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Transcript

The Global Economic, Financial and Political Outlook for 2012

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John Gieve:

My role is to introduce our speaker, Roger Altman. I have here a fascinating and very impressive CV but his one request was that I should not read it out, so sufficient to say that he is a great example of the sort of career that is more common in America than in the UK; that is to say he's a very successful businessman and also he's been a very senior minister in government, notably at the Treasury under Bill Clinton. When he came out of that he founded and is now chairman of Evercore Partners.

He's going to talk today for around half an hour on the outlook – economic, global, political – from an American point of view in 2012 and when he finishes his speech we'll then have some snappy questions and answers from the audience.

Roger Altman:

Well if the questions are going to be snappy I am afraid that means the speech has to be snappy also – it's a high bar.

I want to start by thanking you for inviting me here. I've long respected Chatham House and it's a special pleasure and an honour to come and speak to you today.

I'm going to make a series of comments on the economic, financial and political outlook for 2012. That's a gigantic topic, I'm not going to cover every single facet of it, but try to hit a group of big points and hope to be provocative and snappy.

To begin, the overarching global theme, if you look not just at the short term outlook but the medium and longer term outlook, as well as where we've just been, is the two speed nature of the global economy; the relative stagnation of the US and Europe and Japan *vis-à-vis* the continued powerful growth in a series of big emerging markets, most notably China, Brazil and India; and the gap in growth between those two worlds which has in my experience never been wider.

I want to discuss certain dynamics in each of these two worlds, we can call them the slow world and the fast world, with particular emphasis on three points. The profoundly weak recovery in the United States, the sovereign debt and banking crisis which we're all watching and following here in Europe and of course particularly on the continent, and the medium term outlook for China which I view as cloudy.

Let me begin with a word on the year which just ended. If you take the United States and Europe and Japan together, which still represent more than half of global GDP, it was a dismal year. The United States grew 1.6%, Europe grew 1.4% and Japan shrank a touch under 1%. So across the three, on a GDP weighted basis, the growth rate was approximately 1% and that's the growth rate for the industrialized world three years after the low point of the global financial crisis; in other words, very weak.

And look at the contrast with the biggest emerging markets. China grew 9%, India grew 8%, Brazil slowed down a bit and grew 3% and those three nations that we all know are no longer small or even medium sized factors in global economics. Together they represent just under 25% of world GDP and that contrast between stagnation in the industrialized world and rapid growth in the big emerging markets I think is the single most important element in the recent and the forward global economic outlook.

Let's turn to the three specific points I mentioned starting with the United States. The most noteworthy thing about the American recovery so far – and the trough economically speaking was in June 2009 at the bottom of the recession – has been its weakness. It's simply been a profoundly weak recovery. For the United States to be growing at 2% or so that long after the bottom is very poor by historical standards, in fact it's the only precedent for that in the last 100-plus years is the mid and late 1930s.

The outlook for 2012 is only modestly better. If you've surveyed the leading economists you see they're in the vicinity of 2% - 2.5% real growth for the United States this year. And the labor markets, which get so much attention and appropriately so, are seen as improving only on a grudging and slow and difficult basis.

Let me explore for a minute why that is. I've mentioned three factors.

1) American households are still in the midst of a long-term deleveraging exercise. That means that they are saving more in order to pay down debt and spending relatively less, and keep in mind that consumer spending accounts for 70% of American GDP. It's easy to forget how leveraged American households were at the 2007 peak. The average household – I always find this figure astonishing – carried debt equal to about 140% of its income and that over-leveraging or high leveraging had occurred primarily because housing values had soured, households felt wealthier and they were more comfortable increasing their borrowing and their spending. And then, just as they were way out on that borrowing limb, the bottom fell out and the

average American household lost 20% of its net worth from peak to trough – and that's a big number – as home values and financial values fell sharply.

In other words, they were at the point where the average American household had debt equal to 140% of its income and just at that point the bottom fell out and it put them in a really quite terrible position.

