International Financial Risks

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Ladies and gentlemen it is a pleasure to meet with you at the Hudson Institute to discuss risks to the global financial system. At the outset, permit me to stress that these risks need to be placed on the global economic stage where the range of challenges right now is formidable. These challenges include the slowing of world economic and trade growth; dangers of deflation in the advanced economies; the low levels of commodity prices that have weakened many emerging market and developing economies; as well as significant concerns about China's economic and financial situation.

We need to consider that the world's economy is close to economic stagnation and could fall back into recession. The IMF, which has always had a tendency to be somewhat on the optimistic side, is forecasting global growth this year at 3.2%, after an estimated 3.1% last year.

The IMF projects that growth in advanced economies will be just 1.9%, and this low level is due to a degree to the benefits of low oil and commodity prices. Growth in Japan is expected to be 0.5% yet again and I think it could be lower and it is realistic to talk of prolonged stagnation. When we look at emerging market economies, then three of the four "BRICs" – Brazil, China and South Africa all face very substantial problems including growth today. India, with growth likely to be around 7.5%, is the one bright economy in this context.

My expectation is that the U.S. economy, which remains a significant source of global growth, may itself advance by little more than 2% this year. The weakness in part reflects the inability of our government to put in place policies likely to boost investment. The Administration and the Congress are gridlocked, especially in this election year. The Fed is running out of options in terms of growth, having massively expanded its balance sheet to around $4.5 trillion in recent years. It needs to focus on retrenching somewhat and to finding ways to guard against deflationary risks. It is noteworthy that the Fed has increased its concerns about the international economy as it determines its policies. It is likely to be cautious, possibly making no more than one or two small interest rate increases this year, starting in June at the earliest.

Further in this general introduction, please note that for the third year in a row we are likely to see world trade growth at less than 3%. I shall comment further on this issue at the end of my remarks.

Against this general backcloth of global economic trends, let me now focus in particular on China, on the European Union, including the eurozone, and on the volumes of US dollar-denominated debt held by investors in emerging markets.

My involvement in financial crises over several decades has taught me that the longer governments wait to take tough decisions the more difficult it is to stem the tide and curb the ensuing increase in losses.

China

The leaders of China – the world's second largest economy - now need to recognize this reality as they confront escalating risks across the financial landscape. Further delay in acting boldly will undermine domestic and international confidence in their economic management skills: in the short-term it will prompt increasing capital flight, while ensuring lower medium-term GDP growth.

But, the leadership is likely to delay taking the tough measures that are increasing essential. Premier Li Keqiang is leading efforts to ensure that the economy grows in a range of 6.5% to 7% - it rose by a reported 6.7% in the last quarter – and I do not anticipate that the leadership will act forcefully enough in the short-term on the economic and financial front until it is clearer that the growth target is being met consistently and becomes China's new normal.

As you will note from an article by me in *The Financial Times* today, China's leadership might learn from recent history and the effectiveness of the reforms promoted by former Premier Zhu Rongji in the 1990s. He not only paved the way for China's entry into the World Trade Organization, but he cleaned up the state banking system by forcing them to write off bad loans and raise new capital. He established asset management companies to acquire some of their distressed debts. At the same time, he promoted substantial reforms to strengthen the balance sheets of SOEs, while also closing a number of inefficient ones. His actions played a major role in securing extraordinary economic growth for many years.

Markets may not respond kindly to the lack of tough action by China's leaders in the face today of mounting financial challenges. Consider that the publicly held debt of municipalities, provincial governments and state owned enterprises (SOEs) has been estimated at around 230% of GDP. Official figures may be conservative in estimating distressed bank assets at Rmb1.27tn ($194bn). In addition, the country has a bloated real estate and "shadow" banking sectors that are swimming in debt. I believe it is unsustainable for the Peoples Bank of China to keep on pumping cash into the system to keep all boats afloat.

There is a lot of talk of reducing significant amounts of the distressed assets through debt-for-equity swaps. This kind of approach was popularized in the Latin debt crisis in the 1980s and early 1990s. It may buy some time, but it is not a solution.

Securitization schemes, which are widely under discussion, may also offer some respite, but the authorities have to recognize how large the problem is and confront it head-on. They must strive to write-off as much of the distressed debt as possible. Major institutions must take the losses and some SOEs and 'zombie' companies will need to be closed down. The longer the delay, the greater will be the drag on the economy going forward.

China's authorities have long understood that financial reform is necessary. For example, my conversations with former leaders prompted me to write a column for *The Financial Times* in

2005 that included suggestions for the deepening and broadening of domestic bond and equity markets. Meaningful measures are needed - resort to official injections of funds to prop-up the stock markets are not the way to go.

