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Turbulences in the World Economy and Financial Markets:

What Europe Could Do

Keynote Address

In my talk this morning, I want to focus on four problems confronting the world today, and which merit our special attention. I will commence with two rather pressing problems which pose a significant threat to global economic progress and financial market stability in <u>the near term</u>. First of all, we have the looming crisis on asset markets globally, and the US mortgage market in particular. While this is grabbing the headlines and public awareness at present, it has to be evaluated in the context of ongoing innovation in our financial system as well as the periodic crises which befall that system.

The second problem is the disturbing financial imbalances between certain countries, and even within some countries. Normally, one can rely on the global economy's self-correcting mechanism. But, where public policy is inconsistent with stability, we have to be concerned about the greatly increased potential for disruption.

More long term in nature, but equally short term in the need for remedial action, is the alarming trend in climate change and global warming. The environment cannot be "turned around" in the way that the balance-of-payments of a country, or the inflation rate, can be corrected. The need for <u>sustainability</u> in the global economy requires that we develop, and continue to develop, new and innovative technology which will be more intensive rather than extensive in the use of resources. In this way, we can combine improvements in quality of life with the economic development of underdeveloped countries. Failure in this regard will make us all poorer.

And finally, the threat of nuclear proliferation has been a problem for so long that we have become complacent about the risks it contains. Recent developments, however, including the risk of terrorism combined with growing accessibility to such weapons, has thrust this issue back to the forefront of our concern.

<u>Financial Innovation and Financial Market Disruption</u>

The economic role of the financial system is to support the real economy and to make the organisation of the real economy more efficient. In this way, it makes a very significant contribution to the economic welfare of mankind. It does this by providing the means of streamlining trade and payments. Without a financial system of some kind, all the great economic advances – from the specialisation of labour to industrialisation and automation – would not have been possible. In this sense, the financial system has been the greatest economic innovation in human history. And, the financial system itself has continued to develop and innovate, witness the emergence of new kinds of financial assets as well as markets on which these assets are traded.

For the most part, financial innovation has had a positive effect on economic efficiency. But some financial innovations have had little to do with efficiency and were designed primarily to circumvent the regulatory environment, or avoid taxation. Such self-serving and self-enriching behaviour produces a de-coupling of the financial system from the real economy, as the enhanced profits of the financial sector are no longer the result of real economic gains. Instead, they are the outcome of "rent seeking" behaviour and a transfer from the real economy.

In a recent paper, *Reinhart and Rogoff* list a total of 19 post World War II financial crises which were triggered by a banking crisis or a collapse of a segment of the financial sector. The key message is that a failure on the part of the financial system inflicts large and sustained costs on the real economy in the form of a drop in real GDP – in other words, a recession.

They also draw attention to similarities between the recycling of Petrodollars and the consequent sovereign debt problem in the 1970s and early 1980s, and the current sub-prime crisis. The earlier problem involved the American banking system channelling large financial inflows to Latin- and South American governments; the current crisis was predated by liberalised financial entities channelling financial inflows to the mortgage market, especially the sub-prime component.

There is reason to believe that the recent dramatic growth, and profitability, of structured investment vehicles – the so-called SIVs – have had more to do with the avoidance of capital requirements of banks than with any evident increase in economic efficiency. Whether these constructions have any meaningful future role, once this loophole has been closed, remains to be seen.

The securitisation of mortgages and their sub-division into risk tranches, another innovation of recent origin, represents an important increase in financial intermediation. Whether it constitutes an improvement in economic efficiency depends on whether these instruments can reduce the cost of transferring funds from lenders to borrowers. The attraction of collateralised mortgage obligations, or CMOs, was due, in part, to a mispricing of risk, and also to the need for profitable investment opportunities for dollar balances, given the enormous financial imbalances in the global economy. Neither of these represents an increase in efficiency; the mispricing of risk is symptomatic of the failure of financial markets; the financial imbalance was, and is, a product of the dubious and unsustainable foreign and financial policies pursued by the United States.

At present, the financial eyes of the world are on the United States and the unfolding saga of sub-prime mortgages. And this is despite the fact that a number of other countries are in a similar predicament. I would like to make a number of observations regarding this issue.

First, the international financial system is a patchwork of closely inter-linked financial markets, throughout which impulses are transmitted at lightening speed. So, we should not become obsessed with, or blinded by, the sub-prime market. The markets for near sub-prime, for housing equity loans, bank credits of all kinds, right through to bonds, are but a hair's breadth away from similar distress. Even if we manage to shore up the sub-prime market, our problems will be far from over.

