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American and Global Economic and Financial Challenges

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It is pleasure being with you this afternoon. This is the time for summit meetings – the Asian-Pacific Summit took place this week in Beijing, China, and now, this weekend, the Group of 20 Summit convenes in Brisbane, Australia. So, this is an especially good time to consider the realities of the world economy, the financial challenges and the policy actions that world leaders need to take.

No macro-economic issue is more important today than that of reviving economic growth in most parts of the world.

A key to growth is trade and here two sets of negotiations are vital, TPP, which is the Trans-Pacific Partnership, and T-TIP, which is the proposed Transatlantic Trade and Investment Partnership. It was good to see that the APEC Summit encouraged negotiations to promote major regional trade liberalization, while we need to see major efforts to overcome current obstacles in talks to develop a new Atlantic trade pact. It is very important that the Congress authorizes fast-track negotiating authority to pave the way for TPP and T-TIP and in this regard most observers believe that prospects have improved now that the Republican Party has won control of both houses of Congress.

The importance of such agreements and the linkages between trade and growth are underscored by the dismal performance of world trade, which reflects multiple difficulties in the global economy, including the economic stagnation in the eurozone, the minimal real growth in Japan, as well as slowing of China's economy. World trade has failed to recover to sustainable and significant growth levels since the Great recession. In 2006, before the onset of the Great Recession, it grew by 8.5%, but last year it rose by only 2.2%. The World Trade Organization has noted that world trade growth was at an annual rate of 1.8% in the first half of this year, but it expects the rate for all of 2014 to be 3.1% - which could well be on the optimistic side.

The Search for Yield

I will focus today on the major economies and on the crucial need for political leadership to secure growth – a major theme of my book, *Banker to the World*. But, before discussing these topics, I would like to draw your attention to an issue of rising concern: the issue of actual and potential financial asset bubbles.

Real GDP growth in the mature industrial economies in 2014 may be just 1.7%, following an advance of just 1.3% in 2013 (according to forecasts from the Institute of International Finance) and yet we see stock market indexes at record highs, while we see art auctions this week that are beating all previous records.

As you are all well aware, world property markets are mixed. There is sluggishness in the eurozone and a property bubble in China, which I shall discuss shortly. At the same time, the London market is roaring ahead, while the U.S. housing recovery is gathering momentum. The Chinese, meanwhile, concerned about their domestic real estate situation are increasingly visible in our market – for example, Fosun International recently purchased 1 Chase Manhattan Plaza for $725 million, which is right next door to where we are meeting here today.

In March 2007, and again in March 2008, I wrote articles in the *Financial Times* drawing attention to the rising risks in our financial system. These warnings were largely ignored, even by my own colleagues, as investors were overly interested in the search for yield, and the authorities, for the most part, underestimated the gravity of the rapidly evolving crisis.

In August of this year, another comment article of mine was published in *The Financial Times*, because once more I believe we need to be concerned about financial developments. As I wrote in my article: Financial firms are dialling up risk in their search for yield due to the extraordinary amounts of liquidity created by central banks, and the prolonged low-rate environment. This is often not being done prudently.

A risk culture that encourages imprudent lending and investing has resurfaced in financial markets to a degree not seen since before the 2007/08 financial crisis. The prevailing risk behavior that is now widespread in some banks and non-bank financial institutions alike should be a major concern for the managers and directors of financial institutions and for the regulatory authorities.

The risks in many financial markets are rising and there is too little public attention today on the sustainability of current asset valuations: ones that are unhinged from the fundamental realities of global politics and the world's economy.

After all, once again our forces are flying missions in the Middle East and we are increasing our force deployment in Iraq; and our troops are still in combat in Afghanistan; tensions with Russia over Ukraine are most serious; and, we should not underestimate tensions between China and Japan, which I don't believe have been mitigated by a 25 minute meeting between Prime Minister Abe and President Xi-Jingping on Monday of this week in Beijing.

Now, against this background, permit me to discuss briefly some of the major issues in the leading economies.

The United States

The United States remains the most powerful economy in the world. The good news is that our banking system has recovered well from the financial crisis; our unemployment rate has fallen to 5.8%; and, our real growth, while still below our potential, is heading towards an annual rate of around 3% from the 2% level of recent years.