Now they're steadily climbing back off that limb but the key point is they have a way to go. Household debt is down to about 110% of income but the long-term historical average is approximately 90% and often these pendulums tend to overshoot; they overshoot on the one side with a figure like 140% and it wouldn't surprise me if they overshoot on the other side before it's done and actually come down below 90%.

Beyond that household attitudes in the United States towards debt and spending have profoundly changed. A couple of months ago there was a very – I thought – important survey run by Allstate Insurance in the National Journal magazine on attitudes toward spending and debt and 75% of respondents said that they intended to pay off every dollar of debt they had including mortgage debt and never incur another dollar of debt. Think about that. Because of course in a normal recovery consumer debt rises and that assists the expansion, as people borrow they borrow too, buy durable goods, they borrow for other purposes associated with expansion.

2) The number two factor inhibiting recovery has been the sluggish lending market. Large corporations are doing fine. They have access to the public credit markets and those are buoyant but the banking system in our country is recovering quite slowly. Total commercial and industrial loans as reported every month by the Federal Reserve now total about 1.3 trillion in the United States – that's down from the 1.6 trillion level of 2008 – and it shows you how weak the banking system is or levels of bank lending, and that reflects both the regulatory pressure on banks which is sensible but is intense as they rebuild capital and generally shrink their balance sheets which means reducing their assets and the primary assets are loans, and the psychological shift which has occurred within every one of these institutions where four years ago every loan was a good one – or every loan application – and now every loan application is effectively a bad one. It's a phenomenon we've seen time and time again in finance, but it's important.

Now just in the past two months lending levels have begun to improve. We'll see whether or not that's an authentic turn but to date this has been a factor which is suppressing recovery.

3) And the third factor is our profoundly weak labour markets. Yes they are weak in part because the recovery itself is weak, but their continued weakness also inhibits recovery because the jobless and those with immediate fear of becoming jobless are not able to spend, not willing to spend.

I'm sure you've all seen the recent headlines on a lower employment rate and a goodly rate of job creation in the United States – particularly last Friday there was a strong number – but that masks a very deep weakness in American labour markets. There has not been as much recovery in other words as the unemployment rate improvement would suggest and I would direct your attention to the labour participation rate and the very simple employment to population rate neither of which have meaningfully improved since the worst point of the great recession.

So the unemployment rate in effect reflects that the labour force has shrunk as people have left it – and keep in mind the unemployment rate measures people who are unemployed and looking for work; it does not measure people who are not looking for work and it does not measure people who are working part-time and would prefer to work fulltime. It does not measure people who have gone on disability, and there's been a big surge in that. So the US labour markets are weaker than they look unfortunately. I could talk about other factors including housing, but these are the big ones.

Then let's turn to Europe. In my view what's happening in the eurozone represents the convergence of three crises into one.

The first involves weaknesses which were inherent in the original design and the origins themselves of the eurozone. One, the sheer lack of compatibility among the 17 very different countries, countries that are financially very, very different like Italy and Finland, countries that are culturally extremely different like Greece and the Netherlands, and the difficulty – because this is actually a rather unique historical experiment – the difficulty of knitting together countries as disparate as these.

Then the lack of an enforcement mechanism – we've all read about this ad nauseum in the past few months – for the deficit and debt ceilings which were established by the Lisbon Treaty. Deficits of course were not to exceed 3% of GDP, Federal debt not to exceed 60% of GDP but there was no method of enforcing them and of course they weren't enforced and Greece, Italy and so forth illustrate that.

There also was the ambiguity it seems to me on the mission of the new Central Bank, the ECB, and simply its undeveloped state as a new institution.

Early on it was largely a creature of Germany and emerging in its early days as a wider version of the very conservative and limited Bundesbank. And in that vein it was less than a year ago still that the ECB actually raised interest rates on the fear that inflation might be raising its ugly head.

