



# The Future of the World Economy: Global Economic Crisis Symposium



## Comments by panelist **Ronald P. O'Hanley** discussing the global economic crisis presented the Boston Federal Reserve Bank, January 16, 2009

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I've been asked today to provide a "CEO's View of the Near Future" and perhaps shed some light on what the private sector is thinking about this crisis and most importantly what will be the major challenges that we will have to address as we move forward. My perspective comes as not only as the CEO of a global asset manager, but also through the eyes of BNY Mellon Asset Management's clients who represent public and private sectors and through the eyes of our investment professionals who follow private and public sectors minute by minute around the world.

To begin, I would like to offer some context and perspective on how we got to this point. Clearly, the last several decades have been a golden era for the global economy. Financial globalization has led to trade and investment globalization, thereby facilitating global prosperity of a nature unimaginable as recently as the 1970s. More people on this planet have experienced significant improvements in their standards of living over the past several decades than has ever occurred before in human history. Consider that in the 5 years from 2003 to 2007, every nation in the world grew its economy except 3 countries: Zimbabwe, Cuba and North Korea. So that's the starting point we need to remember: we had several golden decades with real advances in the global real economy, and advances in productivity and innovations (including financial innovations that were very beneficial to support the growth of the real economy).

But, as it often the case, the boom went to excess. The combination of leverage and financial globalization led to a widespread bubble with pervasive effects. The inevitable bust and deleveraging now poses an exceedingly tough hangover. What is at stake now is stability of global economy. This severe downturn probably has affected and will affect more people at once than any other economic crisis. The manner in which government policies and markets across the globe respond in a coordinated fashion will determine how and when we pull out of this. In my opinion, the overarching issues we need to address as we work through this crisis are:

- 1. How can we keep trade and capital flows going and avoid protectionism in the most important global markets?**
- 2. How do we strike the right balance in terms of intervening with free markets and putting in place better regulation?**
- 3. How do we ensure that the stimulus program being contemplated accomplishes its objectives, and doesn't devolve into the mother of all pork barrel programs?**

While I think each of these topics deserves a major discussion in its own right, let me give you some brief thoughts and perspective on each of these three areas.

**1. How can we keep trade going and avoid protectionism globally?** I believe that the single biggest future threat to the global economy is rising protectionism and the curtailment of free trade. Reduced trade is an inevitable byproduct of an economic slowdown. Consider this: combined imports and exports of the U.S. declined by 18% in the July to November period. We cannot add protection into the mix. The toxic combination of global recession and rampant protectionism is one we have tasted before –

in the 1930s. That combination put the world economy and political systems on a death spiral of closed markets and unrestrained fascism that was broken only as a result of a horrific world war. I do not have to say that we do not want to see that again. Furthermore, it is conceivable that this economic crisis provokes a protectionist backlash in the West that could jeopardize economic gains in Asia, and in other developing countries. We have to keep an eye on what happens in developing markets like China as laborers from the hinterlands who have moved to cities in pursuit of jobs are sent back to the hinterlands. In another nod to history, it begins to feel like the same conditions that spurred the U.S. labor market unrest in 1918-1919, when millions of World War I veterans re-entered the job market. We need to ensure that this current crisis does not provoke a protectionist backlash in the West which ends up jeopardizing economic gains in Asia and in other developing countries. Keeping global markets open for trade and capital flows have to be a top priority for us all.

**2. How do we strike the right balance in terms of intervening with free markets and putting in place more enlightened regulation in the U.S. and globally?** Clearly, the pendulum will swing; how can we make sure that it does not swing too far? There are a lot of people right now who say that we need more intervention and regulation, since “free markets haven’t worked.” How would we know? I would argue that we have for the most part have yet to allow markets to operate freely. We intervene with free markets at our own peril. Clearly, society needs to intervene with free markets for good reasons, but we are rarely prescient enough to be able to think through the second- and third-order effects such intervention typically causes in the functioning of markets. Recent examples of *inconsistent* intervention with the functioning of the markets can actually further diminish confidence. Take the different ways in which Bear Stearns, Lehman, and WAMU were handled as a case in point. Market participants are left scratching their heads wondering which way we will behave ‘next time.’ (Let’s hope we don’t have another case like Bear Stearns or the Lehman situation anytime soon!)

How do we make the judgment of where we let free markets work versus where we intervene? Consider some examples: Financial institutions: I think most of us can agree that we do need more regulation here, given recent events and the role a healthy financial system plays as the ‘oil’ for the running of the real economy’s engine. But do we need government telling banks what businesses they need to sell? Do we want government taking over the credit extension function at banks? What about automobile manufacturers? Should they get a bailout from the government? Where do we draw the line? auto part suppliers? Recently, retailers are arguing that they need to be bailed out, since they argue that if they go under, then consumers, who drive 70% of our GDP, won’t have any place to shop, which will dampen the recovery. You can see the slippery slope we’re on here.

Having said that, I think we can all agree that we need some form of regulatory reforms. The difficult balancing act will be how we achieve the right level of regulation, and how we determine where we should not interfere and actually allow free markets to function. What we need is not “more regulation” but more intelligent regulation that is **principles-based**, not rules-based. We need to move away from an adversarial approach and recognize that if a company is or potentially can become a sovereign risk, it will be held to a higher standard.

