

Moving East: The shift in the world's economic centre of gravity

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Mr President, my lords, ladies and gentlemen, good morning.

This conference comes at a difficult time for the world, for Britain and for British business.

We are living through what can now clearly be seen as the worst financial crisis since 1929, and probably the most complex ever. Moreover, it is now clearly impacting real economies, which are in - or moving into - recession in a variety of countries, including of course the UK.

So the urgent challenge, as the Prime Minister has just said, is to work hard to mitigate the impact of recession and eliminate any risk of a downward spiral into depression, with all the dangerous consequences that would have for the world as we know it.

I believe strongly that the policy response internationally

has been increasingly radical, increasingly well coordinated, and broadly appropriate.

Deep cuts in interest rates have been facilitated by fading concerns about inflation and massive injections of liquidity have helped begin a thaw in the interbank and commercial paper markets.

And governments have stepped in to resuscitate a number of banks and other financial institutions. They have become 'owners, or part-owners, of last resort' – a decision that I am sure was as unpalatable for governments to make as it was for the private sector. But it was undoubtedly the right decision.

The alternative – complete financial meltdown – was unthinkable. Pragmatism not dogmatism was in order, and gov-

ernments, including our own, should be congratulated for acting decisively and comprehensively in their policy responses. The support for the financial system, combined with actions by central banks to slash interest rates and create fiscal stimuli should prevent recession from descending into a depression.

It is said of King Solomon that he had a servant whisper to him repeatedly – when things went well and when things went badly - "this too will pass." Well painful as it will be, this too will pass. But when it does, there will, and should, be no return to the status quo ante. And I want to make four main points about what the new environment will, and should, look like.

First, we need to recognise that the current turmoil has as its background, a fundamental shift

in the world's economic centre of gravity, a trend which will continue over the next generation which will not, I believe, be derailed by the current crisis.

Because the current crisis reflects a much wider dynamic at work. A dynamic that will change the world economy as much in the next half century as it has changed in the last. It



is part of the fundamental economic shift that is re-shaping the world we live in and creating a new global marketplace for the 21st century.

This economic shift is not a new phenomenon. For the last two hundred years the world's economic centre of gravity has been centred on Western economies, latterly the US in particular. The G7 today still claims over half of the world's wealth, as measured by GDP, although it has only 11 per cent of its population.

In the last two decades, the economic hegemony of the in-

dustrialised world has been challenged by the rise of emerging market economies, particularly in Asia. And within Asia, the world's two largest populations, China and India. Their rapid growth has been an astonishing boon for humanity, creating and spreading wealth to hundreds of millions of people. The proportion of the world's population

living in extreme poverty has dropped from over a third of humanity to under a fifth in 25 years.

The rapid growth of these economies has created what can perhaps be described as a macro-economic triangle.

The triangle is made up of, on one side, consuming nations – in particular the US but also the UK and a number of other Western economies. On another side you have what might be called the “workshop nations” – mainly the fast growth emerging markets, who have been manufacturing a vast range of goods

for consumption in the West. And the triangle is completed on the third side by the resource providers – those economies whose wealth of hydrocarbons and other commodities have been commanding such high prices in recent years.

Consumer goods bought in the West, made in the East, using resources from commodity-rich nations.

This triangle has delivered the very strong global growth in the last decade, but it is inherently unstable and it has given rise to the financial imbalances that lie at the heart of this crisis.

The workshop nations and resource providers have accumulated massive savings, a large proportion of which has been invested in the world's reserve currency, the US dollar.

This investment had consequences. The equity collapse at the beginning of the decade had prompted institutional investors to move out of equities and into fixed income investments. But yields in the bond markets were significantly reduced as they drew in the surplus liquidity from emerging markets – over 50 per cent of US treasury debt is now owned by foreign investors, with China overtaking Japan this year as the single-largest holder.

So investors started moving their money into mortgage backed securities, which seemed to fit their requirements

of higher yields with – apparently – limited risk. And this in turn stimulated huge growth in these securities – and for good measure, also changed the funding model for banks. In 1990, just 10 per cent of mortgages in the United States were securitised, compared with 70 per cent in 2007.

The combination of a tidal wave of liquidity and the search for yield produced rising risk/reward ratios, with investors moving up the scale, even as the scale itself was rising.

This cheap money in the US also fuelled a consumer boom and rising house prices. It prompted both consumers and banks to, in the jargon, ‘leverage themselves up’ and so created the ideal breeding ground for a massive bubble.

Loose monetary conditions in the US and in much of the emerging world gave added potency to this already lethal cocktail.

It was inevitable that this bubble would burst, and after the party we are all feeling the hangover.

Nevertheless, it is equally important to grasp that this fundamental economic shift to emerging markets will continue.

In the short-term, there are downside risks to emerging market growth. The recession in many of the world’s Western economies will inevitably affect the exports of emerging

markets. It may no longer be the case that when America sneezes, Asia catches a cold, but there will be a few sniffles.

The effect of Western recession will be both direct – on the workshop nations, for example as demand reduces. For evidence of that you need only look at the costs of shipping, which have dropped by up to 90 per cent for some cargos this year.

And it will be indirect, as resource providers are affected by lower demand for energy and other commodities. The decline in oil prices and other commodities from unprecedented highs shows that clearly enough.

But the long-term fundamentals have not been changed by the economic crisis. Fast growth in emerging markets will continue for at least a generation as more people come into the market, creating rapidly growing investment and consumption demand – and thus, by the way, ensuring that recent weakness in commodity prices will not last.

Earlier this month, the Prime Minister spoke about expectations for the world economy to double in size in the next 20 years. But individual economies will grow at different rates and the share of the global economy of mature and emerging markets will look radically different.