You had debates about whether the ECB should be lending directly to the weaker countries, in effect a sovereign lender, or whether it should be in the mould of the US Federal Reserve, a guardian only for the soundness and stability of the financial system. Finally, a month ago, it acted boldly and in my view admirably in mid-December, in an American-style move and that move has been received very well. I'll come back to that.

And finally there was the removal of the self-correcting mechanism which had assisted Europe for decades, namely the appreciation and depreciation of individual currencies to smooth out big differences in competitiveness. In the old days a stricken Greece would have proactively depreciated its currency, the drachma, by cutting local interest rates for example, to boost exports and to give a spur to growth. And a soaring Germany would have seen its currency strengthen, like for example the Swiss Franc did until recent months, and seen its exports weaken accordingly. Today the only alternative for the stricken is austerity and the problem with austerity is that it has a pro cyclical effect not a counter cyclical effect, weakening economies further in the short-run at a time when they fundamentally most need growth.

I don't know whether the euro founders initially understood these flaws but I'm sceptical of it. That's the first crisis which Europe is suffering.

The second of course, the credit market collapse and the great recession of 2008 and here it's very instructive to see the path which the United States took and the path which Europe did not take.

In the United States the authorities subscribed to the time honoured principle of responding with overwhelming force and responding very swiftly. And so our Federal Reserve established $13 trillion of credit support for the US financial system within six months of the collapse of Lehman Brothers and our banks were required to aggressively recapitalize themselves, including with the assistance of the TARP. We enacted $1.5 trillion of fiscal stimulus over three years to cushion the recession and to restart growth and those steps have had a cathartic effect. Our financial system is stabilized, our banking system is much stronger, everyday actually, and of course we've resumed growth and we've resumed creating jobs.

Now Europe took none of those steps. There was no comparable monetary intervention, there was no bank recapitalization to speak of, no fiscal stimulus.

In my view it's not a surprise then that America has resumed growing albeit at this halting rate and Europe has not.

And finally of course the crisis we see today, the sovereign debt and banking crisis which is now raging, I think that's a product of the first two factors I mentioned. It isn't clear to me today whether the European leaders will successfully surmount this or not. If you look at bond spreads right now in Europe they do not suggest that the crisis is waning. Germany's ten year notes are yielding 1.75%, Italy's about 6%. Many emerging countries like Mexico are borrowing at much lower rates than the key European countries other than of course Germany, in some cases at about half the rate of the comparable maturities. That's a phenomenon we've never seen, to the best of my knowledge, in the history of the world.

I mentioned the move the ECB made in mid-December. I admire it. It lent a very large amount, 600 billion in US dollar terms, over three years, not short term in the banking system against a very wide pool of collateral, basically whatever collateral you have they'll take it, and it was a powerful move. There was also the implicit signal that if necessary they'll do it again and this is a double-barrelled move because it provides the necessary liquidity over a meaningful term, three years to the banking system, and also allows the stronger banks if necessary to buy more sovereign debt. I'm sure most of them don't want to do that but if necessary they can do it. And if the ECB continues to act aggressively like that perhaps it will buy the European authorities enough time, which I would say would be at least a year, to install those types of central controls on deficits and debt that I talked about and to recapitalize the banking system, which are the two biggest requirements I think to stabilize the eurozone in financial terms.

But right now it's hanging in the balance, it's very dangerous and of course one consequence is that the eurozone – and in fact the EU as a whole – is expected to suffer negative growth this year, to have a recessionary year, which is very unfortunate following almost three years after the great recession.

Let me now spend a moment on China. We could spend the whole day discussing the whole complex of emerging markets, and in fact we could spend half a day talking about China itself, but this is the biggest variable in this category and it's the most difficult in my view to read. Of course China's the biggest of the emerging markets and projected to surpass the United States as the largest economy in the world, around 2025.

