The world economy now faces severe risks posed in part by slow economic growth, exceptionally slow world trade growth, and rising nationalism, populism and protectionism in many countries, states William R. Rhodes in a presentation to the Hudson Institute. Mr. Rhodes stresses that political leadership now is essential to place the world economy on a faster economic growth track and to educate citizens about the profound advantages of free and open fair international trade, which has been responsible in recent decades for lifting hundreds of millions of people around the world out of poverty and for the substantial increases in prosperity in the major developed nations, including here in the United States.

**Crucial Challenges Before the World’s Economy**

*Address to the Hudson Institute*

*By William R. Rhodes*

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It is a great pleasure for me to join you today and to see so many Washington friends.

The world economy faces a wide range of serious economic challenges. Unresolved, they may create further threats to Western political systems and to the structure of international trade and investment. So permit me to range widely in these introductory remarks and speak about global economic trends, financial markets, international trade and finally, banking conduct and culture.

So many of the problems that we now face are due to slow economic growth since the world economy emerged from the Great Recession. And these problems reflect repeated failures of political leadership in the leading industrial developed economies. No challenge is greater now than seeing that leaders come together to cooperate, to forge new understandings that are geared not only at preventing worrying current trends to continue – but provide the positive leadership that a globalized world economy urgently needs.

Rarely before has the word “risk” been so appropriate in discussing so many facets of economics and finance as it is today. This is an age of uncertainty. The serious risks on the economic front are unfolding against a background of political turbulence in many parts of the world, including here in the United States with our divisive Presidential election.

A middle-class revolt syndrome is evident in an increasing number of countries across the developed industrial world, including the United States. It is driven in part by perceptions of rising income inequality. The deep disenchantment of so many people in so many developed countries with their economic condition and prospects has opened the door to a combination of populism, nationalism and protectionism. These powerful considerations currently manifest themselves most particularly with regard to immigration and to free trade.
The Middle-Class Revolt Syndrome

Donald Trump among others has sought to take advantage of this middle-class revolt syndrome, but so too have prominent politicians on the far right and the far left from Spain to Greece, from Hungary and Poland to France and even to Germany. The Brexit decision was driven in large part by immigration concerns. The fear of immigration from the Middle East and Africa is adding fuel to the populist and nationalist fires.

One cause of this middle-class revolt syndrome is the Great Recession of 2008/09 – and I had warned in published articles in the Wall Street Journal and the Financial Times in 2006 and again in 2007 that a serious crisis could well be emerging. The events of 2008/09 were a hammer blow to economic stability. Its origins were deep and its consequences have been profound.

One of these consequences for the leading industrial countries of Western Europe, as well as for the United States, was the high level of unemployment. Over recent years some economies like the US have done much better than others in new job creation. A grave concern, however, is the persistence of very high levels of youth unemployment, notably in France and southern Europe. Millions of young people have been unemployed since the Great Recession - a generation that in some countries starts adult life year upon year in the ranks of the unemployed. For many others, the sluggish economic growth rates have at best yielded low paying jobs and continuing job insecurity, and the consequence has been rising public support for nationalist, populist and protectionist agendas on the extreme right and the left.

And, then we have seen the development of a culture that has encouraged taking ever-larger risks in financial markets. The intense search for yield in a world where inflation is low, and where central banks have created extraordinary amounts of liquidity, are stimulating today’s high-risk behavior. Central banking policies have created masses of liquidity, pushed interest rates to very low, even negative levels, to boost growth.

Too much of the burden for achieving growth has fallen on the shoulders of central banks, particularly the Federal Reserve, the European Central Bank, the Bank of Japan and the People’s Bank of China, as fiscal policies and structural adjustment reforms have taken a back seat.

The formidable valuation gains seen in the equity markets, the prime real estate markets and at the leading art auctions bare no relationship to fundamental economic developments. These asset values are soaring, while world trade is stagnating and is now at levels far below those seen just a few years ago – world trade growth of no more than 1.7% is likely this year. World trade has for decades been a prime force for real economic growth. At some point in time the fundamentals will assert themselves and we could confront a new set of enormously serious global financial and economic challenges.

The Global Economic Outlook

Now, moving from this broad overview, allow me to turn specifically to the economic outlook and the prospects of the most important players – the United States, China, Western Europe and Japan.

