THE EXECUTIVE FORUM

New York, 25 January 2017.

A New Era of Economic Uncertainty

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Banker to the World: lessons from the Front Lines of Global Finance

Introduction

It is a great pleasure for me to join you again and to see so many friends.

The world economy faces a wide range of 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 now seeing how the middle-class revolt syndrome is encouraging prominent politicians on the far right and the far left from Spain to Greece, from Hungary and Poland to France and even to Germany.

How profound these trends are will be seen in the elections in coming months, first in the Netherlands where a populist-nationalist party led by Geert Wilders may emerge with the largest number of parliamentary seats; then in France where National Front leader Marie Le Pen may reach the final run-off in the presidential contest; and in Germany where Chancellor Merkel faces her greatest challenge yet, spearheaded by a far-right political movement. In the short-term the populist political movements may even secure encouragement by the performance on the economic front by the Trump Administration, which might well act in ways to boost domestic growth significantly – but more about this in a few minutes.

Two paramount issues have been important in one country after another as nationalism and populism have gained traction: first, anti-immigration sentiment; second, persistent unemployment and economic insecurity, 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.

One of these consequences for the leading industrial countries of Western Europe, as well as for the United States, was the high level of unemployment. Over recent years some economies like the U.S. have done much better than others in new job creation, although there are many millions of Americans that feel insecure in this economy, who faced home foreclosures, whose real incomes have not advanced in recent years and who found in Donald Trump a champion.

Most recent official data shows that unemployment in the Eurozone in November stood at 9.8% - slightly lower than in earlier months, yet still representing 15.8 million people. More than three million are below the age of 25. The Eurozone youth unemployment rate still stands above 20% - a whole generation of young people has faced unemployment because of the Great Recession and the failure of the Eurozone's leaders to forge growth-oriented policies.

The Age of Uncertainty

The political developments and trends in Europe and in the United States have added to overall uncertainty about the course of the world's economy. In addition, compounding the uncertainty is the development of a culture that has encouraged taking ever-larger risks in financial markets. The intense search for yield in a world where inflation is low, and where central banks have created extraordinary amounts of liquidity, are stimulating today's high-risk behavior. Central banking policies 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.

Too much of the burden for achieving growth has fallen on the shoulders of central banks, particularly the Federal Reserve, the European Central Bank, the Bank of Japan and the People's Bank of China, as fiscal policies and structural adjustment reforms have taken a back seat.

The formidable valuation gains seen in the equity markets, the prime real estate markets and at the leading art auctions has 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 Global Economy

The economic and political uncertainties today have understandably produced a wide range of forecasts when it comes to 2017 growth.

There is an old tradition: the International Monetary Fund always publishes global economic forecasts that are too optimistic. And, by the way, the Fed has tended to often be just as over-optimistic. True to form the IMF has done this once again. The IMF's latest estimates suggest that world GDP grew by 3.1% in 2016, after a gain of 3.2% in the previous year. The IMF is forecasting 3.4% GDP global growth for this year. By contrast the World Bank recently estimated 2016 growth at 2.3% and sees it at 2.7% this year. The sharp differences reflect the exceptional uncertainties that prevail right now.

One indicator of current weakness is world trade growth. World trade, so long a major engine of international economic growth has slumped badly. 2016 world trade growth was probably no more than 1.7%: the first time in 15 years that trade would grow more slowly than GDP. 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.

Another illustration of current difficulties rests in the economic conditions of a number of major emerging market economies – and I will be delighted to talk more about them in response to your questions later. But, in sum, such major emerging market economies as Brazil, Russia, South Africa and Turkey, are all in the midst of recessions. India and China, with 2016 growth of around 7.8% and 6.7% respectively are important exceptions. Crucially, the outlook for all emerging and developing economies, indeed for the world economy, will depend on what happens in the world's most important economies.

Permit me to discuss each of them and then conclude with some comments on the challenges now of trade policies and maintaining a globalized trading system.

The U.S. Economy

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.

I expect that the final 2016 GDP data to show growth of less than 2%, which is below the average annual rate seen since we emerged from the Great Recession. Quarterly GDP numbers may fluctuate quite widely, but the trend line on an annual basis is low by historical comparison. If growth is to be significantly greater then this it will be because of new regulatory and fiscal measures, rather than further monetary stimulus. Federal Reserve monetary policies, after years of quantitative easing and very low interest rates, have ballooned the balance sheet from $800 billion to $4.5 trillion, have largely run out of gas. The Fed needs to get its balance sheet back into better shape. It raised interest rates in December and, if it sees an opportunity, then it will probably raise rates a further three or four times this year.

For our economy to move out of its slow-growth path we need to see action by the White House, by Congress, by the private sector, including the financial sector. We need to unlock the large savings that many Americans have felt bound to establish and we need to see solid long-term investment here at home.

While President Trump has promised to address healthcare reform and immigration in his first 100 days, these are exceptionally complicated issues and the path ahead for both is far from clear. I believe his other top priorities on the domestic front will be key to the economy's growth and for his own popularity going forward. He has pledged to take long overdue measures to expand infrastructure investment, reform the tax code and deregulate.

