FIRST PART

Global economy and various visions of it

John LIPSKY, Senior Fellow, Foreign Policy Institute at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies (SAIS); former First Deputy Managing Director, IMF

Jean Claude already has hit all the high spots, so I do not have to cover them again. I will just add a few comments to your characterisation of the overall outlook. Globally, the most likely outcome is for continued moderate growth, but it is worth noting that if the IMF's base case forecast is correct, global growth will remain slightly below its medium- and long-term average. In this case, the outlook isn't terrible, but it certainly is not great. Moreover, advanced economy growth has not yet compensated fully for the post-2007 drop in output. In other words, the IMF's forecast of 2% advanced economy growth this year and 2.2% next year, brings these countries' growth rate nearly back to their long-term average, but this still leaves output gaps in many cases of a significant magnitude.

The size of the United States' output gap is in dispute, in part because in the past, the decline of the unemployment rate to 5% would have been associated with accelerating wage gains. At present, however, that does not seem to be the case, even with the wage share of US GDP at historic lows. At the same time, the employment rate is low, because labor force participation has fallen. This is true not just for young cohorts – whose lower participation potentially could be explained in a positive way if this reflected extended schooling before entering the labour market. However, the participation rate also has fallen for working-age males, who traditionally form the group that is almost always employed.

That leaves the question of how permanent the decline in the US participation rate is likely to be, or whether it could be reversed. There is quite an active controversy about this issue, as well as about the importance of the US output gap in determining the likelihood of accelerating inflation pressures. The answer will have an impact on the expected trajectory of Federal Reserve policy.

There also is some degree of controversy about the output gap in Japan. There are those who would claim that the reason output growth has failed to rekindle in Japan, as some had hoped, is because they are virtually at full employment. That was the position of former BOJ governor Shirakawa, and in fact, Japanese growth has been disappointing, while at the same time headline inflation has fallen far below the BOJ's target. The place where there is no controversy, in broad terms, is the Eurozone, where the output gap has remained relatively high, although Eurozone growth is improving.

Therefore, the first point is that the advanced economy outlook is somewhat uneven and uncertain with regard to what output gaps remain and how quickly they might be filled, if they remain.

The second point is that the overall growth outlook for emerging and developing economies contains some broad divergences. The near-term outlook for the commodity and energy producers ranges from very negative to moderately disappointing; specifically, the IMF's forecast for the Russian economy is a contraction of nearly 4% this year, and for the Brazilian economy a contraction of 3%, with the risk that both of those measures are understated. Even the projected growth for a country like South Africa is 1.5%, with downward risks. This reflects, of course, a notable drop in commodity and energy prices, but also, given the global growth outlook, there is no compelling reason to expect any quick reversal in the outlook for commodity or energy prices. Therefore, there is no clear argument for a rapid rebound or a restoration of much stronger growth in these economies.

The area where the outlook remains most favourable is India, where the forecast is for growth above 7% and remaining about 7%. Although the recent disappointments with regard to both the ability of the Modi government to attain Parliamentary approval for key reform proposals as well as their recent setback in the state elections in Bihar call into question the outlook for the government's reform programme.

Generally, growth in sub-Saharan Africa remains at about 5%, despite South Africa's disappointing perforemance. One of the great satisfactions of the period before the great financial crisis in 2008 was that the region's expansion represented the first sustained period in modern times of positive per capita output growth. The great worry was that the setback of the global financial crisis would bring about a reversal of those favourable trends, but so far, that has not been the case. While 5% GDP growth is not spectacular, it is at least would imply a continuation of positive per capita growth rates in this area.

Obviously, the biggest source of fascination is the outlook for China and the uncertainty about whether the slowdown in the Chinese economy represents an inevitable – but temporary -- side-effect of a deliberate policy of shifting the basis for sustained growth away from infrastructure spending, the expansion of state enterprises operating in basic industries like mining and steel, and increasing manufactured exports supported by an undervalued exchange rate. The argument in favour of the view that the slowdown is reform-driven is that the IMF now characterises the RMB as fairly valued, as opposed to previously, when it was characterised as substantially undervalued. One result of this shift is that the IMF staff has recommended that the RMB be included in the SDR basket.

However, there is some question as to whether this slowdown represents mainly a "running out of gas" of the previous growth model, as it increasingly involved huge amounts of investment relative to the growth attained. In particular, if an economy is investing nearly 50% of GDP and only getting 7% or 8% growth, there is a clear prima facie case that investment resources are not being used efficiently. Moreover, the previous investment-intensive growth has been accompanied by a very rapid run-up in indebtedness, especially of both private corporations and in state enterprises. These factors suggested that the old model would come to an end one way or another. Thus, a question of consequence is whether the current slowdown reflects more the old model's running out of gas or rather an inevitable part of the process of transition to a different, more market-led – and ultimately more efficient and sustainable Chinese economy.

The implication, of course, of both of these broad developments is that the growth gap between advanced and emerging economies has narrowed, and once again a question worthy of discussion is whether this represents a "new normal" in which the difference between advanced and developing economic performance will remain much narrower than previously.

I have two final points. Probably the biggest surprise, and perhaps the biggest concern from my point of view, is that even though there has been a lot of discussion about weakness in demand growth in advanced economies representing the key reason for relatively moderate GDP growth, what has been most striking has been the relatively sluggish pace of business investment in the advanced economies. This is despite a sense that technological improvements have been accelerating, especially through the increased capabilities of artificial intelligence and the continuation of extremely low interest rates. Both in nominal and real terms, corporate profits in many advanced economies and certainly in the US are at record highs as a percentage of GDP in the context of relatively low corporate leverage, very strong corporate cash positions, and most recently the drop in energy prices that should have been broadly favourable for business investment outside the energy sector. Stock markets which have performed strongly, especially in the US, especially companies that are engaged in stock buybacks or otherwise returning profits to their shareholders, and in M&A activity, which essentially involves shuffling pre-existing assets, rather than companies that have used high profits and strong financial positions to engage in programmes of capital spending.