Second, central banks do not appear to have any well-defined idea, or plan, for dealing with the new trade-off confronting them. It is clear that a fear of recession has been the dominant guide to policy. Cutting short-term interest rates and massive injections of liquidity may rescue the mortgage market for a while. But, as inflationary expectations take hold, the term structure will shift upwards and become much steeper. Not only will bond markets come under pressure, but the credibility of central banks, built up painfully and over many years, may suffer irreparable damage.

Third, the most important attribute of any financial institutions is reputation. Because of asymmetric information, this is easily lost but very difficult to regain. A loss of confidence in one institution can have widespread ramifications because of the problem of *contagion* which, today, is international rather than domestic in character. The implication is that the financial system cannot afford the luxury of cowboys – one bad apple carries a real threat for the whole barrel, as never before.

And finally, the financial sector has urgent need to address the accusation that it is "addicted to greed". The single-minded obsession with profitability above all else pressurises the mortgage broker into selling an inappropriate product to an unsuspecting and unsuitable client. At the other end of the spectrum we observe the likes of Chuck Prince of Citigroup or Stan O'Neal of Merrill Lynch, receiving astronomic sums from their employers, in spite of massive failure, and in sharp contrast to the misery inflicted on millions of hapless borrowers. Such unjustified reward, combined with the principle of "too big to fail", clearly creates moral hazard in the pursuit of profit. It is a shocking moral example to the millions who try to act responsibly. And it raises the further question whether professional incompetence and lack of suitable caution should be treated as culpable offences - alongside fraud.

<u>Financial Imbalance and Policy Consistency</u>

It has long been understood that it is the responsibility of a reserve currency country, such as the United States, to ensure global financial stability. This implies that the reserve currency country must supply sufficient liquidity, but not too much, to the global economy.

The United States first failed in this responsibility during the Johnson and Nixon administrations. The combination of external war in Vietnam, a "war" on domestic poverty and tax cuts, could only be financed via monetary creation. The result was the collapse of Bretton Woods, global inflation and severe exchange-rate crises in the 1970s. We could also add the indirect effects of the oil-price shocks and the severe adjustment problems which followed them.

The Bush administration has attempted something similar – war in Afghanistan and Iraq, and tax cuts, at least for the better-off segments of society; concerted action on poverty is not apparent. The Federal Reserve has played along, as consumer and investment expenditure have been stimulated by low interest rates, so that domestic savings were quite insufficient to finance public policy. And the economic measure just announced by President Bush to alleviate the current crisis suggests that short-term objectives are still paramount.

So far, the result has been predictable. Not only has the US balance of payments on current account deteriorated, but it now amounts to roughly two thirds of the combined deficit of all deficit countries in the entire world. Of necessity, this has to be financed by huge capital account inflows, much of it coming from Asia and the oil-exporting countries. With interest rates at a low level, the hunt for profitable investment outlets was on. And these were forthcoming from the sub-prime mortgage market, provided partly by economising on administrative costs (i.e. capital requirements), and partly by the mispricing of risk.

In the United States, opposition to this policy problem was muted by the fact that the principal observable consequence was the decline in the foreign exchange value of the dollar. This makes imports more expensive, including overseas holidays. Externally, the main costs include further damage to the reserve currency role of the dollar, the loss borne by all those holding large dollar balances, and all of us will suffer from the predicted decline in real GDP following this episode of policy and financial-sector failure.

The Environmental Conundrum

The threat to our environment is remarkable in several respects – we know what is wrong, we know the cure, but we are incapable of taking the obvious and necessary steps. In economics the problem is recognised as one of common ownership, a lack of private property rights, which inevitably leads to excessive exploitation of the common resource.

In the West we suffer from a problem of moral ambiguity. Our political leaders are elected to serve the electorate, not mankind. For geographic and technological reasons, the consequences of global warming are less pressing in this region, although public reaction to natural disasters such as hurricane Catrina and an influential movie by Al Gore, suggest that public opinion may be beginning to change. In China and parts of Asia, the quality of air is pointing very clearly towards the pending constraints, but so far little is being done about it.

A few figures should serve to illustrate the scale of the problem. The USA and China together account for 50% of world emission, each of them accounting, individually, for about 25%. However, China’s GDP is about one quarter of that of the USA. At this rate, by the time China’s GDP reaches that of the USA, and it has four times the population of the USA, its emissions will be equal to total global emissions as at present. And that is just China! If we combine the USA, the EU and China, representing about one third of world population, they account for 45% of world production but about 70% of world emissions. Should the rest of the world demand the same standard of living, through economic development, and employ the same technology, global emissions are going to increase dramatically.

