



Beyond the Financial Crisis: Building Alignment Across Global Markets



A Speech by Ronald P. O'Hanley at the U.S.-China-India Partnerships Conference

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Before I share my thoughts on how we can all do our part to ensure we learn the right lessons from the current crisis (and avoid extracting the wrong lessons), I think we need to begin with an understanding of what has been happening in the global financial markets - not only from a U.S. view, but perhaps more importantly, from a Chinese and Indian vantage point.

To begin, I would like to offer some context and perspective on how we got to this point. And no, I shall not start with the summer of 2007 as the start of this perspective, as has recently become trendy to do. Let's step a little further back for true perspective: the past 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 that was unimaginable as recently as the 1980s. 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. The United States and the developed world had led this process through higher than trend consumption. Export-led economies ran huge current account surpluses and lent to consumer-led economies. The huge populations of China and India benefited as has most of the rest of the world, with the notable exception of sub-Saharan Africa. GDP and per capita income standards have leapt dramatically. In the past 30 years, India's real GDP has grown at 5.7% CAGR, China's has grown at 9.8%. (India's per capita real GDP was \$186 in 1978, in 2007 it was \$507; China's per capita GDP was \$55, in 2007 it was \$596. Since 1980, through the end of 2006, India's real per capita income has grown at 4% CAGR from \$144 to \$423. China's real per capita income growth has been an astounding 13% CAGR, from \$64 to \$1,685.)¹

So now let's fast forward from golden decades of the 1980s, the 1990s, and the early 2000s, to the summer of 2007 and the early signs of the recent crisis. What began in the relatively small, lower quality segment of the U.S. housing market known as "subprime" spun rapidly into a series of market events that exposed serious flaws in the business models of many major U.S. financial institutions. For example, as recently as 2004 securities firm leverage ratios were limited to 12:1. For investment banks that were now leveraged 30-to-1, a loss of confidence, manifested in the markets by a lack of liquidity, proved ruinous. Worse yet, banks were financing their long-term assets with short-term debt, which made them susceptible to the 21st-century version of an old-fashioned "run on the

¹ Thomson Datastream, Government of India Ministry of Statistics, U.S.D.A Economic Research Service

bank.” Nothing summarizes the environment better than the quip of one financial executive: “On the left side of the balance sheet, nothing is right. On the right side, nothing is left.”

U.S. financial woes spread quickly, and soon we were barraged with headlines of governments around the world bailing out their national banks. We are now witnessing the Great Deleveraging of the financial system, which is engulfing not only the global financial markets, but in fact is reshaping the world’s economy. In a nutshell, the crisis (or more accurately, the *crises*) evolved from a subprime credit crisis, to a crisis of confidence and liquidity, to a crisis of solvency for financial institutions, and has now evolved into a major global recession (some would say ‘depression’) in the ‘real’ economy. Europe and Japan have joined the U.S. in one of the few synchronous recessions in the Triad of the post-second-world-war era. (1973-75 was another.) Nor has the developing world been spared.

In an era of globalization, we became intoxicated with what cross-border linkages were able to deliver on the upside of the boom. But as that boom went to excess and spawned a lethal globalization of asset bubbles, the inevitable bust now poses an exceedingly tough hangover. What is at stake now is the stability of the global economy. This severe downturn probably has affected more people at once than any other global 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.

Global economies are more strongly linked today than ever before. Whatever we thought about decoupling, is simply not true. The economies of China and India have slowed as exports have declined, and stock markets in Asia have suffered, in many cases more so than in the U.S. Since the American financial system is at the root of current market woes, it is clear that many of our partners around the world are expecting the U.S. to lead the way out of the crisis, as has been the case time and again in other economic crises since the 19th century.