It is straightforward when you stop and think about it – the business investment shortfall has to be one of the critical factors that have produced disappointing productivity results. You cannot incorporate the benefits of new technology if you do not install it, and if you do not make investments over time, potential growth rates decline, and if potential growth rates decline, then employment and income growth will also slow, and if income growth slows, so will spending.

Therefore, a critical challenge of the current environment is trying to understand why business investment has not reacted more positively to what has to have been seen as a confluence of positive factors. However, among the advanced economies there seems to be some differentiation in performance, not just currently but over the past few years, corresponding, at least in broad terms, to the relative reliance of the corporate sector on securities markets for fundraising as opposed to traditional bank markets. The US and UK, for exanmple, have performed better than the other G7 economies in a context in which nearly 80% of US corporate funding comes through securities markets, and those economies relying on traditional bank finance have suffered much slower growth. It is worth considering whether there is any causation.

Jean-Claude already pointed out the risks to the outlook, and it is now clear that the Fed will begin its tightening cycle in the course of the coming month, and Governor Carney of the Bank of England has suggested that it is not impossible that someday it will also raise rates, although they are probably way out of practice, like most central banks. It is widely expected, at the same time, that there will be additional stimulative or accommodative moves by the ECB and possibly the BOJ. All that has tended to strengthen the US dollar, which already is at 12-year highs. This raises the question whether the combination of, rising rates and rising credit spreads for corporations, combined with the stronger Dollar, could end up being enough to alter the relative outlook for the industrial economies.

Jean-Claude TRICHET, former President, ECB

Thank you, John. You needed no introduction here; everybody knows you were Deputy Manager of the IMF, that you are now in Johns Hopkins, and that you bring a wealth of experience, private, public and academic, which is remarkable. I now intend to give the floor to Korn Chatikavanij, followed by the view from an emerging country. You are currently president of the Democratic Party Policy Unit in Thailand, and you also have experience of both public and private sector. Let me also mention that we have Horii Akinari, the former Vice-Governor of the BOJ, and to the extent that secular stagnation was more or less floating around the remarks made by John, perhaps you could enlighten us on that. Daniel Daianu will then point at what might be behind this disappointing growth in secular stagnation. Then we will have a discussion, as vivid as possible, and the other speakers should not be disappointed, because they will intervene later on.

Korn CHATIKAVANIJ, former Finance Minister of Thailand

I will be a little presumptuous and try to represent the emerging Asian economies as well as I can. We were one of the fastest growing areas in the world for the past three and a half decades, and in Thailand our GDP growth rate for the past 35 years has been about 2% above the world average each year. However, I would like to jump to the conclusion that there has also been much anxiety among emerging Asian economies. Our growth rate, by and large, will fall below the global average this year, something we are as unused to as western central banks are to reducing interest rates, so we are trying to work out what is going on, whether the economic model that propelled our growth over the last several decades is somewhat out of date and in need of revision.

That particular economic model is obviously well known to most of you, but I will just recap very quickly. Growth, for many of us, came on the back of very strong FDI in the early- to mid-1980s, and for Thailand specifically, it was very much driven by post-Plaza Accord decisions, especially on the part of Japan, to relocate manufacturing industries. We, among many other Southeast Asian nations, were beneficiaries of that, and since then we have been growing on the back of an export-driven model. That was made possible by relatively low wages, an abundance of land and other resources, factor inputs, that are required.

That worked well until the 1997 financial crisis, which was a result of excessive private sector, and subsequently public sector, leveraging, and since then we have doubly enjoyed the export model as a result of weak currencies subsequent to the flotation of our previously fixed currencies. That in many ways, on reflection, lulled us into a false sense of security; we kidded ourselves for the last 12 years that we had regained our competitiveness, when in fact it was mostly just price competitiveness. We failed to keep our eye on our competitiveness, and more than anything else, that is proving to be the biggest challenge many of our countries now face.

We are faced with very similar issues to many of the larger economies, and we are now also talking about the new normal, albeit partly because of talk of the new normal amongst our larger trading partners, forcing us as open economies to consider adapting to lower demand for our goods and services. However, it is also a new normal based on our own domestic economies. One of the disappointments we have had is the moribund domestic demand in our economies, especially given that oil prices are very low and interest rates historically low, and we cannot help but feel that if we cannot stimulate domestic demand in this environment, we may not cope if interest rates begin to rise or energy prices were to revert to their old levels in the longer term.

Lack of investment is in many ways a reflection of this lower domestic demand, and I would put it down to three main reasons, expanding on John's observation of low levels of private sector investment. One is the advent of ageing societies. Some of us are suffering from that already, and my own country is already defined as an old society, with 15% of the population in retirement. Worse, the pace of demographic change will be historical; the dependency ratio for us is 4:1, and it will fall to 2:1 in just 25 years; I do not think any economy has suffered that kind of demographic change so quickly, except through war. Corporates are adjusting mentally to this, with low investments perhaps in anticipation of lower demand ageing societies.

Globalisation has also impacted on investment. Naturally, through globalisation, investments have moved through countries with the lowest costs, but that is no longer the case in most of Southeast Asia, although Vietnam and Myanmar will attract FDI. Therefore, growth in emerging Asia will become even more varied as a result of different domestic conditions within the region.

