise of populist politics. President Trump and the U.K.'s "leave" the European Union campaign both have won popular appeal through calls for protectionism, nationalism and greater income equality. But they are not alone. We are seeing how the middle-class revolt syndrome has encouraged politicians in Hungary, Poland and Austria, for example. Uncertainties continue, for example in Italy, where economic growth hovers around one percent, the banking system is strained, unemployment is high, and the Five Star Movement, pushing populism, gears up for next year's elections.

The election victories for more mainstream, internationally-oriented candidates, in the Netherlands and in France are encouraging, and I expect that Chancellor Merkel will win in the German elections, so rebuffing the nationalists within the Euro area – for the moment.

Two paramount issues have been important in one country after another as nationalism and populism have gained traction: first, anti-immigration sentiment; second, persistent economic insecurity for very large numbers of working citizens, especially since the onset of the Great Recession of 2008/09. I had warned in published articles in the *Wall Street Journal* in 2006 and the *Financial Times* in 2007 and 2008 that a serious crisis could well be emerging. The events of 2008/09 were a hammer blow to economic stability. Its origins were deep and its consequences have been profound.

On the global economy: over recent years some economies like the U.S. have done much better than others in new job creation. Our unemployment rate is around 4.4%, but there are many millions of Americans that feel insecure in this economy, who faced home foreclosures, and whose real incomes have not advanced substantially. Corporate profits have risen, as has the stock market, but we have failed, unlike Germany for example, to massively pursue job retraining and education programs that could give so many in our labor force the chance of higher real incomes. Nationalist trade policies will not provide these Americans with better prospects.

Looking at the global outlook for GDP, the latest IMF forecasts (July 24, 2017) suggest that world GDP may rise by 3.5%, slightly above the 3.2% seen last year. The new predictions point to 2% growth in the U.S. and 2.1% in the Euro area, 1.7% in the U.K. and 1.3% in Japan. The developed industrial economies continue to grow modestly – well below their potential.

Emerging market and developing countries overall are doing somewhat better with projected growth this year of 4.6% according to the IMF. But we see starkly differing situations here, from China and India growth at 6.7% and 7.2% respectively, to Brazil at 0.3% after a 3.6% decline last year and a similar fall the year before – indeed 2015 and 2016 represent the most serious economic decline in a century. Moreover, the weakness of oil prices may dampen growth prospects for quite a number of emerging market economies.

A worrying indicator of current weakness is world trade growth. World trade, so long a major engine of international economic growth, has slumped badly. The IMF estimated that 2016 world trade growth slumped to about 2.6% and that this year it may reach 4%, which is just slightly above the rate of global GDP growth and this may be an estimate on the high side. Between 1985 and 2007 trade volumes shot up at around twice the rate of global GDP; since 2012, the rate of growth has barely kept pace.

It is important, I believe, to underscore this point in a world where trade protectionism is asserting itself: where the Trans-Pacific Partnership (TPP) has been abandoned; where the U.K. is on a collision course with its European partners; where NAFTA is being reviewed; where other U.S. trade relationships, including the South Korea agreement, are being subjected to the rhetoric of "America First."

Financial Markets

I will share a few thoughts with you on some of the leading economies, but first I want to stress a matter of considerable concern. The revival of economies since the Great Recession has largely been due to the expansionist policies of major central banks: they have created masses of liquidity, pushed interest rates to very low, even negative levels, to boost growth and, in fact, driven the investor search for yield.

I believe that a considerable amount of the short-term cross-border investing that we have been seeing is imprudent and involves ever-larger risks. We need to be vigilant in monitoring the health of the financial system and the threats to the system.

The formidable valuation gains seen in the equity markets, the prime real estate markets and at the leading art auctions have borne no relationship to domestic and international growth rates in recent years. Unless there is a dramatic rise in growth there will come a time when fundamentals will assert themselves. In such a situation we could confront a new set of serious global financial and economic challenges.

The U.S. Economy

Now let me turn very briefly to the major economies, which we can discuss in more detail in our question and answer session. First, the United States economy. A number of well-known economists, notably Larry Summers, have for some time been describing our economic condition as one of secular stagnation. Growth is low, savings are relatively high, investment is weak and consumer spending is below what is needed.

It is difficult to see 2017 growth much above 2% - fiscal stimulus from the Congress and the White House is less and less likely. The White House and Congress have been bogged down with healthcare reform and, as a result, they have failed to act in ways that there were widely expected with infrastructure spending, tax reforms, and substantial deregulation, which could have resulted in significantly stronger growth, possibly 3% this year.