There is an old tradition here in Washington: the International Monetary Fund always publishes global economic forecasts that are too optimistic. And, by the way, the Fed has tended to often be just as over-optimistic. True to form the IMF has done this once again. The IMF estimated that world GDP in 2015 was 3.2%, that it will fall slightly to 3.1 percent this year and then regain modest momentum to reach 3.4% next year. Historically these are low numbers – but I think they are still too high. The OECD
is more cautious than the IMF with a 2.9% forecast for this year. There are good reasons to be cautious – allow me to mention just five of them:

**The U.S. Economy**

First, the United States economy. A number of well known economists, notably Larry Summers, have for some time been describing our economic condition as one of secular stagnation. Growth is low, savings are relatively high, investment is weak and consumer spending is below what is needed.

I expect that GDP is likely to come in at about 2% this year, which is approximately the average annual rate since we emerged from the Great Recession. Quarterly GDP numbers may fluctuate quite widely, but the trend line on an annual basis is low by historical comparison. I find it difficult at this time to see growth moving to a higher rate next year. Federal Reserve monetary policies, after years of quantitative easing and very low interest rates ballooned the balance sheet from $800 billion to $4.5 trillion, have largely run out of gas. The Fed needs to get its balance sheet back into better shape. It will probably raise interest rates slightly in December and, if it sees an opportunity, then further modest advances are likely in 2017.

For our economy to move out of its slow-growth path we need to see action by the White House, by Congress, by the private sector, including the financial sector. We need to unlock the large savings that many Americans have felt bound to establish – their confidence in the economy needs to rise, but will it given the bruising presidential election campaign?

As long as the American consumer remains hesitant about going out to spend, and business is hesitant to invest – especially as export prospects are less than encouraging, we will have slow growth.

We need the Congress to enact tax reforms that encourage business investment. We need Congress to promote meaningful infrastructure investments. We need Congress to push for trade agreements that strengthen the fabric of our globalized economy – with safeguards for American workers. And on U.S. trade policy, we need the Administration to be more forceful when it comes to enforcing international trade agreements and press hard when our foreign trading partners violate these agreements.

Further, we need some sensible regulatory reforms in a range of economic sectors to streamline overly complicated regulation, to enable firms to operate with greater flexibility and with lower compliance costs. After this troubling election season I am worried that 2017 will again see the kind of gridlock in Congress that will block so many of these essential economic policy actions.

**China’s Economy**

Second, China is the world’s second largest economy, whose economic machine drove a commodity boom for many years that was crucial to the economic growth prospects of many emerging market countries. For two decades China had double-digit yearly growth. Now, the economic growth rate has slowed many are somewhat skeptical about the official data showing an annual growth rate of 6.7% over the last three quarters.

Some of you here will remember that in November 2013, one year after he took control of the Communist Party, President Xi Jinping addressed the Party’s Central Committee and announced a vision of a China Dream, or the “great rejuvenation of the Chinese nation.” This envisaged substantial economic advances to 2020 – the centennial year of the Communist Party’s founding. Well, much of that Dream has been put on temporary hold until next year’s Party Congress.
This is a time of major shifts on the political stage in China where economic policy is to some degree taking a back seat to political developments.

A crucial economic concern is the staggering scale of China’s debt-to-GDP ratio of approximately 280 percent, and, very importantly, it continues to grow. Foreign exchange reserves have declined by roughly $1 trillion to around $3 trillion in the last 18 months or so. Further declines could come with full RMB convertibility.

The vast state owned enterprises in steel, coal, shipbuilding and other sectors continue to swallow up funds as if there is no tomorrow. The housing boom has long been in an unsustainable bubble. Municipal governments are borrowing heavily. Non-performing loans at banks are piling up, shadow banking is a major worry and the zombie companies have not been closed, as they need to be.

As a sign of concern the authorities are now proposing the conversion of non-performing bank loans into debt-for-equity swaps, rather than writing them off. This is not the answer to the problem. Some key economic policy decisions may be delayed for another year until the 19th Congress of the Chinese Communist Party in the fall of 2017. Five of the seven members of the all-powerful standing committee will be appointed at that time. Thereafter, the leadership will have to address the core financial problems of the nation, and this will probably force a slow-down in growth.