The third reason for lower investments in our region probably has something to do with technological development. A lot of the investments have gone into IT, and of course IT prices have collapsed, so not as much has been required in Dollar terms to make that investment. The challenge, therefore, is how to stimulate investment, hoping at the same time for recovery in larger economies so we get our export demand back, reflecting at the same time on the fact that it may not be possible for us to become rich before we are old in the same way that Japan or many of the Western European nations have managed. This is a problem, because we have had expectations that we would be able to continue to grow so that, on a per capita basis, we can at least be at the same level as the developed world, but that is increasingly becoming too high a mountain for us to climb.

We have to look at a more local model. The reality is that, whereas agriculture makes up less than 10% of GDP now, it still employs almost 50% of the population. We need to revert back to revising our agricultural model, not least because one of the important trends is that 60% more food production will be required in the next 25 years. Rather than focusing on industrialisation as a model, many of us have to look back to see whether there is a different model based on food production and services. However, in the short term, our main concern, more than anything, is when our major markets in Japan, the US and Europe will return to where they were before.

Jean-Claude TRICHET, former President, ECB

Thank you very much. I could see that a lot of us were very shocked when you mentioned the demographic challenge that you have, and which is not very well known.

John LIPSKY, Senior Fellow, Foreign Policy Institute at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies (SAIS); former First Deputy Managing Director, IMF

One thing that we notice is that global trade has grown more slowly than GDP in the last few years, but nowhere has it been more noticeable than in intra-Asian trade. Some say it is just because China's demand has slowed, whereas others say it is a much more structural shift in Chinese demand, in that low-cost manufacturing has been sent out to Vietnam and Myanmar, but the high-value production chain has been brought more vertically into China and is less dependent on industrial inputs from the region. Do you have a view on that?

Korn CHATIKAVANIJ, former Finance Minister of Thailand

You are right that intra-Asian trade has been stuck at just below 30% for quite a few years now, and it illustrates the fact that, frankly speaking, we are more competitors than we are trading partners, in that we are making the same things, and that has been problematic. Looking at each of our important markets, that is obviously true with China. We are part of the global supply chain, and the end product not necessarily being sold here, so when global demand falls we are equally affected.

We are now belatedly beginning to look towards how we can increase the level of intra-regional trade. At the end of this year we will see the advent of something called the ASEAN Economic Community, which basically opens up borders to a greater degree, but again the impacts in the short term will be marginal, because there has already been free trade in terms of zero duty for trade of goods and services across the region for a number of years now. Therefore, the bottom line is that we are not trade partners so much as manufacturing competitors.

Bozidar DJELIC, Managing Director, Head of Central & Eastern Europe, Lazard Sovereign Group; former Deputy Prime Minister of Serbia

Since you are competitors, and we have the pivot of the US to Asia in the signing of the TPP trade agreement, who in your view are the winners and the losers in this accord?

Korn CHATIKAVANIJ, former Finance Minister of Thailand

It is a very topical question being hotly debated and that was mentioned in the very interesting plenary discussion yesterday, that TPP has been somewhat divisive. I can attest to that; it is true. It was also mentioned that TPP should be considered an add-on to the WTO rather than a competitor, but that it is not how it is perceived, because if it were an add-on it should basically have been built into an architecture that involves all WTO members, but that is not the case. However, specifically answering your question, Vietnam is seen to be a potential beneficiary, but frankly, not in the short term, as the number of domestic adjustments they will have to make in order to comply with TPP will take them years to achieve. Most of us in the meantime have bilateral agreements with the main TPP signatories, so there will not be any immediate short-term impact.

Japan has significant investment in Thailand and has suggested to our government that we should seriously consider joining TPP, and we have to listen. Therefore, there is a very good chance that there will be additional members of TPP in the future, not just Thailand but also of course Indonesia and Korea. In the meantime that needs to be balanced with initial concerns over the potential impact on issues such as the price of medicine, which was a major hindrance to our initial participation.

The final conclusion, as we understand it, of the TPP discussion was much less onerous than the initial US position on this issue, so frankly it is more the political and social aspect that we must consider.

Jean-Claude TRICHET, former President, ECB

We have a lot of questions, but I will proceed. We remain in Asia.

Akinari HORII, former Assistant Governor, Bank of Japan, Special Adviser of The Canon Institute for Global Studies

Before making my remarks about slow growth, let me point out the fact that TPP covers a wide area of businesses; it is not just tariffs or simple non-tariff barriers, but also standards of goods and services, foreign direct investments and competitive policies, so it is really big. I hope there will be a big gain out of this mega free trade agreement, but I am afraid outsiders might lose a lot.

Having heard John’s very comprehensive analysis and Korn’s very solid discussion, let me offer you something like my conjectural analysis, or let’s say, bird’s eye view of the world economy. Seven or eight years have passed since the great financial crisis happened, and economic growth is still lacklustre in many parts of the world. I have two very grand hypotheses. My first one is the balance sheet adjustment pressure on financial intermediation, and the other concerns the peace dividend stemming from the end of the Cold War. That is why I said it is grand.

Let me begin with the financial element. We are all familiar with how the banking system has been left with a huge volume of non-performing assets after credit bubbles burst in the US subprime mortgage market in 2007, and also the European sovereign debt market in 2010. We were busy putting Band Aids here and there, but the Japanese are very familiar with their own post-bubble financial as well as economic conditions. Americans, particularly old central bankers, remember the so-called S&L crisis and the post-S&L crisis economy, which Alan Greenspan referred to as a

50-mile-an-hour headwind. Everyone became cautious about risks after bubbles burst, and after the Lehman Brothers failure in 2008 particularly, people became very sensitive about risk taking. There was no confidence in counterparties, no assurance of your own survival, and no trust in the system. That is where we were in 2008.