Some further modest tightening by the Fed is likely with another rate rise probable this year. The Fed needs to start reducing its balance sheet that in recent years grew from $800 billion to $4.5 trillion. Such action is long overdue and will probably begin in September. The deleveraging that results could have an impact on financial markets.

To ensure greater U.S. growth ways must be found to unlock the large savings that many Americans have felt bound to establish. We critically need to see a boost in productivity, which demands significantly higher levels of investment.

China's Economy

China is the world's second largest economy. How the relationship between the U.S. and the Chinese economies evolves will be the paramount factor in determining global economic growth and prospects for many years to come. Moreover, the strategic relationship that is forged, mindful of the threats from North Korea, China's ambitions in the South China Sea and other sensitive issues, is enormously important.

The era of China's double-digit growth has ended and it is uncertain whether it can continue to secure the 6+% GDP growth anticipated for this year. But it will slow next year as the government directly addresses the serious challenges that the economy faces, which could have an important impact on the world economy.

This is an important year for President Xi Jinping as he looks to consolidate his political power. Important decisions will be taken in the fall at the 19th National Communist Party Congress, which will see the replacement of five of the seven members of the all-powerful

Politburo Standing Committee. I do not expect major economic policy actions, which could threaten growth, before the Party Congress.

But in due course the government will need to directly address mounting financial challenges. The Chinese have been struggling to stabilize the exchange rate and in so doing they reduced their foreign exchange reserves by over $1 trillion in the last year (down to a current total just above $3 trillion). Capital controls have been increasingly tightened to stabilize the currency's level. Current approaches may prove unsustainable and there should be concern that the debt-to-GDP ratio has soared from around 150% of GDP in 2008 to 280% today and it is still growing.

The mounting financial problems reflect excessive borrowing by industries, municipalities and by real estate developers who are adding to an existing housing bubble. There has been a formidable rise in credit extension both by banks and the shadow-banking sector, which alone represents about 87% of GDP or around $9 trillion.

China's authorities need to take a series of actions that include: writing-off non-performing loans at banks and ensuring the recapitalization of some banks; bringing under rigid control the liquidity tap used by major public sector borrowers; closing zombie enterprises in sectors such as steel, coal, shipbuilding and other areas; and introducing legislation to regulate the expanding shadow banking sector.

Japan's Three Arrows

Let me now turn to Japan. Prime Minister Abe and Central Bank Governor Koroda have been striving to bring the country out of prolonged virtual stagnation that has lasted for 20 years. The Prime Minister has sought to promote three arrows for growth: fiscal, monetary and structural reform.

Despite extraordinary measures taken by the Bank of Japan, which have seen substantial quantitative easing and negative interest rates for the first time, the economy is not responding in a sustained and meaningful manner and the deflation threat persists. Moreover, Japan has an exceptionally large public debt of over 300% of GDP that in time may become a major policy challenge. Japan's continuing low levels of growth are effecting the domestic popularity of Prime Minister Abe.

The structural problems that Japan confronts are not going to be resolved in the short-term. Meaningful structural reforms are essential: the economy must become more open to foreign imports and investment, such as TPP would have accomplished; it must find means to provide young people with exciting entrepreneurial opportunities; it needs to stimulate consumption by a population that cherishes its savings.

Europe

The economies of Western Europe are exceptionally challenged by political developments. Britain and the European Union will tussle for the next 20 months over Brexit, and the economic costs to the U.K. could be significant. The political challenges within the EU, notably from Poland and Hungary whose governments are directly pursuing policies contrary to core EU democratic values, should not be underestimated. I have already mentioned the serious problems – both economic and political – in Italy, the third largest economy in the Euro area.

The tensions between Turkey and Germany are also serious. While there are good reasons to be encouraged by the election victory of President Macron, however, we need to see if this new leader can do better than his predecessors in modernizing the labor market, making it more flexible, and curbing the most radical of the trade unions. I am hopeful and positive, based it on my interaction with senior members of his economic team.

No challenge for the Euro area's 19 countries is greater than that of managing immigration problems. There is not only the continuing inflow of immigrants from Syria, but there is a major inflow from sub-Saharan Africa – a trend likely to increase in coming years. The desperate humanitarian crises in Yemen, South Sudan, Somalia and Northeast Nigeria, are producing millions of migrants, the most desperate of whom are striving to reach Europe.

