**Address to the Center for Financial Stability**
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# Today's Central Economic Challenges

**By**
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Thank you Larry and David for inviting me. We are meeting at a time when the world economy confronts many challenges. Today, I want to both highlight some of the lessons of experience, drawn from past sovereign economic crises, which I discuss in my book, ***Banker to the World***, and focus on recent developments, notably in the United States, China, Japan and in the euro-zone.

The world economy is in a period of slow growth. The OECD expects only 1.2% growth in its 34-member countries this year. The World Trade Organization sees 2013 global trade growth at just 2.5%, compared for example to around 13% in 2007. Unemployment levels in most of the major industrial countries remain very high.

In March 2007, I warned in a *Financial Times* article that the global "Goldilocks" economy and markets would face a material correction within the next 12 months and there was a need to exercise greater prudence in lending and investing. This warning was ignored by most people in the private and public sectors. One year later, in March 2008 and six months before Lehman Brothers imploded, I underscored my continuing concerns in another *FT* article. Once again we saw investors overly interested in the search for yield, while authorities for the most part continued to underestimate the gravity of the rapidly evolving crisis.

Now, I want to stress again that I believe the period ahead for the global economy will be one of strains. In the euro-zone, for example, the immediate outlook is for stagnation with very high unemployment levels, especially among young people. Then we see pressures on emerging markets, which could be significant depending to no small degree on how the Federal Reserve manages to "taper" its government bond purchases.

I will discuss these and other key issues today, but I want to underscore before going into detail that this needs to be a time when caution and prudence should be the guiding watchwords for business and for participants in financial markets. It is also a time where bold political leadership is vital.

## Key Lessons from Past Crises

Against this background, permit me to highlight briefly some of the lessons that need to be drawn from the experiences of managing sovereign economic crises, notably the Latin American crisis of the 1980s and the Asian financial crisis of the late 1990s. In the Forward to my book I underscore the importance of these lessons as we look at the persistent difficulties within the euro-zone.

In sum, here are seven important lessons:

1. First, each country is unique. There can be no single formula that applies to all countries at the same time. A cookie-cutter approach does not work – the depth and breadth of today's euro-zone crisis reflects in part the fact that the authorities for too long treated all of the crisis countries in the same way and tried to impose policies of austerity across the board.

2. My second point relates to contagion. We must not lose sight of the risks and speed of contagion – be it economic or political, or both. I was pleased last year, after my warnings on this issue, that German Finance Minister Wolfgang Schäuble finally publicly admitted that he and his euro-zone colleagues had underestimated the dangers of contagion. It was a costly error.

3. Thirdly, Paul Volcker taught me back in 1982 when he was Chairman of the Federal Reserve Board that the longer one waits to take tough decisions in times of crisis, the more difficult it is to stem the tide and curb the ensuing increase in losses. Postponement of the start of the "tapering" by the Fed could, for example, prove to be costly if not handled in a proper manner.

4. Fourth - When in crisis, reforms and measures that a government can present to the population as being home grown in origin rather than imposed by an external source have a greater chance of acceptance by its people. We saw such leadership in times of crisis in Brazil (1994), in South Korea (1998) and in Turkey (2001) – we have not seen it in the euro-zone.

5. Fifth – the focus needs to be on growth: reforms must provide a country and its people with a sense that any austerity or fiscal reform program will provide a road to sustainable growth in the future. An emphasis on restoring and sustaining growth needs to be central to public policy.

6. Sixth, private sector participation must be involved in any country reform program from the beginning. In most cases, it holds the majority of the debt and can ultimately help the country return to the capital markets with access to financing at reasonable rates.

7. Finally – There has to be strong and courageous political leadership to implement unpopular, but necessary reforms. I would suggest, for example, that we have not seen enough of this in the United States in recent times, let alone in Europe.

   The key is to seize the moment, announce measures clearly and firmly, explain why they are essential and detail plans, including timelines, for their implementation.