There still remains a significant degree of uncertainty over bank viability, even after banks have recovered some profitability. As long as a bulk of non-performing assets sits on their balance sheets, quite naturally, banks are busy deleveraging their balance sheets while potential borrowers are reluctant to borrow, since they had a terrible experience at the time of the credit crunch that followed GFC. Therefore, in a nutshell, we are still in the aftermath of the great financial crisis, where both lenders and borrowers are cautious about risk taking.

There is also a political element which is unfavourable to economic growth. During the Great Recession, people got angry, blaming banks, the government and central banks for the loss of jobs and property value. They had good reasons for their anger, of course, and the problem was that bank regulators were under intense pressure to penalise banks. All this was liable to create a political momentum to kill the animal spirits, which in any case are in short supply under a stagnant economy. This is my first hypothesis.

Regarding my second hypothesis concerning slow economic growth, the world economy expanded tremendously, supported by globalisation in the 1990s and 2000s. After the Cold War ended, labour and other resources of the former Eastern Bloc became available for multinational companies to produce goods and services and sell them to the global market. Particularly noticeable, of course, was China's entry to the global market, and as a consequence of globalisation, world trade expanded much faster than GDP.

However, a few years ago the Chinese economy passed the so-called Lewis point, meaning that after a flat supply curve it bends up sharply. That is something the Chinese often refer to as the Lewis point. Wages and other production costs began to move up steeply as demand increased. There are, of course, other places of unexploited resources in the world, but in comparison with China, those places have a limited amount of labour readily available for the global market. Globalisation might have run its course in this regard. This does not mean that all the economic gains of globalisation will disappear, but the excess profits that globalisation has brought with it will diminish over time, and world trade will grow in line with GDP, which is not surprising at all.

There was another peace dividend that the end of the Cold War brought about, that is, civilian use of formally military technology, for example Internet for telecommunications, GPS for automobile navigation and resource exploration, digital graphics for entertainment and new materials for a variety of uses. All of these contributed to gains in total factor productivity in the 1990s and 2000s.

Nowadays some people still speak of a new Industrial Revolution by pointing out drones and artificial intelligence. As I am not a scientist or an engineer, I have no idea whether this is the case, but two and a half decades after the Cold War ended, the productivity gain out of civilian use of military technology may be diminishing, alongside extra gains stemming from globalisation.

These are my two grand conjectural hypotheses albeit with no solid evidence at all.

Jean-Claude TRICHET, former President, ECB

It is fascinating. It is highly philosophical, and you will have a lot of questions, I am sure.

Akinari HORII, former Assistant Governor, Bank of Japan, Special Adviser of The Canon Institute for Global Studies

There is another hypothesis which is often pointed out, demography. I do not agree with that, particularly in the case of Japan. The Japanese population growth rate was 1% in the 1960s, when Japanese GDP was growing 12% or something, and it peaked in the middle of the 1970s at a little over 1% before gradually declining to slightly in minus. Even in the 1980s the economy grew at a rate of 4% or 5%. Before deflation set in in the late 1990s, Japan's economy grew by 2%.

Therefore, the decline in the growth trend is more readily accounted for by declines in productivity gains rather than the decline in population growth. The German population hardly increased in the first ten years of the 2000s, and it actually decreased in the late 2000s, even including immigrants, but the German economy grew without falling into deflation. Let me stop here.

Jean-Claude TRICHET, former President, ECB

It is very stimulating, but I was surprised myself when I recalculated growth per capita over the last 25 or 30 years in the US, Europe and Japan and found that it was more or less the same. Therefore, there are a lot of areas where Japan’s problem seems to be the problem of the advanced economy in some way, and we are the first to show a number of diseases. That being said, I will turn directly to Daniel. Do you have some remarks on what we just heard?

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

John has presented, in my view, a relatively rosy picture of the global economy. One could argue that the numbers fit pretty well in what could be seen as very long-term series, and there is probably nothing wrong with it. I say it because 4% or 5% growth rates in advanced economies currently would be quite unusual given the end of the highly stimulating period of economic reconstruction after the Second World War and economic catching up in emerging economies that is likely to lose steam in the years ahead.

I will try to give some food for thought as to why I am less optimistic than my predecessors. In many regions of the world governments and central banks are resorting to unnconventional policies; some of them seem to, or may work. But there are significant side effects, unintended consequences;policy-makers are groping in the dark to a large extent. People who attended annual IMF meetings in recent years know what I am talking about. Macroeconomics is a subject afflicted by increasing doubts and controversies, and there is no longer a solid conventional wisdom.

Secondly, when I say that policy-makers are groping in the dark, cognitively speaking I am referring both to what we think we know and, also, to models we are using; there is a breakdown of models at both macro and micro levels. Just think about models central banks use; we continue to use the same models, although we discern their big flaws, because others are hardly available. Finance is not captured adequately in central banks’ models, in macroeconomic models in general. Claudio Borio, from the Bank of International Settlements, put it quite nicely when he said that this is like Hamlet without the Prince.