This sentiment came across loud and clear when I was on a recent business trip in Asia. While I was there, I heard some other important messages:

- The Asian view appears to be pessimistic about the U.S. markets, at least for the near term. For example, Asian Sovereign wealth funds, who earlier in the year dominated the financial news with purchases of U.S. financial institutions, have been noticeably “gun shy” as the crisis has deepened. As the chairman of China’s \$200 billion sovereign wealth fund says they “don’t have the courage” to invest in financial institutions because “we don’t know what trouble they are in.”²
- Asian central banks have started to reconsider their longstanding policies of buying U.S. government debt. Interest rates on U.S. Treasuries are at or near all-time lows. Those countries that have benefited from strong exports are likely to use their financial resources to stimulate their own economies. China’s recent \$586 billion stimulus package is a case in point.
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² *China Fund: Banks in West are Risky Bets*; Wall Street Journal; December 3, 2008

- The overwhelming sentiment I felt was a “wait and see” about the U.S. markets overall. On top of the “wait and see” attitude, there is a pervasive feeling of disappointment with the U.S. Asian countries have devoted a good deal of time and energy to developing their own capital markets patterned on that of the U.S., and the disappointment is palpable.
- I also encountered a concern that the U.S. might be turning its back on free capital markets. Companies like AIG have iconic status in China, and its new condition as a ward of the state was perhaps even more unnerving to Asian markets than it was to the U.S. Certainly I detected frustration when it was noted that the West advised Asian governments not to prop up their banks during the last Asian crisis. No doubt, by so markedly expanding the “too big to fail” doctrine, the West (and its global institutions like the IMF and The World Bank) have lost a good deal of moral authority along these lines. Most importantly, exporting economies fear the prospect of rising protectionism in the U.S.
- The pro-cyclical nature of the U.S. dollar is causing pain for Asian economies whose currencies are pegged to the U.S. dollar. The U.S. dollar has strengthened recently, due to the unwind of the carry trade and a flight to quality. As the dollar strengthens, Asian currencies pegged to the dollar will also rise, causing exports from those countries to become less competitive.
- Having said all this, as I mentioned earlier, the general expectation is that the U.S. must lead the way out of this situation.

Enough about the events that have brought us to this point and the views of the crisis from the U.S. and Asia. Where do we go from here? As the saying goes, it is a shame to waste a crisis. I propose that we take our time together to step back and think about some of the broad issues that the developed world and developing world face that shape capital markets and economic growth. Some of these are caused or exacerbated by the current economic crisis, but others are more structural. In the interest of time, I will not be comprehensive here, but shall rather just offer up some thoughts to spark our discussions.

We need a road map for capital market *reform* in the West, and capital market *development* in Asia. I think we can all agree that we need to reform the current system in developed markets. At the same time, in Asia, capital markets are being rapidly developed. For example, the Fixed Income markets in India and China are still in a nascent stage. What should the design model be? How do we appropriately reform Western capital markets without strangling financial innovation? Can newly developing markets learn from recent events to “leapfrog” to a better model? How can we quickly develop exchanges to replace OTC markets around the world? How can we promote and monitor global financial innovations going forward so that we do not repeat past events with the next generation’s equivalent of SIVs and CDOs?

The balance between savers and consumers across the globe needs to (and will) shift. What it will mean for the financial markets is unclear; what is clear is that the status quo will not stay the same. The old adage is that Asia saves and invests in the U.S., allowing the U.S. to (over) consume. China has recently overtaken Japan as the largest holder of U.S. government debt. Both the U.S. and China have benefited as a result, although no one believes the status quo can last indefinitely. The economic crisis poses a major challenge to the relationship. In the near term, it looks like Americans are putting the brakes on consumption and deleveraging their personal balance

sheets. Will Americans be able to increase their personal savings adequately after years of financial profligacy? Will high savers in China and India loosen their savings habits and consume more? Some of this rebalancing will occur naturally as a result of the current deleveraging and recession. Will increased domestic consumption in China and India be able to power these nations' economic growth, picking up the slack left by lower American consumption that has hitherto powered the export-sectors of these countries? It will be a tall order: for example, consumer spending makes up 35% of China's GDP. Consumer spending in the U.S., by contrast, accounts for more than 70% of the economy.