Moreover, we are becoming the world's largest producer of oil and natural gas, which is placing downward pressure on energy prices and which will reduce our import bills and our dependence on foreign sources of supply. The decline in recent months of nearly $30 per barrel of oil will provide significant stimulus to domestic U.S. consumer spending and support growth. The oil price decline, as I shall note shortly, will have negative consequences for a range of oil exporting emerging market countries and Middle Eastern producers.

Despite our economic recovery, real incomes for most Americans have barely increased and the perception that the recovery has not embraced most Americans was undoubtedly a major factor in determining our recent mid-term election results. We are seeing persistent worries about the outlook and the legacy of the Great Recession on the part of middle-income Americans.

The worries of many Americans relate to the fact that our government has not addressed fundamental issues that are key to the sustained future health of our economy. Congressional actions are needed to contain the medium- to long-term financing of the combination of major entitlement programs – Social Security, Medicare, Medicaid and the consequences of the Affordable Care Act (Obamacare).

Without changes in these programs and without meaningful tax reform, young Americans face the rising prospect of seeing their nation live increasingly beyond its means. This danger already dampens long-term investment prospects and it will increasingly do so. Let me underscore the need for tax reform, where efforts should be made urgently to create incentives for U.S. corporations to repatriate cash from overseas and invest these funds here at home.

The revival of the U.S. economy in recent years has been due to heavy reliance on monetary policy – a fact that is evident today in most economies. Fiscal policy and structural reform and deregulation policies have not played their full part in securing greater investment and growth.

So now, today, all eyes remain fixed on the Federal Reserve Board. The markets have digested the ending of quantitative easing, which was essential given the enormous growth from $800 million to over $4.5 trillion in the Fed's balance sheet. While uncertainties remain as to when the Fed will permit increases in interest rates, it is increasingly likely that this will be in the first half of 2015.

In early February, in an article published by the *Financial Times* under the heading, "Central banks must coordinate policy," I stressed that we are entering a period of increasing divergence in monetary policies. The Fed and the Bank of England are moving away from their easy money policies, while the central banks of the eurozone, Japan and China are further easing monetary policies. I have long argued that the leading central banks need to improve coordination, consultation and communication. I want to underline this point again today - the failure to coordinate does risk a period of exceptionally volatile and disruptive cross-border financial flows that could create financial market turmoil and undermine efforts to revive economic growth. Traders may win, while everyone else may lose.

China's Important Changes

Developments in China are having an increasingly important global impact. China is the world's second largest economy. It is in a period of fundamental political and economic change. We are in the Xi Jinping era. He is already emerging as the most powerful leader of China since Deng Xiaoping. And he is being tested on many fronts, from curbing corruption and pollution, to steering the economy in difficult times.

The Chinese leadership is committed to reducing the export-orientation of their growth model, while encouraging consumer spending. This involves convincing the Chinese people to spend more and save less. It demands liberalizing the financial sector, including the freeing up of interest rates, the introduction of deposit insurance and, eventually, full convertibility of the currency. A significant step in the right direction was the decision this week by the Chinese authorities to approve the so-called "Shanghai-Hong Kong Stock Connect" that links the two stock exchanges and allows international investors to buy shares in Shanghai, while Chinese investors can purchase shares in Hong Kong.

These major changes need to take place in an environment where China can no longer expect double-digit annual economic growth. It will be a struggle this year for the government to secure more than 7% growth and part of the cost of reaching this goal will be delays in financial liberalization and in addressing profound problems in some parts of the financial sector.

As the Governor of the Peoples' Bank of China, its central bank, recently noted, there is a debate taking place now in the leadership in China about the timing of measures to liberalize interest rates and introduce deposit insurance. The former maybe be delayed, which I think would be an error. There are indications that plans for FDIC-type deposit insurance may start to be unrolled in coming months.

Meanwhile, the government needs to ensure greater discipline and effective regulation of shadow banking, of non-performing loans in the mainstream banking sector, and the high propensity of state owned enterprises and municipalities to borrow. Concerns about the investment environment, including in real estate, are an important factor in decisions by major Chinese firms to boost their foreign investments significantly.