Thirdly, in my view, in spite of what the Fed will do, and I, too, suspect the US central bank will raise its policy rate, interest rates will stay low for a substantial period of time. Having said this, I am not implying that many are making a lot of fuss about nothing. However, I also think that growing amounts of savings in the world in conjunction with ageing, that is happening in both advanced and emerging economies, and a scarcity of safe assets (as Caballero stresses) bring about lower interest rates along the curve. People save more, and there is a dramatic fall in investment. This is why Larry Summers and others are coming up with the thesis that highly negative real interest rates seem to be needed for a proper utilisation of resources. Summers highlights the bads of very low interest rates for resource allocation, so that he would rather see budget policy, public investment, as an optimal tool to bolster demand under the current circumstances.

Jean-Claude TRICHET, former President, ECB

Do you buy that yourself?

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

I am thinking about that, and I will get back to it. BIS experts make a worthy point about the impact of low interest rates, via the search for yield, on resource allocation – and here they meet with Summers. Richard Koo from Nomura Research Institute points out the balance sheet effect, which overlaps with Ken Rogoff’’ emphasis on overdebt, since there is enormous overdebt in Europe, if one puts public and private debt together. All these views can be reduced to a bottom line: there is much overdebt, there is a dramatic fall in investment, there is severe underutilisation of resources and there is a growing sense that we have to do something about the hysteresis phenomenon. Because, if a country has a 20% unemployment rate, one needs to do something about it; a 50% unemployment rate among youth is a recipe for disaster; it can strain societies economically and socially enormously, it can damage democracy itself.

There is a currency war underway too. There is economic slowdown, and it may be true that we are getting back to normalcy judging things from a long term perspective, but economic growth rates, by the way, are fuelled by unconventional policies, QE programmes, very low interest rates, and so on. If there is a big plunge of investment, what underpins economic recovery? Why are economies recovering? This is a type of credit-less, investment-less recovery; whenever there is a very deep economic recession, this is likely to be followed by an economic rebound. However, the big issue is what will happen after a while, if low investment persists, and going back to what John has said, further slowdown will take place. Then the issue is what kind of investment, its structure are needed.

There is fragmentation of markets. Economies are turning more inward-looking, there are different patterns of networking, which is also driven by the fear of conflicts, of tail events, and the preference of relying on suppliers which are closer geographically than suppliers located 2,000 or 3,000 kilometres away. Have we repaired finance? Not much. I am probably overshooting in this respect, but finance is still quite destabilising for the world economy. It is oversized in large chunks of it and banks still rely very much on trading, speculation for making a buck. My personal view is that finance needs to be much simpler, which does not imply getting to narrow banking.

There is an economic growth model crisis. We have mentioned Asian economies and their economic slowdown, but the growth model in European emerging economies relied extensively on borrowing, on debt, whether private or public; the big game in town was just attracting more and more funding, investing and investing, it did not matter where, and much of that investment went into non-tradeables. Finally, I would mention a crisis of globalisation, for there are limits to openness; we are now paying a pretty hefty bill for having gone too far with globalisation. There are limits to openness. Jean-Claude, you have said we should care about a level playing field. What does that mean? We have to define it.

Jean-Claude TRICHET, former President, ECB

Are you pro-segmentation and pro-fragmentation?

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

What I am saying is this. For instance, take the banking crisis in Europe. Some lenders, banks overexposed themselves, went into unknown territory without due diligence, so there are limits to rational expansion. There is now a rational retrenchment, getting back closer to home.

Jean-Claude TRICHET, former President, ECB

Daniel, we all agree.

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

Take the case of the big guys, who were supposed to come up with good practices and to practice what they preach. They rigged markets, they engaged in all kind of controversial transactions, they have a hard time in managing complexity and in forcing their own people to comply with the rules. It is not for nothing that Mark Carney said that the problem is not about a few apples but the very box these are kept in, the culture of banking. Something has to change dramatically, as otherwise we will have people in the streets, and not just a few.

Jean-Claude TRICHET, former President, ECB

Everything you say is true.

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

I know it is true, and this is why things need to change.

Jean-Claude TRICHET, former President, ECB

The G20, for instance, have just published a very important report on changing bank culture. You cannot only be negative, however.

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

I am not negative; I am, I guess, just presenting reality. This is reality. Let me give another example. We have highly strained societies. How are you going to send the message to people that got accustomed to relatively high economic growth rates that they need to forget about it, that they have to adjust to new circumstances, to a new normalcy? This is what our colleague from Asia has alluded to. And, by the way, we have not considered the issue of climate change in this context. There is also growing income inequality, which strains further our societies. You say, Jean-Claude, that this is too dark. No, this is, I would argue, reality.

Jean-Claude TRICHET, former President, ECB

You know the motto of IBM: 'If you are not part of the solution, you are part of the problem.' We have to see what to do. We very much agree, of course.

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

I will finish on this note, because in the European Parliament I was one of those who have pushed for a radical reform of the regulation and supervision of financial markets at a time when top European policymakers were in a reality denial mode; they were saying that the financial crisis is an American affair and had nothing to do with their economies, which were robust, and would not succumb to the follies of American finance. That was nonsense. That happened in the spring of 2008. It was only in November last year that Mark Carney said we have a serious problem with the culture of banking. We have huge ethical problems in this industry. Take the car industry too. I was in the European Parliament when climate change was very high profile in public debate, and enormous lobbying efforts were made by car manufacturers, saying that there was an economic crisis and that if restraints were imposed in order to reduce carbon emissions, the car industry would suffer and, thereby, our economies would slow down, and so on. Look at what we have now with scandals involving major car manufacturers. Thinks of what we have on our plate now.

Jean-Claude TRICHET, former President, ECB

Thank you very much, Daniel. We do not have a more comprehensive list of what is wrong, and we know that we have to change that.