We must finally come to grips with the impact aging populations will have on the economies of large parts of the world. The developed world, Russia and China face rapidly aging populations; India and the rest of Asia do not. (It is clearly split: 50% of BRICs have aging populations, and 50% do not.) What is the impact on the baby boomer in the U.S. who has seen his or her life savings in the equities markets devastated by the recent savage downturn? What are the implications in the longer term for social security and pension savings in each country? What about the impact on health care systems? China in particular has led the way in establishing a pension system and broader access to health care. But the costs and problems of addressing the needs of a rapidly aging population are enormous. What will that mean longer-term as (younger) India trades with (older) China?

We can not let possible political and social unrest undo the gains of the past few decades. The past few decades have witnessed rising living standards across much of the globe, boosted by a trend toward free trade. In all the major countries, including the U.S., the EU, Japan, China and India the pace of liberalization is slowing, public support for globalization has diminished and leadership enthusiasm for further opening has diminished. What will happen in developing markets as laborers from the hinterlands who have moved to cities in pursuit of jobs are sent back to the hinterlands? 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. Will the crisis provoke a protectionist backlash in the West that could jeopardize economic gains in Asia and in other developing countries? Will China and India face greater social unrest as a result of their economies slowing down? I believe that the single biggest future threat to the global economy is rising protectionism and the curtailment of free trade. 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. We do not want to see that again.

I have given a glimpse of some of the broad issues that the developed world and developing world face. As I mentioned, some of these are caused or exacerbated by the current economic crisis, but others are more structural. I firmly believe that we need coordinated global efforts to discuss these issues. I'd like to share with you a future vision for cooperative government and industry activities to sustain and expand capital markets and global economic growth.

Our efforts to make multi-lateral forums succeed must be redoubled. For starters, the roster of participants needs to expand. The post-World War II institutions, like the IMF, and consultative mechanisms, like the G8, have become obsolete, and fail to reflect the new global economic

realities. In particular, we need to include a broader set of members than the G-8. A robust global forum must underscore the importance China and India have in global trade and finance. The recent G-20 summit in Washington was a good first step – but nothing more than a first step.

Let's consider Bretton Woods as a major successful historical precedent. The monetary system that was developed there worked for decades for a number of reasons including a belief in capitalism and the compelling call to action grounded in the chaos of World War II and the Depression. In a nutshell, they gave up a degree of sovereignty in return for the likelihood of greater collective prosperity. I believe the conditions that drove the success of Bretton Woods exist again today, as we are all unified in wanting to put this crisis behind us. Whatever we do create must strike the appropriate balance between on the one hand the appropriate level of intervention, and on the other hand allowing free markets to operate and self adjust without undue interference. Specifically, we will need to define the role of Central Banks around the world, and define how and when they take away the punchbowl when the party gets too loud, and bring it back when the party gets too quiet.

Is my vision of coordinated global economic efforts to deal with the current crisis nothing more than an idealist dream? Not so, I would argue. In fact, the model for global mobilization to respond to other types of crises already exists. Consider the instant mobilization across the developed world to support the Indian government as it addresses the aftermath of the recent tragedy in Mumbai. Or consider the broad-base mobilizations to support countries in the wake of natural disasters like earthquakes, hurricanes and tsunamis. We are collectively good in a crisis. In some cases we can work together over more sustained periods of time: consider the concerted efforts of the WHO to eradicate specific diseases like polio. We need to build the same kind of global alignment to support one another on an ongoing basis as we further develop the world economy for our collective benefit.

I think we can all agree that there are important issues that need to be addressed at a global level - and these issues are not just limited to the current financial crises. We need to create the right global forums to build cooperative government and industry actions to sustain and expand global economic growth. But we should not wait for a global political forum to take shape. These issues are too important to wait. Let us spend our time together over the next day thinking about the global market-shaping issues. And I challenge all of us to identify ways that we can begin to productively work on the solutions that will extend beyond the end of this conference and our time together.

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