Not only are risks to the financial system at issue now, but also indeed the consensus over far-reaching economic reform is being questioned increasingly. In 2013, it agreed on a reform course at the Third Plenum of the 18th Communist Party Congress, but it has been only partially implemented. Interest rates have been freed up and the inclusion of the RMB in the IMF's basket of Special Drawing Rights is a move towards currency convertibility. But far more needs to be done to modernize and liberalize financial markets, to boost domestic consumption and make the economy less dependent on exports.

The development of these reforms will be eased by debt write-offs and balance sheet cleanups in the financial sector and in major SOEs, including the heavily indebted ones involved in coal and steel whose problems are compounded by overcapacity and slowing economic growth.

China's authorities should not delay in moving to secure confidence at home and internationally. Decisive action is essential.

EU and the Eurozone

But, decisive action is also essential across the world in the European Union and, when it comes to finances, especially in the 19 eurozone member countries.

In broad terms, efforts to secure sustained, meaningful economic growth and avoid deflation, are all the more difficult right now because of a range of crucial political challenges. First, German Chancellor Angela Merkel opened a 'Pandora's box' when she embraced the notion of limitless immigration. The refugee crisis in Europe has grave humanitarian aspects, but it is also tearing at the fabric of politics in one country after another, while creating tense relations especially right now between the EU and Turkey.

Britain's "Brexit" debate appears to be far more difficult to predict than had been widely expected. The anti-EU forces in the UK reflect in part a broad disenchantment with the leadership and the effectiveness of the European Union and the EU Commission, which was a key factor in the recent referendum in Holland where Dutch voters opposed an EU trade pact with Ukraine.

But, more deeply, the populist and nationalist sentiment voiced by the UK Independence Party finds strong echoes in the nationalist parties on the right, notably France's National Front, just as we are seeing radical parties on the left, notably in Greece (Syriza) and Spain (Podemos). The inability of the eurozone's leaders to secure and sustain meaningful growth has influenced these concerning political trends.

The fact is that today, six years after the Great recession, more than 16 million people, including 3.1 million under the age of 25, are unemployed in the eurozone – the jobless rate stands at 10.4%.

The tepid growth in the eurozone – which the IMF predicts will be no more than 1.5% and could be less – partly reflects the weakness of banks and their inability to be robust engines of finance for productive investment in the eurozone. This in turn reflects the failure of the eurozone's leaders to put in place a fully comprehensive and effective banking union, despite the valiant efforts by European Central Bank President Mario Draghi. A viable common currency demands a workable common banking system.

In an open-question period at a conference in London in July 2012 – the one where Draghi pledged to do "whatever it takes" to preserve the euro – I asked the ECB president about his expectations for a banking union. Draghi underscored it was vital for securing the euro and for the region's growth. He said he expected a blueprint from the European Commission to be ready within a few months and final decisions to establish the banking union to be taken in 2013.

We are now in 2016 and the banking union remains very much a work in progress. Supervisory authority has been consolidated to a degree in ECB hands so that finally there are meaningful bank stress tests, like the one in October 2014. Progress has been made on resolution, although recent problems with small banks in Italy have highlighted deep structural problems there. A bail-out fund is being established, but it may not prove to be sufficient.

Moreover, the confidence of bondholders in banks has been badly shaken by the inept actions of the Portuguese authorities. They created Novo Banco after the collapse of one of the country's largest bank in 2014, Banco Espírito Santo, and then they forced some of the bondholders to take substantial losses. The authorities are still seeking a buyer for Novo Banco.

Importantly, there has been no progress on a key pillar of eurozone banking union: deposit insurance. For some months now, the German finance ministry has circulated a paper among European Union officials that details objections to eurozone-wide bank deposit protection. Berlin appears adamant that its citizens should not contribute to a central fund that might have to be used to support depositors in banks outside Germany. Firm language is being used to suggest that the ECB needs to confine itself to monetary policy and not further extend its mandate in the banking sector.

One is bound to conclude that the ECB's mandate remains too narrow. Greater ECB authority could address some of the profound weaknesses in many parts of the euro zone's banking sector. Structural issues need to be noted in this context: in the United States we have larger, more robust and deeper capital markets so that banks account for no more than 30% of total credit generation – by contrast, the banks account for 75% of credit generation in the eurozone. The health of the banking system is crucial for economic growth, but many banks in the region are in the midst of curbing investment-banking activities, shedding staff, restructuring and raising capital.