At one level China is powering forward on a growth path which is the envy of all the world. China grew 9% in 2011 – the lowest forecast I've seen for 2012 is about 7.9% - and every nation in the world would like to have growth rates like that. In addition, China has accomplished a feat never before seen in the history of this world which is it has lifted 440 million human-beings out of poverty over the past 20 years. That's never happened in a period like that in human history and actually there's never been a growth spurt on the part of a major country like China's had in the past 20 years ever. And the medium term consensus is more of the same. Almost all the forecasts for China, if you look ahead five years or ten years, straight up.

But China is facing a series of big structural challenges and they lead me to conclude that the next ten years are not going to be straight up. There is the demographic problem. China's population – and I notice that a lot of people don't focus on this – is for example older than America's. Its working age population will peak in five to ten years and then begin to fall. There is this slow weakening of the model which China has used over these past 20 years to drive this phenomenal growth and phenomenal achievements and well-being of the society. And that model has been an investment driven and an export driven model.

The investment share of GDP in China is nearly 50% – that's extraordinarily high by any historical standard – but China can't continue at that rate indefinitely because the returns on that investment, for example infrastructure and housing, are falling and will continue to fall and eventually, by definition, will become zero. In other words, if you travel to any number of China's cities other than the obvious, Beijing and Shanghai, you see that what's driven the growth in those places is infrastructure; rings of highways, huge housing projects. But there's a finite life to the degree in which you can invest successfully doing that and China is out there within the next five to ten years facing the prospect of declining and maybe disappearing efficiency of doing that.

And as for exports, the two biggest Chinese export markets are the US and the EU. Obviously as we've just discussed they're both weak and because of China's internal inflation rate, which is a lot higher right now than the US or Europe, it's currency actually is appreciating in real terms about 10% a year which if the Chinese authorities could wave a wand they'd like not to see.

And you have the octopus-like role of the state in Chinese enterprises in the Chinese economy. State owned enterprises account for 40% of China's GDP. China has 42 companies on the Fortune 500 global list, all but three of them are state-owned enterprises. 75 of the 100 biggest publicly traded Chinese companies are state-owned enterprises, and the question of course is do these state-owned enterprises actually realise, are they actually profitable, do they actually realise a positive return on capital or on equity or investment and there are a lot of people who think the answer to those questions in a real sense properly measured is no.

So it's just a matter of time before China has to begin the shift to domestic-led growth as compared to export-driven growth, and consumption-led growth as compared to investment-driven growth. This is going to be a very hard adjustment and the reason I don't think it's going to be straight up for the next ten years is just how difficult it is to do this.

For example in China the consumption share of GDP actually has been falling. It used to be 50% now it's 35%, and that shows you how hard it will be to make this adjustment. So over the next two, three or four years I think you'll see China continue to experience high growth. Will it still be doing so in ten years, I would say the jury is out on that.

Let me close then with a few comments on the political outlook in the United States. First, there's not going to be any serious legislation in the United States in 2012 – there never is in a presidential election year absent a crisis that requires it. The only thing I think you'll see happen is that the payroll tax and emergency unemployment benefits which were extended for two months at the end of last year and expire at the end of February this month, will be extended through to the end of the year. That'll be the only action that's foreseeable. There won't be a budget adopted. Instead there'll be a continuing resolution and so forth. No tax reform legislation.

Second, it's too early really to read polls but the economy will be the determinant or the primary determinate of the outcome of our elections in November both at the presidential level and at the congressional level.

At this very moment President Obama has opened up a lead, this is all in the last one month. His approval rating has returned to approximately 50%, that hasn't been seen for a year and a half or so. In the head-to-head match-ups as they call them, he leads all the possible Republican candidates and he's in a pretty strong position on the betting sites. There's a good one called *Intrade*. A lot of people follow it; I follow it. He's at 60% probability of re-election on *Intrade*. Three months ago he was at 49%.