With most commodity prices soft, including oil prices, the other major emerging market countries with the notable exception of India, have very low growth – indeed recessions continue in Russia and in Brazil. Mexico is heavily dependent on the United States and NAFTA. As we all know South Korea is also heavily dependent on international trade. I will be delighted to respond to questions on specific emerging market countries after my remarks.

**Japan’s Three Arrows**

So third, Japan. Prime Minister Abe and Central Bank Governor Koroda are striving to bring the country out of prolonged virtual stagnation that has lasted for 20 years. The Prime Minister has sought to promote three arrows for growth: fiscal, monetary and structural reform.

Despite extraordinary measures taken by the Bank of Japan, which have seen substantial quantitative easing and negative interest rates for the first time, the economy is not responding; fiscal policy is also insufficient. The third arrow of structural reform, is more urgent than ever, but politically difficult.

Deep structural changes and deregulation are essential to make Japan more competitive, to strengthen entrepreneurship, to provide meaningful employment opportunities at all levels for women and to make the economy more open for imports. I hope it will happen but I share the depressing forecast for Japan of the IMF – a continuation this year and next of 05% growth.

**Europe**

The fourth reason for concern about the global economic outlook is the condition of Western Europe.

Britain and the European Union tussle with Brexit, and make no mistake this involves a cost to investment levels and to economic growth. The continent struggles to find equitable and decent policies to the inflows of people from the Middle East, Afghanistan and Africa. The policy problems on this issue
have damaged the cohesion of the European Union to an important degree. And this is especially unfortunate because cohesion is essential to formulate a constructive negotiating strategy for Britain’s EU exit.

Moreover, economic policy leadership in the 19-member Eurozone that emphasizes growth, not austerity, is urgent. After all, unemployment levels remain unacceptably high – notably in youth unemployment, especially in France and in southern Europe; negative interest rates prevail but their impact is untested; threats of deflation are a constant; and low economic growth persists.

The European Central Bank (ECB), under the able leadership of Mario Draghi, has done the maximum possible to add liquidity and to seek through stress tests to oversee the health of the banking system. But, it has to share authority with the European Commission and politics is playing too large a role for comfort. The vitality of the banks is crucial to European growth prospects: the banks account for around 70% of all the credit generated in the Eurozone, with capital markets picking up the rest. The U.S. is a virtual mirror image, with just around 30% of credit generation attributable to the banks.

The European Banking Authority was too slow, unlike the Fed, to address key issues of capital, bad loans and restructuring in the banks and now the Eurozone is paying a price. Politics has played a role in creating delays in the finalization of a banking union. As a result, bank resolution systems are far from being robust and in some cases, as was seen in Italy they barely exist. Further, there has been no progress on introducing a harmonized Eurozone deposit insurance scheme.

The ECB and the European Council of Finance Ministers also have grounds to fear new crises. For example, Portugal continues to have serious growth problems. Italy has seen serious banking difficulties and in December it will have a vital constitutional referendum.

And then there is Greece once again. Greece is in its seventh year of what now must be called a depression. It is subject to loan conditions from the IMF and its Eurozone partners that it cannot meet. It has a debt to GDP ratio of 175% and it is rising. Without new debt relief Greece will fall back into a serious crisis challenging the Eurozone once more.

**World Trade and Protectionist Risks**

And, fifth there is trade. There has been a very serious lack of international leadership in this area. I am worried about the impact of trade today on the outlook for the world economy and, more importantly, on the prospective relationships between nations.

Permit me to quote a summary in The Economist of a couple of weeks ago:

“Global trade is in a grim state. Between 1985 and 2007 trade volumes shot up at around twice the rate of global GDP; since 2012 the rate of growth has barely kept pace. Things appear to be getting worse. On September 27th the World Trade Organisation slashed its forecast for growth in trade of goods from 2.8% in 2016 to just 1.7%, implicitly predicting that for the first time in 15 years, trade would grow more slowly than GDP.”