The EU's Council of Finance Ministers has for too long promoted austerity. Now is the time for growth strategies. The European Central Bank (ECB), under the able leadership of Mario Draghi, has done the maximum possible to add liquidity, but this has not been sufficient.

There have been modest improvements in Euro area unemployment, but the numbers remain concerning – overall unemployment in May stood at 9.3 %, down from 10.2% in May 2016. Youth unemployment rate was 18.9 %, down from 21.3% one year earlier.

We have to be particularly concerned when noting that in some countries the youth jobless rate remains extraordinarily high – 46.6% in Greece, 38.6% in Spain, and 37% in Italy – there are millions of young people in Europe – indeed a generation – who start their working lives with scant prospects for a decent income. This may have profound longer-term political consequences.

The European Banking Authority was too slow, unlike the Fed, to address key issues and complete the long-planned banking union. The goal has been a supervisory system that amounts to a three-legged stool: strengthening bank capital and standardizing regulatory oversight primarily by the ECB, which is the one part where there is significant progress; then introducing a comprehensive resolution system, which is still a work in progress; and then introducing a new area-wide deposit insurance scheme, which has still not been addressed.

The general consequence of the slow pace of reform is a banking system across the Eurozone that is not operating at full throttle and providing the vital support that the region's economy so urgently requires.

And finally on Europe, the Greek crisis persists. Each new crisis is resolved by kicking the can down the road. Greece has an unsustainable debt burden. The IMF recognizes this, at last, and calls for debt reduction. The Euro area's leaders refuse to deal with this matter. Without new debt relief in the coming year Greece will fall back into a serious crisis challenging the Euro area once more.

Banking Culture

In conclusion, I have been asked to share a few thoughts about the health of our international banking.

For diverse reasons, the post-Great Recession regulations imposed on banks are likely to be eased to some degree in the U.K., in the Euro area and here in the United States. Our U.S. major banks are healthy overall. But we should not forget the critical issues of banking culture and conduct. More work by quite a number of banks is essential on this front.

Restoring public trust and confidence in our banking system relates explicitly to issues of reputational risk; and actions in this area require forthright leadership by corporate boards.

Banks must deal with four major areas of risk: credit risk, market risk, operational risk, including cyber risk, and reputational risk. I believe that reputational risk is by far the most important, because if a corporation loses its reputation, it can go out of business.

Embedding a strong culture of integrity unquestionably strengthens staff morale, which is a vital ingredient for a successful business.

Public trust in banks fell sharply as a result of the sub-prime mortgage crisis and the financial crisis that it triggered. There continue to be grounds for concern about the reputational risk management approaches by many banks. A study by the Boston Consulting Group[1] found that over the last eight years the world's largest banks paid $321 billion in fines for all manner of violations, including $42 billion alone in 2016 and it is still rising in 2017 – as we see high-profile cases such as those involving Wells Fargo, Deutsche Bank, Barclays and Royal Bank of Scotland.

The scale of the fines highlights how crucial cultural and conduct reforms are. There is no one size fits all – there is no prescription for exactly what the contents of an institution's culture should be.

1 The Boston Consulting Group – "Global Risk 2017: Staying the Course in Banking," March 2, 2017.

When I started in banking, I was taught to believe that the highest priority was to defend the reputation of the bank and to serve our customers and our community. The banking culture I grew up in was driven by this priority and demanded that we spare no effort to earn the trust of the public and ensure that we maintained it. But that priority was rudely set aside and replaced by a drive for short-term profit maximization.

In my book, *Banker to the World*, and in a number of articles that I have written for *The Financial Times, The Wall Street Journal* and for *Reuters*, I have underscored the need in banking for sound risk management. Working with the Group of 30, and serving as its co-chair of the working group, published a 2015 report* on this topic that highlighted many necessary reforms - later this year the Group of 30 will pursue follow-up research with a view to publishing a report in 2018.

I would feel a good deal more comfortable about the overall economic and financial outlook if I saw greater evidence of prudence in risk-taking in financial markets and in culture and in conduct at some of the world's major banks. We know the problems and we know what must be done – what counts now are for the banks to pursue continuous actions in this area on a sustained basis.

Thank you.

- *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform – 2015, The Group of Thirty.*

- Recent – Reuters Breakingviews, guest article by William R. Rhodes "Don't Forget Banking Culture."
  https://www.breakingviews.com/features/guest-view-culture-cant-be-bank-reform-casualty/