But it's the economic trajectory in 2012 which will be the decisive factor and here, apropos of my comments at the beginning, it really isn't clear how this year will unfold in light of how profoundly weak the American recovery has been so far.

If a forecast for 2012, like the Goldman Sachs one, should materialize – and they have a very good economics department – it will be a very close difficult election for the President. Now their forecast has 2% real growth in 2012 and a year-end unemployment rate of 9%. We're at 8.3% now, so under their forecast the employment rate's going to come back up. I happened to speak to their chief economist yesterday and they're sticking with that forecast.

So if that forecast materialized this is going to be a very close election and a very challenging one for President Obama but if we see another year like last year where reality contradicts the forecasts, and this time on the high side, the opposite could occur. This time last year, if I'd been speaking right here at this podium a year ago today, the forecasts for 2012 on American growth were very healthy. People expected about a 3% year on growth and progress in labour markets and so forth, and as we discussed at the beginning of these remarks that's not what happened. We had 1.6% growth and we had really no progress on labour markets.

So it's very unclear as how the American economy will perform in 2012 and whether it will assist President Obama's re-election or whether it will impede it. And remember, at least in our country in presidential politics, it's the trajectory of the economy that's more important than the absolute levels. In other words, if growth is rising and unemployment is falling, it's more important that those trends be established than the absolute levels of GDP itself and employment. We saw that in 1984 when President Reagan was re-elected with a 7.2% unemployment rate but it had been improving a lot leading up to the election and everybody felt that we were on the right track and going to turn the corner.

As for our Congress, our legislature, it's really hard to guess. The conventional wisdom today is that it's 50-50 on which party ends up with control of our House of Representatives. Right now the Republicans have a 25 seat majority. On the Senate the Republicans are narrowly favoured to take control of the Senate because they only have to defend ten seats this time and the Democrats have to defend 23.

But in political terms the election of November 2012 in the United States is so far off it might as well be the election of 3012. So many events will happen, internationally – they could surround Iran, they could surround Syria, they could surround Israel – domestically in terms of the economy and all kinds of other issues. It's just too far off.

My own guess is that you will not see either party control all three sources of power. You won't see one party end up with the White House, the Senate and the House because the voters don't tend to like that. They tend to like divided government and the check and balance aspect of divided government.

Finally, and this is my last point, there's going to be a fascinating moment in our country at the end of 2012 because all of the Bush tax cuts are going to expire, not just the so heavily publicized high income tax cuts but *all* of the tax cuts, most of which were middle income tax cuts like the expanded childcare tax credit; they all expire. At that time also the debt limit will have to be raised again. We saw how ugly the fight was last summer about that. In addition the payroll tax extension which I believe will be made until the end of the year that will expire. And the ten year $1.2 trillion set of cuts, half defense, half non-defense which were automatically triggered when the so-called 'super committee' failed in September they begin at the end of the year.

So you have this amazing confluence of giant events and all in the context of what we call a lame duck session of Congress; in other words, the election's been held, the new Congress hasn't been sworn in, these things happen or expire in the hands of the old Congress some of whose members will have been voted out of office but are still sitting there.

This has the possibility of being not just fascinating but a giant train wreck. And it seems to me that if the Republican candidate, probably Governor Romney is elected, then the simple thing to do from their point of view will be to extend all these things for six months, give the new Congress time to come in, give the new president time to settle in and pick his team and deal with it six months later. But if President Obama is re-elected – and if I had to bet $5 I'd bet that – he's not going to want for example the high earner of Bush tax cuts to be continued. He is going to oppose that fiercely. He needs the revenue from a deficit reduction point of view, he doesn't believe in those, and now he'll have the ability to veto them and presumably have that veto sustained, so he can get rid of them.

So it's going to be a fascinating historical moment at the end of this year. It could be really quite unique. On the other hand it could be a real mess. So I have to go and pick up my Swiss passport now and I'm going to stop my comments but I hope you enjoyed them. I'm happy to take any questions you'd like to ask.