Greece

Further, as the eurozone grapples with its multiple problems, let us not forget Greece, where at the end of 2009 a crisis erupted which continues to this day. As I have often said, the greater forceful action is postponed, the greater the crisis becomes. Greece is indeed an example of this. So here we, moving towards the 7^{th} year of crisis and what amounts to a prolonged economic depression. Adding to its troubles, Greece is now also in the midst of the refugee crisis, which makes grappling with its economic problems still harder. And now with regard to external financial support for this country, yet another difficult chapter is about to begin.

The German government has made it clear, so far, that it will not consider debt relief, yet the Greeks entered into a deal last year that everyone knew contained impossible demands.

Greece cannot reach a substantial 3.5% primary budget surplus, even with exceptional German pressure. The IMF came far too late to the conclusion that Greece needs debt relief – but now at last it is pressing for this vital step. It has suggested that it will not participate in an extension of the Greek financing arrangements unless there is debt relief. Currently, Greece faces a primary budget deficit this year of around 1.5% and a debt burden of close to 180% of GDP.

Volatile Financial Flows

Permit me now to turn to the no less critical issue of vast and volatile financial flows. We need to also consider that in a world of abundant liquidity and low, even negative interest rates, the dangers of the short-term search for yield are ever present. I believe we shall see unpredictable and disorderly flows of capital across national borders and in and out of currencies, equities, bonds and other financial assets, are proving to be highly disruptive.

The costs and consequences of years of imprudent investing driven by the reach for yield will increasingly be counted, especially as holders of vast amounts of mostly US$-denominated assets face repayments and start to unwind their positions.

With GDP rates having fallen significantly in quite a number of emerging market economies, we will see the pace of asset liquidations increase, especially by investors and corporations, including state-owned enterprises.

Three fundamental factors are combining to trigger the disruptive surge in international capital flows: first, the slow-down in China's growth which has damaged all countries heavily reliant on commodity exports; second, the collapse of oil prices due partly to China's slow-down, the determination of Saudi Arabia and Russia to keep pumping high volumes of oil, and the increase in U.S. domestic oil and gas output; and third, U.S. interest rates which, I have noted earlier, are likely to move upwards at a most modest pace, in sharp contrast to the trends in Europe, Japan and China.

Since 2008, the holdings of US$-denominated debt by non-financial institutions across the world is close to $10 trillion – most significantly, such holdings in emerging markets have almost doubled to around $3.3 trillion. Possibly one-third of this total volume has been borrowed to finance international trade transactions in U.S. dollars, no doubt a further portion has been used for long-term productive investment, but the majority has almost certainly been held in relatively short-term debt instruments.

Since the dollar has gained in strength, and US$-denominated assets have moved towards maturity, so foreign holders have felt increasingly squeezed. The need to liquidate positions has been increased by many highly-indebted non-financial corporations in emerging markets whose profitability has been declining.

These factors have influenced an unprecedented reversal in net capital outflows to emerging markets in 2015 amounting to an estimated $735 billion, according to the Institute of International Finance. Further, the BIS reported a decline of $300 billion to a total of $3.3 trillion for the first time since 2009 in the total stock of US$-denominated credit in bonds and bank loans to emerging markets (excluding banks) – the first decline since 2009. I believe these trends will accelerate.

Moreover, over the last year, China's foreign exchange reserves have declined by close to $700 billion. I believe the amount might have been greater had it not been for the imposition of informal capital controls by the authorities. Nevertheless, further large capital outflows from China are likely.

The unwinding of internationally owned US$-denominated assets now and in coming months will add to volatility in almost all financial markets. Currencies perceived as weak will face further downward pressures, especially against the U.S. dollar. Then, the financial squeezes within publicly and privately owned companies in emerging markets – from China and Brazil, to Russia, Turkey and South Africa - will soften investment activity, slow world trade yet again, and raise further fears of a global recession.

Trade

In conclusion, let me emphasize my concerns about global trade. I believe that globalization despite faults that have been highlighted at times has been an enormous engine of global economic growth, job creation and corporate investment. We need to be concerned about the degree of political support for the Trans-Pacific Partnership -TPP - now in Congress. At the same time, we need to be sensitive to efforts by our foreign trade partners to pursue policies that weaken their currencies relative to the US dollar and yield trade advantages.

Protectionist policies always contain grave geo-political dangers as history has taught us. We should not forget those lessons, nor cast aside the gains that freer trade has secured.

Ladies and gentlemen, world trade is stalled today at a sluggish level. Right now we are seeing in our own election campaigns a lot of rhetoric by some of the candidates in favor of protectionism. Indeed, we are hearing views expressed by the candidates in support of the kinds of mercantile policies likely to exacerbate the negative impacts of the multiple financial and economic concerns that I have raised with you today.

Thank you.