What these few figures illustrate, and one could quote many more, is that, as things stand, environmental sustainability and economic development are incompatible. Something has got to give. In the absence of discovering some new miracle technology which economises on scarce resources and reduces, or eliminates, polluting emissions, the prospects facing mankind are not promising.

So, we have a clear choice. We must find new innovative means of using the resources available to us on this planet in order to avoid a serious ecological catastrophe. We are committed to improving the prospects of underdeveloped countries, a goal which is unavoidable for human reasons. At the same time we wish to see progress in developed countries as well. The quest for such innovative technologies is already in progress. Failure is not an option we can consider.

Country	Share of World Population (%)	Share of World GDP (%)	Share of World Oil Consumption (%)	Share of Global Emissions (%)
USA	05	27	25	21
EU	08	30	18	15
Japan	02	09	06	04
China	20	06	09	19

Nuclear Weapons Proliferation

Forty years ago this year, the nuclear non-proliferation treaty (NPT 1968) committed all signatories, including those countries in possession of nuclear weapons, to the goal of nuclear disarmament. Although some acknowledged “realists”, including Henry Kissinger, regard total disarmament as an achievable goal, it is difficult to imagine the world “forgetting” or “losing” any technology once it has been invented. No one knows how such global amnesia could be implemented.

Nuclear weapons have a number of intriguing characteristics. First, they are almost exclusively defensive in nature – the fallout from their deployment would make it impossible to occupy any region in which they had been used. Their main function is to create a deterrent. No country possessing nuclear weapons is likely to be invaded, or even attacked, no matter how superior the attacking force.

Unfortunately, the possession of nuclear weapons, as well as the concerted effort to stop others acquiring them, has become an expression of modern-day imperialism. “It is OK for us to have them, but not you”, is too patently hypocritical a position to convince anyone but the completely naïve. Tony Blair openly insisted he was prepared to use nuclear weapons against Iraq “if necessary” – undermining any sense of moral superiority of the invading forces, and obscuring the problem with Iraq possessing weapons of mass destruction. Concern on the part of Israel that Iran should not obtain such weapons, or that North Korea should be stopped from the same at all costs, has little to do with security, and everything to do with preserving supremacy.

But supremacy of the old colonial variety is an illusion in this age. Gunboat diplomacy, as exercised by the British Empire in the 19th century, has no place in the modern world. The United States enjoys unquestioned supremacy in terms of military technology, but it has no answer to the determined, low-tech suicide bomber who welcomes the prospect of mutual assured destruction.

The modern day problem with nuclear proliferation focuses on so-called mini-nukes or suitcase-nukes. Strategic industrial infrastructures, not to mention financial centres such as those of London or New York, are perilously exposed to suicide bombers with small-scale nuclear devices. The suicide bomber has the advantage of fanatical motivation, combined with the opportunity for perfect mobility, without any need to worry about the logistics of escape.

The only approach to terrorism with any prospect of success is to eliminate the source of the injustice which causes it. Ironically, this is the only approach we have yet to try in a serious way. We have tried to conquer terrorism with superior military force. A failure! We have tried to restrict civil liberty and reduce mobility via enhanced security measures. An abject failure! When will we learn that we must tackle the cause of the disease rather than its symptoms?

What Europe Could Do

Europe’s role in shaping the future of the planet may not be very dramatic, but it is vitally important.

Europe, by which I mean the EU, needs to be identified as a consistent proponent of the long view and the big picture. It must represent the position that “prevention is better than cure” and acquire a credibility which is free of any suggestion of partisan or political considerations. Above all, Europe must be seen to put global interests above its own.

Europe must also have the confidence to launch broad initiatives, in close cooperation with others and especially along a North Atlantic axis. It has to take a more offensive approach to seeking sustainable global solutions. It has to shake itself out of its state of lethargy and accept a leading role in tackling the challenges produced by a world in transition.

And, Europe must seek to steer a clear course between credibility and diplomacy. Credibility comes from being consistent on issues of justice, equity, human rights, and so forth. Diplomacy enhances the working environment between nations. Credibility must not be compromised in the interest of diplomacy.

And finally, Europe must show that it is prepared to make hard choices, and accept the sacrifices which the long-term welfare of our planet will require.