My own sense of Donald Trump is that we should never underestimate his determination. I believe he will push his pro-growth economic policies very hard and that he will convince the Republican-controlled Congress in the immediate weeks and months ahead to support his agenda. If he succeeds in each of these three areas, then 2017 U.S. growth could be 3% or more.

It remains to be seen how the short-term fiscal boost will impact longer-term job creation and productivity. The economic challenges faced by the middle-class are increasingly related to the advances in all forms of technology and this demands major programs to retrain workers and to provide excellent technology education to young people.

China's Economy

China is the world's second largest economy. How the relationship between the U.S. and the Chinese economies evolves in coming months will be the paramount factor in determining global economic growth and prospects.

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 6.7% GDP growth seen in 2016.

Some of you here will remember that in November 2013, one year after he took control of the Communist Party, President Xi Jinping addressed the Party's Central Committee and announced a vision of a "China Dream", or the "great rejuvenation of the Chinese nation." This envisaged substantial economic advances to 2020 – the centennial year of the Communist Party's founding. At its core, the reorientation of the economy aimed to expand consumption, reduce savings and curb high reliance on exports. Much of that "Dream" has been put on temporary hold until this fall's Party Congress.

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. It is probable that given these political developments that the President will be most reluctant to take measures before the Congress that could slow economic growth, even if such actions offer the best longer-term course out of significant pressing economic difficulties.

China today faces mounting financial challenges that may be complicated by the views of some of President Trump's advisors who assert that the Chinese have manipulated their currency and who want to see a stronger reminbi, "the people's currency." Uncertainty surrounding the Chinese currency's exchange rate with the dollar will add to volatility in international financial markets through most of 2017.

The Chinese have been struggling to stabilize the exchange rate and reduced their foreign exchange reserves by over $1 trillion in the last year (down to a current total just above $3 trillion) for this purpose. All the same, the RMB is falling and set to go above 7 to the dollar. The ambitions for greater convertibility of the RMB may have to be curbed until such time as there is greater stability in its exchange rate.

The current approach to supporting the RMB is expensive, while the use of both formal and informal capital controls, which has been intensified in recent days, is unsustainable. These measures will do nothing to arrest the rise in the nation's balance sheet – its debt-to-GDP ratio has soared from around 150 percent of GDP in 2008 to 280% today and it is still increasing.

The high level of debt reflects a financial system that has gone full throttle for economic growth and at the expense of prudent risk management aside. The mounting financial problems are due to out-of-control borrowing by state-owned enterprises in steel, coal, shipbuilding and other sectors, by municipal authorities, by real estate developers who are adding to an existing housing bubble, and by companies that have secured very large lines of credit from the major banks and from the shadow banking sector.

It was clear to me from my most recent visit to Beijing that the authorities are well aware of the situation, but that they might take only stopgap measures now to secure some temporary relief until after the 19th Party Congress. They are toying with debt-for-securities swaps as part of the solution. They may be allowing some banks to book loans as investments, rather than cleaning up their balance sheets and dealing with problem loans when they see them. Tougher and more comprehensive actions are needed and the more they are postponed, so the greater will be the eventual cost to economic growth.

China's authorities need to take a series of actions as soon as possible that include: writing-off non-performing debts 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; and introducing legislation to regulate the expanding shadow banking sector that stands at an estimated 80 percent of GDP, or around $8.2 trillion.

Japan's Three Arrows

Let me now turn to Japan. Prime Minister Abe and Central Bank Governor Koroda are 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; fiscal policy is also insufficient. The third arrow of structural reform, is more urgent than ever, but politically difficult.

Deep structural changes and deregulation are essential to make Japan more competitive, to strengthen entrepreneurship, to provide meaningful employment opportunities at all levels for women and to make the economy more open for imports. I hope it will happen but I agree with the IMF's forecast for Japan, which estimates 2016 growth at just 0.5% and now predicts a slightly lower rate for this year.

Europe

The economies of Western Europe are exceptionally challenged by political developments. Britain and the European Union tussle with Brexit, and make no mistake this involves a cost to investment levels and to economic growth. There will be a "hard" Brexit. The U.K. has been warned clearly by the EU's leaders that leaving the Union involves paying a significant price in terms of reduce trade and economic access.

Prime Minister May comes to Washington this week to meet with President Trump. There could well be a meeting of minds between these two leaders and no doubt their first meeting will end on a high note and talk, assuredly from the British side, of the importance of the old "special relationship." I believe that for both President Trump and the British Prime Minister there is a strong interest in an eventual bilateral trade deal. Nevertheless, forging such a bilateral US-UK trade deal at a time when Brexit uncertainties prevail, and finding common ground as well on NATO policies, may prove to be more complicated than their meeting might suggest.

The European continent, meanwhile, struggles to find equitable and decent policies to the inflows of people from the Middle East, Afghanistan and Africa. The policy problems on this issue have damaged the cohesion of the European Union to an important degree. And this is especially unfortunate because cohesion is essential to formulate a constructive negotiating strategy for Britain's EU exit.