I mentioned China's property bubble earlier and this is important given that by some estimates the property market accounts for between 20 and 25% of GDP. Some real estate prices have declined modestly in recent months, but the excesses in this sector are concerning. For example, a recent report by the World Bank noted that in some of China's biggest cities, such as, Beijing, Shanghai, Guangzhou and Shenzhen - home inventory levels have more than doubled since the start of 2013. For every square meter of homes sold in those cities, there are 13 square meters of unsold property.

The slowing of China's economy and its domestic financial challenges have a major global economic impact. For example, China's imports of many commodities will continue to be moderate, which will dampen prospects for commodity-exporting emerging and developing countries, from Africa to Latin America.

Japan's "Abenomics"

Now, turning to Japan, the world's third largest economy, which is in the midst of implementing major economic reforms that are named after Prime Minister Abe. Abenomics consists of three arrows: monetary stimulus, fiscal stimulus, and structural reform. We have recently seen a major additional easing of monetary policy, which is weakening the yen relative to the dollar and may boost Japanese exports. We have also seen the government increase the consumption tax in order to reduce over time the exceptionally high current level of debt to GDP of 249%. The tax increase has created a drag on economic growth.

New data shows Japan in recession – GDP growth was negative 1.6% in the third quarter of this year following a 7.3% second quarter decline. I believe this will lead Prime Minister Abe to call an election in coming weeks and postpone the planned next consumption tax increase that is scheduled for next April.

Crucial, however, to Japan's prospects is success with the third arrow – structural reform – that, so far has not been promoted meaningfully. The government needs, for example, to assist Japanese business to become more competitive and this calls for long overdue deregulation. Then, a national energy strategy is required, especially given the public concerns about nuclear power. Importantly, fundamental structural and social policies need to be addressed – sooner rather than later – as the budget consequences of an aging Japanese population are considered.

Eurozone Challenges

The challenges before the 18-member country eurozone are at least as daunting as those of Japan, if not more so. The eurozone's growth rate was minus 0.4% in 2013 and it is unlikely to be above plus 0.7% this year. (In the third quarter growth was just 0.2%, following a gain of 0.1% in the second quarter). Finally, after a period of denial and excessive optimism, the eurozone's political leaders are being more candid about the seriousness of the situation.

It is very clear that the three biggest economies in the eurozone, which have a major impact on the zone's overall growth are in difficulty. This is a picture of stagnation.

Eurozone's 3 Largest Economies - seasonally adjusted quarterly GDP 2014 Growth rates Compared to the Previous Quarter (*Eurostat*)			
	1st Quarter	2nd Quarter	3rd Quarter
Germany	0.8	-0.1	0.1
France	0.0	-0.1	0.3
Italy	0.0	-0.2	-0.1

The eurozone has been in recession, or stagnation, for a long time and the outlook is not encouraging. Over the last five years I have repeatedly warned that the eurozone faces a lost decade and others have finally started to accept this view. Just last Wednesday in a speech in Seattle, Treasury Secretary Jack Lew remarked, "The world cannot afford a European lost decade."

Pro-growth fiscal and monetary policies are essential. The European Central Bank is now doing all it can, but its approaches have too often been too little, too late.

The ECB has completed very important bank stress tests. The banking system in the eurozone is far more important in providing finance than it is the U.S. – fully 75% to 80% of the eurozone's financing is accounted for by bank lending, compared to around 25% here in this country, where non-bank financial institutions and capital markets play major roles. The stress tests have shown that most of the banks are healthy, although there are still concerns about non-performing loans at some institutions. It is also important to note that the ECB is gradually taking supervisory charge of the banks as efforts are pursued to create an effective banking union.

But it will be some time before the banks are positioned to strengthen lending significantly for investment and consumption. Moreover, demand is very weak in many countries. This is a major reason why the inflation rate, at around 0.4% is so low and why we need to be concerned about deflation in the eurozone.

The seriousness of the stagnation in the eurozone is illustrated by the scale and the depth of unemployment. The eurozone rate is 11.5% and more than 19 million people are officially out of work. In Greece and Spain unemployment is respectively 26.4% and 24%.