   Leadership in times of crisis requires the patience to see the reform process through and the ability to successfully sell such programs at home.

## Global Economic Concerns Today

Against this background, permit me now to turn to current global economic and financial issues and offer some perspectives based on the lessons of experience that I have just highlighted. I shall highlight a wide range of issues and then in our discussion I will gladly go deeper on any of the topics that interest you the most.

## The United States

Let me start here at home. The economy is recovering – but painfully slowly and is unlikely to grow by more than 2% this year, while estimates for 2014 are around 2.5% to 3%.

Business confidence to invest is weakened by the politics that dominate Washington. There are some indications that there may be a short-term budget deal, agreement to modify the impact of sequestration and avoid the risk of another government shut-down, while moving forward to raise the debt ceiling. I am hopeful that this will be the case come January.

However, such deals are fundamentally stopgap solutions. There has to be longer-term, fundamental budget reform. The entitlement programs – and now we need to place Obamacare (the Affordable Care Act) in the mix with Social Security and Medicaid and Medicare – must be modified to be sustainable. The bad news is that I do not see the compromises being shaped in the near- or medium-term. Such failure will weigh heavily on confidence and therefore on economic growth.

Meanwhile, Bernanke hands over to Yellen as the start of a course change in monetary policy emerges. “Tapering” could start as soon as next month and if not, then it should certainly start early in 2014. The pace of “tapering” will be crucial – not just for the domestic economy, but also for every economy in the world.

Talk of “tapering” earlier this year impacted emerging markets. Once “tapering” starts in earnest, the impact on investment flows in and out of emerging markets could be most challenging. Managing the “tapering” process will test the Fed and its new Chair. Central bank coordination across the world will be vital to avoid excessive financial market volatility.

Fed communications will be key and here the recent record is not encouraging. I hope lessons have been learned. Perhaps, Janet Yellen and her Fed Board colleagues will accept the view noted on September 26 in a speech in Frankfurt given by Fed Governor Jeremy Stein, who stressed that what is particularly important for the central bank now is – and I quote – "Doing everything we can to ensure that this difficult transition is implemented in as transparent and predictable a manner as possible. On this front, I think it is safe to say that there may be room for improvement."

Postponing policy changes can involve risks. Earlier I stressed the lesson that delay in taking resolute policy actions can add to problems down the road. I think this is now a risk when we look at how the Fed is going to move away from its exceptionally easy monetary policy. The Fed's balance sheet has ballooned from some $800 billion to close to $4 trillion since the beginning of quantitative easing. Over time if this exit is not handled well then it could become a problem for our economy and create future economic bubbles.

## China's Important Changes

Permit me now to turn to China, the world's second largest economy. I have been to China 5 times in the last year, and about 70 times over the last two decades. On each visit I gain deeper insights into many aspects of this fascinating nation.

We are seeing the most far-reaching change in Chinese economic policies since former leader Deng Xiaoping made his famous 1992 Shenzhen speech. Then, he took his "modernization" program further by stressing the urgent need for the economy to strengthen investment and become far more export-oriented. Now, China's leaders are striving to put in place a new economic model that places domestic consumption at center stage and sees a further and most substantial opening up of the economic system.

The years of double-digit economic growth in China are over. The challenge before China's leaders is to move to the new model and attain at least 7% annual growth.

The recently held Third Plenary Session of the 18th Communist Party Central Committee will, probably, go down in history as being as important as similar sessions held in 1978, which was the start of opening the Chinese economy, and in 1993, which set the course toward China joining the World Trade Organization.

You have no doubt read about the decisions to amend the one-child policy, to establish a special council that will provide full power of national security and military matters in the hands of President Xi Jinping, and you may well have also read about the far-reaching plans announced to strengthen migration from rural to urban areas for millions of Chinese and to strengthen the social safety net. These are all important decisions.