Korn CHATIKAVANIJ, former Finance Minister of Thailand

The bar has been set too high.

Jean-Claude TRICHET, former President, ECB

Jean-Pierre, you have the floor.

Jean-Pierre ROTH, Chairman of the Cantonal Bank of Geneva (BCGE)

Daniel, I am so pleased that I am not the only pessimist in this room, because I totally share your view. I would like to come back to two points, one being that it is important to change the culture of banks, but it is also important to change the culture of government, because governments do not tell the population the truth about the situation. When they claim victory because Europe will have one-point-something-percent growth next year, we know that it is impossible to reduce unemployment at that level. We have an ageing population, but we have so many young people who are unemployed and available to be integrated in the labour market, depending on training and education, which is another issue, but huge human resources are available in Europe, so 1% or 1.5% growth is not enough, and government should be more ambitious. That means they have to set the right objectives for structural reform of the labour market and the education system to make Europe more competitive on a global basis.

The second point is in reaction to you, John. I totally agree about the weakness of investment that we see now, but it is even worse than that, because part of what we investment is productive investment with zero interest rates, but we invest in real estate. There has been a huge increase in mortgage debt among the public in order to finance housing and real estate. Is that productive, growth-producing investment for the future? No, it is not. The worry we have now is that, in a lasting low interest rate situation, we invest more and more in things which are not exactly the right investment for our future, so we start to decrease the quality of the stock of capital, and in the long run we will have less growth because the quality of the stock of capital has decreased. Therefore, we complain about weak investment, but the quality of investment is not what it should be.

Jean-Claude TRICHET, former President, ECB

Thank you very much. I have a question for you and also for John. I am struck by the fact that the motto in the US in particular, but also in a large number of the advanced economies, is that we are desperately looking for strong domestic demand, that weak investment is a catastrophe, and so on, but when I look at the current accounts, what do I see? I see a deficit of minus 2.5% in US current accounts. Is there really a lack of US domestic demand? It is minus 5% in the UK. Is that a lack of domestic demand? It is minus 3% or 3.5% in Australia, minus 3% in Canada, so where is the lack of domestic demand? There is still overconsumption and overinvestment which is absolutely flagrant, but I am hesitating to make a real diagnosis about some of the advanced economies.

I will include my own country in this category, but not all advanced economies. It is true that Europe, or the Euro area, looks strange, because we have a current account surplus of 3%, and other countries look even stranger. John, how would you react to that?

John LIPSKY, Senior Fellow, Foreign Policy Institute at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies (SAIS); former First Deputy Managing Director, IMF

I was sitting here thinking that if I could I would give you all a plane ticket to Silicon Valley, where the weather is better and people are very excited about prospects. It is a completely different mood, and it is quite striking here. Where do I start? Daniel, there is a lot to what you say, for sure. When you talk about currency wars, it is a little like fingernails on the blackboard, as we say in America; it gives me shivers up my spine, because I remember the first time that was uttered by Guido Mantega, the Brazilian Finance Minister, in Seoul. It was very helpful, because you knew he was trying to say he did not want to talk about his fiscal deficit but wanted to blame somebody else, and now the chickens have come home to roost on that one.

I would say that, frankly, given the tremendous uncertainties of the post-2007 period, I have been surprised at the stability of the major trading currencies, not the other way around; I do not think they have been the source of huge problems until recently with the Dollar's recent rise to a 12-year high. As I said in my remarks, you start to wonder if it is possible that it will get to a point where it will inhibit the outlook for the US. However, it is not clear to me that so-called currency wars have been so harmful to the other major economies; to the contrary, so that one does not bother me so much.

Jean-Claude TRICHET, former President, ECB

I have lived with the G7 for 35 years. There has been a period where all major convertible currencies, say the basket of the SDR, were playing a free-floating game. I myself remember having enormous difficulty trying to convince the US, together with my European friends, that at 0.83, perhaps the Euro was too low and the Dollar too high, but we had a lot of difficulty. Today, it seems to me that we are in a totally different world because all the economists in the US would have claimed long ago that such a non competitive dollar would be unacceptable. From the standpoint of the exchange rates there is really a pre-crisis period and mood and a post-crisis period and mood, and I have to say that is was the same when the Euro was skyrocketing at 1.50. I tried to get my US friends on board, to tell them they had to do something, because the dollar was too weak and the Euro too high, and it was very difficult. That was before the crisis, of course.

It seems to me that now we do not have “currency wars”, but the major partners pay very special attention to the level of the core currencies. That is certainly important, as perhaps it gives a window of opportunity to the main currencies together with the IMF to decide that they should not depart too much from “agreed equilibrium rates”. To the extent that we are looking it much more carefully now, perhaps we could embark on a new way of running the floating exchange system? We will see...

John LIPSKY, Senior Fellow, Foreign Policy Institute at Johns Hopkins University’s Paul H. Nitze School of Advanced International Studies (SAIS); former First Deputy Managing Director, IMF

Regarding exchange rates, I must say I was quite surprised at all the excitement about the movement in the Chinese currency in August. The Dollar peg had carried the RMB up by about 12% the previous year in real effective terms, and the August move reversed only a small fraction of these earlier gains, I must say I thought it was a lot of excitement about relatively little.

Similarly, can I be a little sceptical and just slightly cynical about QE? There is a limit to how much you can have expected from QE. While the initial round in the US and elsewhere was productive, in the sense that it eliminated uncertainty about the stance on monetary policy, it not at all clear to what degree the United States’ QE2 and QE3 policies were effective. The initial move (QE1) basically was a signalling that said, ‘Do not worry about us; we will be accommodative in a big way.’ I would have thought if I were a central banker, I would never want to be in a position of being out of ammunition and having nothing to do to be helpful. Therefore, the subsequent rounds of QE were more like, ‘We will try be helpful, but do not expect too much.’