Trade was once an engine of global growth, not today. This must be addressed. National leaders in developed industrial countries have done a poor job over many years in explaining the benefits of fair trade and the need to continue to pursue multilateral trade negotiations and achieve new agreements. Now, it is imperative that the national leaders across the developed industrial world confront the populists and nationalists and protectionists, and a crucial component of this action is a major effort to educate the public on the benefits of free and fair trade.
I have always believed that serious trade negotiations between countries are in themselves a vital barrier to protectionist pressures – ones that arise time and again and are driven so often by narrow public perceptions of their real economic interests. Education in support of globalization that fairly distributes the benefits is more vital now than ever. People need to recall the explosive conditions that resulted from the beggar-thy-neighbor policies of the 1930s.

Today, the populist idea is widespread that free and fair trade and expanded globalization has enriched major international corporations and banks at the expense of the working people of the leading industrial countries. Effective counter arguments have not been made. For example, in the run-up to the EU referendum in the UK the champions of the remain campaign did a very poor job of highlighting the many benefits to Britain of the free flow of goods and services to and from the EU.

In France with its National Front party, in Brexit Britain today, and in other important countries of Europe the protectionist forces are advancing, while the proponents of free trade are largely silent. In the United States the election campaign has been a major influence in turning away from our long tradition of seeking major trade agreements.

So serious is the situation today that the Europeans have found it exceedingly difficult to muster the political support to conclude a relatively simple trade agreement with Canada, which has been under negotiation for seven years. Based on this experience the prospects of a trans-Atlantic trade pact (TPPP) are bleak. Moreover, here at home, President Obama will seek Trans Pacific Partnership (TPP) support from the Congress before he leaves office, but I doubt if he will get it.

**Banking Conduct and Culture**

Public confidence in our financial system, especially in our leading banks, is at a very low level. Individual crises seem to come so rapidly that they combine to create a very bad image for many institutions. Wells Fargo has been in the headlines, not for its profits, but for its misdeeds. Deutsche Bank, Germany’s largest bank, seems to be constantly in the headlines: it is under great pressure to change its business model as it grapples with charges of wrongdoing in business in Russia and in Italy; and it confronts the prospect of very substantial legal fees, including a major fine for past misdeeds from the US Justice Department.

In my book, *Banker to the World*, and in a number of articles that I have written for *The Financial Times* and others, I have underscored the need in banking for sound risk management, which has been increasingly undermined in recent years by the search for yield and short-term profit maximization. Working with the Group of 30, and serving as its co-chair of the working group that published an important recent report -- *Banking Conduct and Culture: A Call for Sustainable and Comprehensive Reform* -- I have stressed the need for a reset in the conduct and culture at many of the most important banks. They must recognize that reputational risk is important, often more important than the other types of risks. Far-reaching reforms in this area are in the explicit self-interest of the banks. Once you lose your reputation, it is very difficult to regain it.

A feature that has come to the foreground in the politics of our times on both sides of the Atlantic has been the loss of public confidence and trust in our major corporations. This has also affected the banks, and perhaps trust in them has been particularly impacted. Actions by a number of banks have compounded problems of public confidence.

Reform of banking conduct and culture demands that the CEO and Board of Directors sets the integrity tone. This tone at the top must be reflected in the actions of all employees right down to the
teller at the local branch. It is essential that there is a very active board of directors when it comes to oversight of every aspect of reputational risk and this means, for example, setting compensation policies that reflect and incentivize excellence in this area; and willingness to fire top executives who fail in this regard; and encouragement, of whistleblowers who see wrong-doing in the institution.

**Conclusion**

Let me stress in conclusion that reforming banking culture, just like ensuring that governments adopt constructive growth-oriented economic policies and educate citizens about the need for such policies, is not easy. I make no claim that the policies I have advocated here today can be easily adopted and implemented in all cases – but I believe they are essential to restore the trust of the public.

On trade, in particular, it is time for leading governments to encourage each other to do what is right. They need to use the Group of 7 and the Group of 20 as well as the multilateral official agencies to increase public understanding of the need for free and open international trade and investment, which has been a force for expanding global growth over many decades since the end of World War II.

Today, protectionist risks are serious. The question arises: are we at the end of the era of open trade and globalized economic prosperity?

Ladies and gentlemen, the last few decades have been an era of extraordinary accomplishment – hundreds of millions of people across the world have been lifted out of absolute poverty, while the industrial developed economies have seen prosperity levels attained that were unimaginable 70 years ago. This era of openness based on trans-border economic cooperation may well be coming to an end. This should be a profound concern to all.

Thank you.

**By William R. Rhodes**

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