**3. How do we ensure that the stimulus program being contemplated accomplishes its objectives?** There’s a lot of hope being pinned on the stimulus program that our new President and Congress are contemplating. How do we ensure the stimulus program accomplishes its objectives, and doesn’t devolve into either (1) the mother of all pork barrel programs, or (2) a ‘peanut butter’ fest where the program is spread so thin and evenly that it accomplishes too little in any area to make a real difference?

Let me propose five Guiding Principles for the stimulus program:

1. **Principle 1: Let's be clear about what the real objectives of the program are, and let's test each potential action against the objectives to ensure they are congruent.** If we want the stimulus program to succeed, we need to be crystal-clear about its objectives. Do we want to get people to spend more by putting more money in their pockets? Are we advancing a Green agenda? This can't be an all-singing-all-dancing program that panders to everyone's desires. Once we have agreement on objectives, we have to evaluate each action carefully.
2. **Principle 2: We need to be clear about the end state we want for the balance between government and business.** Is the stimulus package transitory and we will eventually move back to the old equilibrium? Or are we headed for a permanent shift? If we are headed to a permanent shift, I encourage everyone to cast their mind back to Japan in the 1980s when newly government controlled companies were truly the "walking dead." My sense is that the Obama administration is not seeking a permanent shift. The implication is that stimulus measures need to be reversible. And business needs to understand that any aid or incentives are not permanent.
3. **Principle 3: Let's focus the stimulus/ infrastructure spending by the government on high-priority policy areas of broad societal benefit, where the private sector is unlikely to get the job done.** I'm surrounded by economists in this room who understand the free-rider problems in society a lot better than I ever will, so I won't delve into that. But let me provide some examples of areas where I do believe the government is the only entity that can get the task done.
  - **Take the notion of a Clean Energy Grid.** Basically, we need to upgrade the nation's transmission grid to ensure that we can effectively move the energy generated by clean technologies like solar and wind energy sources to the areas where that power is required. Right now, we do not have lines that connect where the wind is to where the power is needed. We also need a "smart" grid to optimize how the grid works, and to open up the grid to alternative energy supplies. No one other than the government is up to the task of fixing our national transmission grid.
  - **Mass Transit.** We need better, more efficient access along our busiest corridors (like NY-Boston and SF-LA). The government needs to get involved to resolve the many issues, beginning with the eminent domain considerations.
  - **Health care administration.** We need to figure out once and for all how to have healthcare delivered efficiently and effectively to 100% of our population.
  - **Catching up on the long-neglected maintenance of our infrastructure of roads, bridges and tunnels** is another example of an area where the government probably does need to get involved.

But in a whole lot of areas, we should probably not have the government *directly* involved. I believe that the government can achieve a lot of other stimulus activity through the private sector, as long as the government wields the right tax policies. Think about the old Investment Tax Credits – they work fine, and can get the private sector involved to create more jobs. We clearly need to add a tax incentive for job creation. However, we need to resist the temptation in some quarters to have the government run everything directly. The last time a large nation tried that, it didn't end so well in the former Soviet Union.

4. **Principle 4: Like it our not, we need to get the balance sheets of our large financial institutions cleaned up.** The reality is that without strong financial institutions, we will have neither the “lubricant” of credit nor the multiplier effect that a functional financial economy has on the real economy. We need to reduce the level of troubled assets on balance sheets by buying assets, guaranteeing assets, and/or possibly creating a good bank/bad bank. I have no comment on how much we should penalize the institutions that have created this particular problem in our markets.
5. **Principle 5: While the stimulus program is focused on increasing spending, we cannot make ‘Save’ a four-letter word.** Keynes noted the ‘paradox of thrift’ whereby if everybody saves more during a recession, aggregate demand will fall, which in turn will result in lower total savings in the population. Having said that, we need to incent savings, especially as such savings relate to solving the retirement crisis. This capital market crisis could not have happened at a worse time, given the large percentage of the population reaching retirement age and the historic underfunding of many retirement plans. There is a genuine societal benefit from social security, defined benefit and defined contribution plans. This social contract has come under huge strain: defined benefit plans are vanishing, few can rely on social security, people who invested their wages in defined contribution plans now have lost a third of the value of their assets if they were invested in a standard equity index fund. Consider that “cash under the mattress” became a well talked about investment strategy in 2008. The stimulus program needs to incent the right savings behaviors, and not simply encourage more spending. If we don’t encourage savings for retirement, we’ll just be laying the foundation for the next set of consumption-driven problems and a huge societal issue of underfunded retirement savings down the road. We should round out the equation by considering tax benefits for maintaining contributions as part of the tax package.

So in summary: I suggest that we start with a focus on the fundamental issues. How do we:

- Avoid protectionism,
- Strike the right balance in terms of intervening with free markets and putting in place more enlightened regulation, and
- Ensure that the stimulus program being contemplated accomplishes its objectives by developing a series of carefully crafted principles.

I look forward to discussing these ideas further in the Q&A session.

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