We all remember Mario Draghi’s famous remarks, ‘We will do whatever it takes,’ and the rest of that phrase was, ‘And believe me, it will be enough.’ Then I take you back to what he said, not this year, but a year ago in Jackson Hole. My interpretation of what he said was now changed to, ‘We will do whatever we can, and believe me, it will not be enough (on its own).’

Jean-Claude TRICHET, former President, ECB

Thank you for this remark, because it illustrates something very important and under-assessed by the global observers. The ECB actions have very largely been off-balance sheet commitments. The ‘Whatever it takes’ was a pure off-balance sheet commitment; it did not materialise. The full allotment at fixed rate, which is a general rule in Europe for providing liquidity, is an extraordinary off-balance sheet commitment: if the ECB is asked tomorrow for EUR 2 trillion, it will deliver EUR 2 trillion, because it is the commitment, and that is not really taken into account by the observers, or even by the market participants, because it is not visible, it is not in the balance sheet, and one has difficulty understanding that it is a commitment. Everybody would know if it were a private corporation taking a gigantic off-balance sheet commitment, but for the central banks it is not fully recognised.

We will have two interventions and then continue the transition with monetary policy.

John LIPSKY, Senior Fellow, Foreign Policy Institute at Johns Hopkins University’s Paul H. Nitze School of Advanced International Studies (SAIS); former First Deputy Managing Director, IMF

I will make two final remarks. It is certainly possible that there is a long tail of heightened risk-aversion following a big crisis. It is also possible that the ageing of populations has changed attitudes toward risk, but I would come back to the area that I think is underappreciated, and that has been the difficulties of the financial sector. It is not that there is one way that is good and another that is bad, but one of the advantages of a corporate financing mechanism dominated by the sale of securities is that it produces relatively a quick cleaning of balance sheets and a restoration of more resilient asset values. This process is much harder and slower in a banking-driven system.

Secondly, it is still not widely recognized that about 50% of all “toxic” US mortgage assets ended up on European institutions’ balance sheets. As the Crisis unfolded post-Lehman, it produced localized effects, in which you had some European institutions holding Dollar assets financed through wholesale sources. When the interbank market shut, they would have become insolvent if it had not been for the actions of the monetary authorities. Subsequently, the clean up of European bank balance sheets – and the associated write-downs -- has progressed very slowly, representing an underappreciated headwind to EU growth.

Jean-Claude TRICHET, former President, ECB

John, I partially agree with you. Do not forget, firstly, that before the crisis 80% of the financing of the European economies was made through banks, and only 20% in the US, so it was easier to clean up 20% of the financing of the economy. The size of the problem in the US, if you concentrate on banks, was very modest in comparison with ours, so it was much more complicated for us. What we had to do was to clean up, but not to stop, the financing of our own economies, exactly as the Fed had to do for the US markets, namely to avoid a sudden stop to the financing of the whole US economy through these extraordinary bold purchases of mortgages and treasuries.

However, it is a little too easy to practice “European Bashing” and to explain that the European banks were rotten and that we were laborious in cleaning the situation. One could equally say that the US financial markets were also totally rotten; it was so rotten that it was in a situation of immediate threats of sudden stops, and the Fed on one hand and Freddie Mac and Fannie May on the other had to do whatever they could to rescue the system. This was pure socialism, if I may take the vocabulary of the right wing of the political spectrum in the US. It was really the public authorities rescuing the whole of dysfunctional markets. However, this is never said; what is communicated is that the Europeans were dramatically clumsy in dealing with the crisis. It is a little bit more complex, obviously, but I agree with you, of course, on the fact that it was very lengthy and laborious, and it still is, because part of Europe still has a gigantic lever of non-performing loans, and it is a very complex story to get out of that.

Korn CHATIKAVANIJ, former Finance Minister of Thailand

I would like to come back to Daniel’s second point about the prospects of the Fed raising rates and whether they should be doing that given the high savings rate that we have in the system, partly reflected by the high level of profits in the corporates, and how this might actually incentivise even greater levels of savings.

My observation, which is really a question, is that the US appears to be considering the potentiality of raising interest rates based on domestic conditions, but the reality is that it is a global issue. When QE was introduced and rates were reduced, as we all know, what happened was that a lot of the excess liquidity sought high yields in emerging markets, in a leveraged way too, so it was not 1:1 but 1:5 or 1:7. Therefore, when the US makes a decision to reverse that, there will be a multiplier impact, especially on the emerging economies, and that could be very destabilising. I just wonder how much of that is part of the decision-making equation that the Fed takes, if it is a concern, and in fact what the harm would be if rates were to be kept low given low rates of growth around the world. Why is it necessary for rates to be increased at this stage?

Jean-Claude TRICHET, former President, ECB

Could you accept that when they started QE and the zero rates, the emerging world was protesting vehemently and saying it was totally destabilising, and it was, obviously, a shock?

Korn CHATIKAVANIJ, former Finance Minister of Thailand

The protestation from Asia was part indignation in memory of US policy through the IMF on our interest rate policy in 1997, which was the other way, but I think we all admitted that this was a necessary step, and in fact we should have taken the same step back in 1997 to find resolution. We were indignant.

