

Opportunities and Risk in Globalized Financial Markets

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It is a great pleasure for me to be with you today, to share some thoughts on the subject of global financial markets, and equally important to listen to yours in the two days ahead.

I am by nature an optimist. In my service as a global strategist over the past thirty odd years in almost all parts of the world, for governments, international organizations, and private companies, I have watched prosperity, living standards, and life expectancies rise almost everywhere except in parts of Africa, where special challenges remain. Drudgery in daily life and work has been greatly reduced for billions of people. Ancient diseases have fallen to advances in science, medicine, and hygiene. While there will always be new challenges, such as the AIDS epidemic, and now the threat from bird flu mutations, we will face them with weapons unimagined by the previous generations.

In providing economic advice and analysis, I am generally also an optimist when it comes to future trends. But we all know that there is such a thing as business cycles. There are also times such as 1999, when bubbles appear in asset markets, and different advice is appropriate for investment advisers.

Understanding where new risks are appearing is vital for the financial industry as it moves from local bases whose politics and personalities are known from long experience, to the more global arena. Today, what happens in China impacts everything from commodity prices to emerging market bonds.

There are over a hundred trillion dollars worth of derivative contracts outstanding, hedging every kind of risk imaginable. Many of you are deeply involved in this process of risk diffusion.

So, today, I want to say a few words about the risks associated with present financial conditions in some parts of the world, where you may have direct or indirect exposure.

It appears that a modestly weakening trend may be impacting the global macroeconomic picture. The most recent IMF World Economic Report summarizes some of the reasons why this trend may be beginning. Rising oil and energy prices are only one of the many such factors. Indeed, some prominent Central Bankers believe that a global growth rate closer to 3.5% is more appropriate in part to avoid supply bottlenecks, than today's 4.3% growth rate.

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Inflationary pressures are also playing a role in what is likely to produce higher global interest rates than we had believed, as recently as a month ago. In 1996, the Boskin Commission in the United States pointed out that the American Federal Reserve formula for determining inflation was generating statistical evidence of greater inflation, by as much as a full percentage point, than was justified by the facts. Boskin pointed out the higher value of products such as cars and computers which today last longer and are cheaper to maintain than their counterparts of 25 years ago. He cited many other examples.

Today, however, people like Morgan Stanley's Byron Wien and other more prominent individuals have expressed the view that some of our inflation formulas may be understating somewhat the underlying inflation rate in the American economy. They cite such things as, possibly, an excessive weighting of rental costs in the overall housing cost formula. There is also concern about the potential impact of any future dollar depreciation on the U.S. consumer price index, and on the interest rates that will respond to address resultant inflationary pressures.

Thirty years ago, Chairman Arthur Burns commissioned a core inflation rate formula upon which he preferred to base U.S. monetary policies, that excluded volatile food and energy costs. For a time, this new formula appeared to allow easier monetary policy than otherwise would have been justified. But we all know what the final chapter of Chairman Burns' record on inflation looks like. So the Federal Reserve is, no doubt, very anxious not to repeat that mistake during the current period of energy price pressure. Increases in oil and energy prices seem less and less likely to be as volatile as in the 1990s, with structural factors suggesting higher long term energy costs.

Lower global interest rates have produced bond markets where risks are not always priced into bond costs. Argentina's earlier 70% haircut on its defaulted bonds appears to have been forgotten by some market participants. Yet, countries heavily dependent upon oil imports are facing heavier strains on their macroeconomic situations, particularly those countries attempting to buffer the impact of higher energy costs on consumers by subsidizing them.

We all know that in the past, periods of higher interest rates and slower growth rates have revealed weaknesses in some emerging markets and companies. We have only to think about Mexico in 1994, or in a more extreme form, in the early 1980s. We clearly do not face problems anywhere near as great as Paul Volcker faced in the 1980s, but present low interest rates seem clearly unsustainable, without risking new inflation. This will also have implications for the U.S. housing markets, related consumer spending, and growth rates.

During the past year, I led a project looking at the global economic imbalances, including the American current accounts deficit of nearly 800 billion dollars for this year. Next year, this deficit is projected by some respected analysts to increase to a trillion dollars. The President of the New York Federal Reserve, Mr. Geithner, delivered an important

analysis on the possible future implications of this unsustainable situation for the American and global economy on Oct. 19 at the Asia Society in New York. I commend this analysis to all of you.

The United States has an absolute requirement to create the market-based conditions whereby our country can produce more of the goods it consumes, and export more goods it produces than is today the case. We will not only need enough exports to pay for our future imports of goods and services, but also enough to pay the hundreds of billions of dollars in annual service charges for our rapidly accumulating foreign debts. These debts are product of long-term U.S. trade deficits. Investment on the scale necessary to generate the additional manufacturing capacity to produce these tradable goods will not happen without a significant change in global currency ratios.

Many observers believe it is not a question of if, but only of when and how this happens. Should a substantial currency shift occur, it will have important global consequences.

The U.S. current accounts problem can not be solved by a mere change in U.S. fiscal policy, important though that is. Fiscal deficit reduction will only occur gradually, while our debt mounts at a rate approaching a trillion dollars a year. It is important to remember that when the U.S. current account fell out of balance in 1971 and 1985, it required a 40% depreciation of the dollar in both cases. What has happened with the dollar thus far is only a fraction of what may eventually transpire.