The rate of youth eurozone unemployment, meanwhile, is at 23.3%. The highest rates are evident in Spain at 53.7%), Greece at 50.7%, and in Italy at 42.9%. For many young people a decade, perhaps even a generation, of lost opportunity is unfolding in Europe.

The serious economic situation is having political consequences: populist parties, on the right and on the left, are gaining ground as we saw in the European Parliament elections earlier this year.

The eurozone today needs pro-growth fiscal policies to stimulate investment and jobs, it needs consistent ECB policies to strengthen bank lending, and it needs a host of structural reform and deregulation actions in many countries to create jobs and secure a return to sustainable growth.

<u>Emerging Markets</u>

Alongside the multiple economic challenges confronting each of the world's largest economies, including China, we are seeing difficulties in many emerging market economies. They were largely spared the problems of the financial crisis and in the years directly thereafter many of them secured substantial growth, indeed they were the engines of global growth. In 2012 and 2013 they slowed somewhat to an overall average annual growth rate of about 4.6%. This year they may slip below 4%.

They should have taken full advantage of the global excesses of liquidity and low interest rates to push ahead with public investments, with structural reforms and measures to make their economies more modern, competitive and robust. Mexico did this and we are now seeing important reforms there, notably with its energy, fiscal, and education reforms. However, there are still very serious security issues in the country.

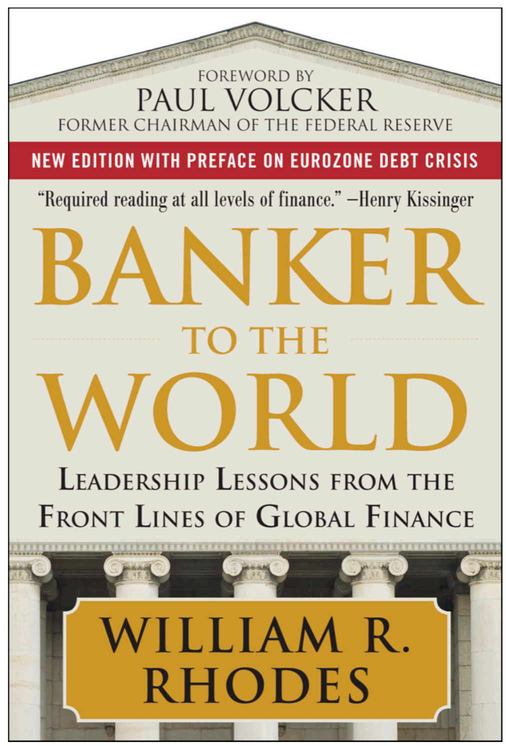
Recent data suggests the Brazilian economy has fallen into recession. We have seen economic policies in Brazil that have risked rising inflation, depressed growth rates and undermined investment. The economic difficulties have recently been exacerbated by the decline in oil prices. Dealing with the economy is clearly the top priority now for President Dilma Roussef who won the recent election by the narrowest of margins.

One bright spot, I believe, is India, where the election of Prime Minister Modi is boosting confidence and offering hope of a significant revival of an economy with enormous productive potential. South Korea too will continue, I believe, to be one of the world's most dynamic economies.

Meanwhile, the emerging market economies of Central and Eastern Europe are being impacted by both the very slow growth in Germany and across the eurozone, as well as the mounting problems in the Russian economy: problems that range from falling oil prices to the economic impact of Western sanctions as a result of the conflict in Ukraine. We have seen a significant decline in the value of ruble. These developments, together with the unstable situations on its borders, are also impacting the Turkish economy.

Leadership

Finally, let me focus on leadership – especially with regard to the Western democracies. I am concerned that today's leaders are not learning from the lessons from past crises, and so they are failing to promote pro-growth policies that build public support and revive the engines of investment and growth. I highlighted the key issues in my book, *"Banker to the World: Leadership Lessons from the Front Lines of Global Finance."*



Leadership in times of political or economic crisis demands understanding the need for a strong reform process and having the patience to see the process through, as well as the ability to successfully sell such programs at home.

Thank you.