Jean-Claude TRICHET, former President, ECB

I understand your point. Whatever the major economies, the advanced economies, are doing, it is destabilising for the emerging economies in any case, because it is too influential. The real economy is now very much balanced at the global level, and the financial influence from the advanced economies is still gigantic, but still very modest from the emerging world. Therefore, anything which is being done by the advanced economies on this front is consider arbitrary, because the emerging countries have to cope with a financial shock which is not designed for their needs. It is the asymmetry of the financial and monetary influence that is at stake, it seems to me.

Bozidar DJELIC, Managing Director, Head of Central & Eastern Europe, Lazard Sovereign Group; former Deputy Prime Minister of Serbia

I will not speak about monetary policy, although we actually said a lot about it, nor the bankers, even though I am a banker and no longer in public policy. We will certainly talk about that later. I just have two thoughts, one general; the tone of our discussion reminded me that every so often when things are hard, and it is hard right now, we are doomed. We were doomed in the 1970s, and the Club of Rome published an article and a report that we should all stop making babies, that it was over, and in about 20 years there would be hunger, and so forth. I was a graduate student at Harvard when America was about to be taken over by Japan, and in fact I remember vividly that a patriotic colleague took the names of all the professors who had Japanese cars, and that was published. It was high treason because America was about to be taken over by Japan. We should guard ourselves against this.

Secondly, please do not take what I am about to say as a free advertisement for the shop where I work right now, but we do actually work with many governments around the world, and they pay, quite expensively actually. However, it is a nice proxy for what they want to do, because talk is cheap and reform backed by some resources is harder. I would like to give you a few points from that vantage point, which is not macro- or meso-, to illustrate that not all governments and evil politicians are like sitting ducks waiting for the storm generated by receding QE and commodity prices.

I will just give a few examples. Oil is a curse, but when it is taken away, it forces you to do certain things, so in Gabon right now the people who have been in power felt the heat so they had to cancel 80% of investment projects. How do you react to what and what do you propose? Take Oman, where His Highness Qaboos bin Said al Said is the leader, the prime minister, the minister of foreign affairs, the minister of defence, the minister of finance, and governor of the central bank. He is currently in poor health, but the point is that the very big drop in hydrocarbons leaves no choice but to work on governance. You can imagine the very difficult discussions we might have if Oman, as is the plan, were to tap international capital markets. Who would invest in self-governance?

However, this is being done. It will not be finished in one year, but it is an interesting indication. Regarding Ukraine, the huge Russian subsidies built into the gas price even before the fall of the Berlin Wall were cut by 80%. Does it mean this will never come back if there is a change in the politics there and the pro-Russian side win? I am not saying that, but the current leadership has taken away 80%, and it hurts, of course, but it is done. Therefore, governments are reacting.

The last example I would like to give, there are security concerns in the Arab world, coupled with very significant internal issues, which are not all to do with Islamism. Since we work quite a lot with Egypt, the one thing I heard from President Sisi each time I met him was that every year there were 1.6 to 1.9 million new Egyptians, and he asked what they were going to do. When you work for the Tunisians, every day, because it is a democracy, you see young graduates in front of the parliament showing their diplomas saying that they had been told to study but have no job. The point is that in the Arab world the Arab Spring did not turn into a summer, but there is a lot of effort to make sure it does not become deep winter, taking the rest with them. My only comment is that humans have the uncanny ability to find ways to survive.

Jean-Claude TRICHET, former President, ECB

I could even add to Daniel's drama by saying that my understanding of what happened in 2008 was that we were on the verge of a dramatic depression that could have been worse than 1929, but we got out of it because we reacted very rapidly, as a matter of fact in two and a half days. Jean-Pierre has some memory of that. The governments also reacted, and I did not myself hear them saying at the end of that week that it was not their problem, because it was their problem, and the entire financial world was collapsing in Europe as well as the US.

Daniel DAIANU, member of the Board of the Central Bank of Romania; former Finance Minister of Romania

I just wanted to make some very brief comments. I agree with you, but unfortunately, in the objective function of the Fed there is nothing about externalities around the world. However, there are trade-offs. What should the Fed have done? It was years ago. Should they just have watched the financial sector collapsing, as Jean-Claude has said, along the lines of the Great Depression? Think about the Great Depression in the US and Europe and the impact on the rest of the world. I know it very hard to implement macro-prudential policies, and it is not tested, but there are trade-offs.

Jean-Claude TRICHET, former President, ECB

Let us note to the credit of the Federal Reserve that the minutes we were given from two meetings ago mentioned the impact at a global level of their own decision, and they explicitly mentioned the situation in the rest of the world. I agree, and it is likely to have just made them delay their decision a little, but something is moving there, and in any case the right solution would be when we have a more balanced world, because I understand pretty well that the present asymmetry is difficult for the emerging world to accept.

John LIPSKY, Senior Fellow, Foreign Policy Institute at Johns Hopkins University's Paul H. Nitze School of Advanced International Studies (SAIS); former First Deputy Managing Director, IMF

I have just one remark. I suspect that the sensitivity over potential Fed action is heightened by the experience of the so-called 'taper tantrum', and it was always my belief that the Fed action per se was not the major cause of the markets reaction at that time. Rather, the Fed's announcement of a prospective 'tapering' of its securities purchases crystallised the feeling that was then prevalent in the market that US growth had been underestimated. Thus, the Fed's announcement came just as a moment when investors were starting to think they were in the wrong place with their portfolios. The result was a kind of market panic – a rush for the door, if you will. However, when you looked at how long that reaction lasted, it was not very long.

Therefore, if they tighten in December, it must be the most telegraphed action ever, and if there is a big surprise response it will be amazing.