Another risk factor for the globe has to do with the fact that political leaders in many parts of the world are losing the ability to lead. In my country, President Bush is facing increasing difficulties with Congress in implementing his program. In Europe, important votes were registered in France and Holland earlier this year that appeared to repudiate leaders' visions of the future. Germany's recent election produced an ambiguous result. Polls everywhere show that security in the face of globalization pressures is worrying more and more voters. Important policies can not move forward in democracies without popular support. This is also true in the United States, where millions of manufacturing jobs have disappeared in recent years, along with pensions in some cases. Congress is reacting to such concerns and faces a critical election a year from now.

Chinese leaders also face disaffected populations, notwithstanding the remarkable improvements in living standards for hundreds of millions of people since Deng Xiao Ping's reforms began. In China, there were 74,000 riots last year, according to China's official statistics on "mass based incidents". Special units in the army, including helicopter forces, are being created to deal with popular disaffection over corruption, environmental abuses, land seizures, and other matters.

These concerns make it much more difficult for China to voluntarily slow down its growth rate. But China's economic model depends on foreign trade for more than 50% of its entire GNP, and has a built-in assumption of 30-40% annual compound increases in exports. China's export/investment dependence is steadily increasing as a percentage of its GNP. An export-led growth model on this scale may be accommodated by the

global trading system for a micro-economy, such as Singapore. It can not be sustained for an economy of 1.3 billion people, without destroying the economic and political support base of the global trading system itself. Far more domestic-led demand in China is essential, not least of which because unsold inventories of manufactured goods are piling up in warehouses all over China. However, as we recall, attempts to build more domestic-led demand in Japan in the 1980s produced asset inflation, subsequent collapse of financial markets in Japan, and a fifteen-year period of stagnation. This period has also left a still unresolved legacy of public debt and contingent liabilities in Japan that may be in excess of 200% of GDP, the highest in the world.

Some present risks in Japan are more subtle for the financial industry. We have seen several false recoveries in Japan since 1990, encouraged by government statistics and public relations campaigns that subsequently were proven to have overstated the positive picture. We have only to think of the Financial Service Agency's earlier discredited reports on the health of the Japanese Banking system. But even a year ago, it was discovered that Japan's real growth rate was overstated by nearly 2% points due to exaggerations in the official deflation statistics.

We all hope that the current signs of recovery in Japan are sustainable. After 15 years of erosion, real estate values in Tokyo appear to have stabilized. Japanese banks and many companies now possess healthier balance sheets. The Government has just won an important battle over the privatization of the huge postal savings system, which, over the coming decade may allow for a more productive use of Japanese capital. Still, Japan faces serious long term challenges in financing its immense public debt, which will carry higher services charges in the future as interest rates gradually rise. There are also demographic problems, and a long term commercial and strategic challenge from neighboring China.

China's statistics are, of course, are far less reliable than those of Japan, and on every level. That is one of the many reasons why Shanghai's promise as a financial center will be delayed. No financial center can operate without reliable statistics upon which to price risk and make investments.

One small example: Of the 22 billion dollars of loans extended to automobile purchasers in China since 2002, more than half of the borrowers have already defaulted. There is no reliable credit rating system in China for either individuals or corporations, and there will be no revival of China's stock market until this situation and other problems are addressed.

Improving and updating the statistics upon which financial risk is priced is a vital and ongoing process everywhere.

It is also important to monitor closely developments in the derivative industry. Gerry Corrigan's task force recently identified a number of problems in New York in the credit derivative area. When such problems are discovered, rapid implementation of reforms is needed.

This is particularly true at a time when the macroeconomic environment is less certain than seemed to be the case a year or so ago. New stresses may well appear in the financial area during the year or two ahead.

All of us have a stake in reducing risk in the financial industry. And all of us have a role to play in addressing such problems. Governments and regulatory agencies can not do their work in this regard without the help of people like yourselves in the industry who are best positioned to detect problems at an early point, and recommend solutions.

We will, of course, never completely remove risk from the financial industry, nor should we. Intelligent risk-taking is at the heart of the industry itself. Neither can we completely prevent dishonest people from occasionally causing large problems for individual institutions. I remember the head of General Electric Company telling the Economic Club of New York one evening at dinner that, while he had undertaken every possible measure he could think of by way of due diligence, his recurring nightmare was always that somewhere in his vast company someone like Nick Leeson or a small group of Nick Leesons, were conspiring to conceal a large problem or to commit fraud.

So, by way of conclusion, I wish to repeat that, while I am optimistic about the future of the financial industry, and assume that globalization is a trend that will continue to produce positive results for millions of investors and consumers worldwide, globalization also brings with it risks that require vigilance and cooperation by all involved at every level of the financial arena. National supervisory agencies today carry much of the burden for enforcing standards, but increasingly this will have to be shared by global institutions and monitoring operations, like the BIS. The challenge the authorities at all levels face is addressing systemic risks and crime, without killing an industry that brings huge benefits to millions. The closest cooperation between industry and governments appears to be the best way of accomplishing this objective. Thank you.