Permit me to briefly focus on the economic reforms. The Chinese government has released extensive documentation on the decisions taken in the course of the recent Congress. When you read the 60 paragraph abridged version of the government's "Decision on Major Issues Concerning Comprehensively Deepening Reforms," it is striking how absolutely key are the economic reforms within the total framework of reforms that are embraced – social, cultural, governance and political reforms. The many economic reform proposals are far more detailed than the media has reported.

The plans that have been set may well serve for the next decade. They will see a major strengthening of market forces in China; the gradual transformation of state owned enterprises into far more market-based and better managed institutions; and the encouragement of all manner of programs to see that Chinese save less and spend more so that the consumption becomes a key driver of growth. We will see far more opportunities for foreign investors in China and for the Chinese to invest abroad.

We will likely see far-reaching financial reforms: I would not be surprised if there will be full RMB convertibility in five to 10 years. The government has announced that it plans to establish a free trade zone in Shanghai, which will serve as an important laboratory for testing financial sector reforms.

One of the major economic problems that the government needs to address is that of non-performing loans in the banking sector. The government must act to ensure the banks do not get back into the crisis situation seen a decade ago when a host of costly and complex special measures had to be taken, such as having the Peoples' Bank of China recapitalize the state owned banks and establish asset management companies to take over their problem loans. The government must also be mindful of the risks of excesses that may be rising in shadow banking.

As we look at the very large range of policies that the Chinese government has announced, while also considering the challenges it faces to counter pollution and curb corruption, then the question that arises is – can the government implement these measures in a timely and effective manner. There is a need, for example, in the financial reform area, to move towards publicly stating the timetables for implementation.

## Japan Surges

Now, turning to Japan. After nearly two decades of stagnation, Japan's leaders have set out on a new course. The strategy that Prime Minister Abe is pursuing – Abenomincs - consisting of "three arrows:" aggressive monetary easing, fiscal stimulus, and structural reform. They have moved on the first two, but action on structural reform and deregulation has been slow and it will be absolutely vital to the success of the program as a whole. Prime Minister Abe recognizes that monetary expansion and a weaker currency alone will not turn around the Japanese economy.

There is also concern that the rapid weakening of the Japanese currency will have negative effect on the exports of its neighbors, notably South Korea and China. It could also cause problems with the very important trade agreement, the Trans-Pacific Partnership (TPP), which the United States is promoting.

A sustainable revival of growth will demand far-reaching structural reforms. 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.

A difficult issue at the center of budget management in Japan is debt. The current debt to GDP ratio is the highest of any developed country in the world and it is approaching 240%. Although Japanese institutions and individuals hold an exceptionally high level of government debt, at approximately 90% - the highest among developed industrial economies – the debt overhang needs to be addressed. This is important to place banking and the economy on a sounder long-term footing. In this context I believe the government is right to press ahead with a consumption tax rise from 5% to 8%, which is scheduled to be approved next March.

## Euro-zone Challenges

Now, let me turn to the area of the world economy where the problems are the most complicated, where solutions remain elusive, where the lessons from my book that I mentioned earlier have largely been ignored at great cost – the 17-member country euro-zone.

The European authorities and many economists have been suggesting in recent months – and too much of the media has been echoing their views – that the euro-zone is on an economic recovery path. I have disagreed. I have long suggested that at best the region was moving from recession to stagnation, with Germany being an exception.

But, this underestimates the depths of the difficulties. Let me highlight them for you:

-- on growth - GDP rose by 0.1% in the euro area during the third quarter of 2013, compared with the previous quarter's annual rate of 0.3%. With such minimal growth nobody should be complacent.

The details underscore the malaise: when we look at third quarter numbers, compared to the second quarter of this year we see a GDP gain of just 0.3% for Germany and a gain of 0.2% for Portugal, plus 0.1% for Spain and for the Netherlands, while there was a decline of 0.1% for France; minus 0.1.% for Italy, – and while the European statistical office has not yet obtained the latest preliminary data for Greece it is bound to be significantly in the minus zone once more. Greece is in its sixth year of recession – it is in a depression.