The of the Eurozone's 19 countries in recent years have been greatly strained by very difficult immigration management problems, by an excessive focus on austerity policies, by the failure to fully implement a planned banking union, and by the ongoing problems of Greece.

Switching from austerity to growth is absolutely urgent. The European Central Bank (ECB), under the able leadership of Mario Draghi, has done the maximum possible to add liquidity and to seek through stress tests to oversee the health of the banking system. But, it has to share authority with the European Commission and politics is playing too large a role for comfort. The vitality of the banks is crucial to European growth prospects: the banks account for over 70% of all the credit generated in the Eurozone, with capital markets picking up the rest. The U.S. is a virtual mirror image, with just around 30% of credit generation attributable to the banks.

The European Banking Authority was too slow, unlike the Fed, to address key issues of capital, bad loans and restructuring in the banks and now the Eurozone is paying a price. Politics has played a role in creating delays in the finalization of a banking union. The goal has been a supervisory system that amounts to a three-legged stool: strengthening bank capital, 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. The delays in forging a comprehensive resolution approach are now being highlighted by a serious crisis in Italy. The tip of the iceberg is Monte dei Paschi di Siena, the world's oldest bank, which urgently needs around $10 billion to shore up its balance sheet. But other Italian banks have large non-performing loans and indeed the combination of the lack of a clear Eurozone resolution system; the defeat recently in a referendum of Prime Minister Renzi; and the rise of the anti-EU Five Star political party; are creating a potentially serious confrontation between Rome and Brussels.

The ECB and the European Council of Finance Ministers also have grounds to fear additional crises. For example, Portugal faces both serious economic and banking difficulties. And then there is Greece once again. Greece is in its seventh year of what now must be called a depression. It is subject to loan conditions from the IMF and its Eurozone partners that it cannot meet. It has a debt to GDP ratio of 175% and it is rising. Without new debt relief Greece will fall back into a serious crisis challenging the Eurozone once more – the crisis could erupt at any time.

World Trade and Protectionist Risks

Finally, permit me to turn to world trade. Donald Trump has used his first days in the White House to make one thing very clear: he wants bilateral trade deals, not multilateral agreements. He has abandoned the Trans-Pacific Partnership; he will seek to renegotiate NAFTA; and he will not proceed with a trans-Atlantic trade pact either.

National leaders in developed industrial countries – especially in the United States - have done a poor job over many years in ensuring that anti-dumping violations of trade agreements have been fully enforced. More generally, they have largely failed to explain publicly the benefits of fair trade and the need to continue to pursue multilateral trade negotiations and achieve new agreements. They have not educated the public to understand the risks involved in the nationalist and protectionist rhetoric of populist political party leaders.

I have always believed that serious trade negotiations between countries are in themselves a vital barrier to protectionist pressures – ones that arise time and again and are driven so often by narrow public perceptions of their real economic interests. Today, the populist idea is widespread that free and fair trade and expanded globalization has enriched major international corporations and banks at the expense of the working people of the leading industrial countries. Effective counter arguments have not been made, as was evident as the British voted to leave the EU.

When President Trump signed an executive order pulling the U.S. out of the 12-nation Trans-Pacific Partnership he offered no specific alternative to our Asian and Latin American partners. Scrapping TPP without a clear plan of constructive action, leaves old trade partners in a position where they may well turn now to China for new and deeper commercial agreements under their own version of a an Asian regional trade pact, which could have negative consequences for the United States. It is far from clear now what this decision will do for our trading prospects across the Asian-Pacific going forward.

Moreover, history tells us that securing bilateral trade deals can be a long process – as was evident in the agreement with KORUS-FTA with South Korea. No doubt, we will learn a great deal from the experiences that the Trump Administration gains in coming months as it seeks to negotiate new trade arrangements, for example, with Canada, Mexico and Japan.

The decision to abandon TPP comes together with the launching of an industrial policy by the White House of a kind that has not been seen in decades – a policy that involves direct Administration intervention in the market system and the decisions of individual companies. Companies considering foreign investments are now under pressure. The Congress will have to decide whether to impose selective tariffs on companies that are seen to be investing abroad and then importing into this country. Congress may go along to some degree, but the longer-term economic impact of such measures is unclear: domestic consumer prices could rise, corporate earnings could be weakened; and other countries may feel bound to take similar protectionist actions.

In my book, *Banker to the World*, I write about many travels, many crises and many episodes where, ultimately, goodwill resulted in positive outcomes to very difficult situations. I spent over 50 years as a commercial banker and led many efforts to build cross-border relationships for the United States, for the banking and financial community, Citigroup, and the business community at large. Those efforts were modest contributions to the forging of a world system of commerce and finance that could, and that did, transform our economy and the economies of most nations.

It was this effort at building an open, fair multilateral commercial architecture that also helped to keep us safe and avoid the mercantile rivalries that so often in history were the causes of wars. I remain hopeful that the benefits will not be forgotten here at home or by our partners abroad.

Thank you

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