-- on unemployment: according to latest Eurostat report the rate in October was 12.1% - down slightly from 12.2% in September, but up from 11.7% in October 2012. The euro-zone has about 19.3 million people out of work. The youth unemployment rate has now reached 24.4% so that there are about 3.6 million young persons under 25 without jobs. In Spain about 57% of young people are out of work, while in Greece the number is 60% and in Italy it is over 41%. In a number of countries we are looking at a decade of grim prospects for young people.

-- on inflation: the euro-zone's annual inflation rate in October was 0.9%, up slightly from 0.7% in October and down from an annual rate of 2.2% in November of last year. Concerns about deflation are now significant.

-- on banking: despite a great deal of policy discussion, it remains far from clear that all member countries agree to banking union, to providing overall power to the European Central Bank and to accepting a common resolution approach. Agreement by all 17-member countries is very important and urgent as it is a key factor in moving from stagnation to growth. They are already one year behind schedule on launching supervision under the ECB. A common resolution system, if it does get concluded, is not seen as starting before 2018. Let me emphasize that delays on banking union translate into real costs to the health of the financial sector and its ability to lend to business. This is particularly important for small-and –medium sized enterprises, SMEs, who are key job creators.

As you look across the landscape of euro-zone policy discussion you see only one bright light and it is shining from the European Central Bank. Despite opposition, Mario Draghi did force through an interest rate cut recently - I have been saying for more than a year now that the ECB needed to take this action. Further, an additional rate cut will probably be necessary.

Mario Draghi has also announced that the central bank is prepared if needed to undertake a further LTRO program – these Long-Term Refinancing Operations have been encouraged by the IMF. These operations provide banks with more long-term loans to keep money market interest rates low.

ECB efforts to reduce interest rates and to pursue some other policy actions have faced opposition at times from the strongest power in the region, Germany. Constructive leadership by Germany is going to be essential to restore confidence in the prospects for the euro-zone economy.

The euro may indeed be too strong in terms of the dollar to enable European business to boost its competitiveness in world markets. Export growth will be a vital component for reviving growth in the euro-zone beyond Germany.

The euro-zone story brings to the fore all the lessons of the past debt crises that were ignored:

- The risks of contagion from Greece were dismissed by the authorities;
- those same authorities were unwilling to engage private sector creditors early;
- the decision to put off difficult policy actions has been a continuous characteristic of how Brussels has worked;
- the failure to recognize that the objective of securing growth is the key to restoring public confidence and securing support for the necessary tough reforms;
- strong leadership has been absent when it comes to putting in place in a timely fashion the euro-zone-wide policies that are now so essential.

## Banking Issues

Now, as a final comment, let me turn to banking issues in general. Trust in banks here and abroad remains low. The solutions cannot rest alone in more and more regulation. I believe that the U.S. banks are in improved health, while their European counterparts overall have not recapitalized to the same degree. Therefore, the stress tests that will be pursued by the ECB are going to be important.

More generally, permit me to draw your attention to a brand new report from the Group of 30 – "New Paradigm: Financial Institution Boards and Supervisors." In this report my G30 colleagues and I underscore the need for a new paradigm in relationships between supervisors and boards of directors.

We believe that there needs to be a far greater emphasis on dialogue between supervisors and boards, where expert judgment by both sides – rather than mandated compliance checklists – are central. This means upgrading in many cases the quality of both supervisors and boards. It means a far tougher oversight of crucial issues of systemic risk, including reputational risk. It also means heightened attention to bank culture, with an emphasis here too on risk culture, and transparency.

I believe that a deficiency or failure of culture, with its impact on reputation, can be as destabilizing to an institution as problems of capital or liquidity. Considering culture together with governance and business strategy is an essential part of forward-looking supervision.

My hope is that our approach will be widely discussed so that we move away from the preoccupation with more rules and regulations and strengthen attention on actual reform implementation and performance. The global banking system is still vulnerable and no effort should be spared to strengthen its safety and soundness.

Thank you.