On the most recent figures from the World Bank, high income countries – those above 11,000 dollars GDP per capita

– account for around 60 per cent of the global economy. If you apply the growth rates we see today to emerging and high-income economies – at the end of two decades the world economy will have doubled but the high income countries will only account for less than half of the global economy. And of the 60 trillion dollars of growth, about 40 trillion, two-thirds, will come from emerging economies.

This is a massive shift. You can see why the axis of the world economy is moving East. And if you have visited Shanghai or Bangalore or Hanoi recently, you can literally see it happening in front of your eyes.

To my mind, there is only one real risk to this forecast. And that is the risk that protectionism will gain ground as people and economies endure the pain of recession.

For what it’s worth, and notwithstanding the grandstanding by politicians in some countries on this – I believe that protectionism will be confined largely to words, rather than actions. I should say that the UK, with its long history of openness is a clear exception here – we have an honourable and bipartisan tradition of openness to the world which dates back now many years.

My second point is that we need to be careful and avoid learning the wrong lessons from all that has happened.

There are plenty of lessons we should learn, of course – for banks, for regulators, ratings agencies, investors and borrowers. Banks became overgeared and too dependent on wholesale funding. Regulators did not pay enough attention to liquidity management in the banks. Ratings agencies were too ready to work with structured product innovators to help achieve high ratings, which, as it turned out, did not stand the test of illiquidity. Investors chased yield and forgot the “too good to be true test”. And borrowers have too often succumbed to the temptations of jam today which was proffered too freely by lenders.

So yes, there are some hard lessons to be learnt. Less gearing by banks and by borrowers; less dependence on wholesale funding by banks; avoidance of product complexity that meets no real need; realism about returns and avoidance of short-termism by investors; realism about affordability by borrowers.

There are also a number of very technical issues to be addressed in the public arena. In the accounting world, for example, there are implications for policy because of the way fair value accounting has operated in markets which have effectively broken down. This and other topics such as regulatory capital adequacy and prudential liquidity management

will require careful debate in the months and years ahead.

But equally, there are important lessons we should not learn.

It is neither possible nor desirable to turn the clock back and to do without capital markets or securitisation. It is neither possible nor desirable to return to the days when all financial intermediation was carried out through banks’ balance sheets. It is intrinsically inefficient in a modern economy. Capital markets are the crossroads of capitalism, where the providers and users of finance come together. And as capital markets today are borderless, we need to accept that national economies are inextricably interdependent.

Likewise, there is no workable alternative to the market system as a whole. And despite the plethora of articles on the “end of capitalism” and the schadenfreude engendered by some institutions that are symbols of capitalism taking taxpayers’ money, we should never forget that markets are a prerequisite for successful, vibrant, modern economies. We have an imperfect system. Governments have had to intervene in markets before; they will again. But for all the obvious problems and issues, to paraphrase Churchill on democracy: capitalism and free markets are the worst system, except for all the others that have been tried.

It is important in the midst of this crisis that we remember the extraordinary achievements that free markets – and free capital flows are an important component – have made possible over the last few decades. They have allowed hundreds of millions of people to lift themselves from poverty, to raise their standards of living and open new doors of opportunity.

But free markets are in the dock because confidence has been destroyed. The market system, the capitalist system, is at its heart about trust, and nowhere is this more true than in banking. The word credit actually derives from the Latin word *credere* meaning ‘to believe’. So when we talk about a credit crisis, we are also talking about a crisis of confidence, and this brings me to my third key point.

If we are to restore trust and confidence in the financial markets we must address what is at its root a moral question. Trust and confidence cannot be restored overnight and they cannot be restored by fiat. Actually, the process of renewal has to begin with a recognition of the moral dimension to what has happened. It is as if we have grown increasingly accepting of the idea that the value of what we do is fully delineated by the market, by regulatory compliance, and the law of contract. If the market will bear it, if the law allows it, if regulations permit,

then it must be OK.

Yet we all know this isn't good enough. We have to recognise - Boards, managements and owners alike - that values go beyond "what you can get away with", and that values are in the end critical to value - to sustainable value, that is.

Better risk management, enhanced regulation, codification of Directors' responsibilities in company law - all these things are necessary. But they are not, and cannot be, sufficient without a culture of values. As individuals, we do not govern our behaviour simply by what is to that allowed by law or regulation. We have our own codes of conduct and hold ourselves accountable. We take responsibility for our actions. Companies have to do the same

For companies, where does the responsibility for this begin? With their Boards of course. It is their job, and one which by its nature will never achieve perfection, to promote a culture of ethical business throughout their organisation. True for banks at this time, but also true for all our businesses at all times.

And you know, the good news is that, certainly in my experience, the vast, vast majority of colleagues want this. They want to be able to look at themselves in the mirror and feel confident they are making a contribution. Boards and managements that take this challenge seriously

will find themselves pushing at an open door.

One specific aspect of this that has rightly received attention, so far as the financial markets are concerned, is the question of remuneration. On which I would say, that there is clearly urgent work to be done to ensure that compensation structures in the banking industry do not create unhealthy incentives to encourage short-termism and excessive risk taking. This is not a straightforward exercise. After all, staff at Lehman Brothers owned around a quarter of the company - which on the face of it looked a hugely strong incentive to stay in business. But any responsible bank will be looking very hard at this issue.

And I should say that the FSA's approach under which they will look at increasing capital requirements where they perceive incentive structures leading to excessive risktaking is just the sort of principles-based approach that is required.

Fourthly and finally: a few words, if I may, on the policy dilemma we all now collectively face.

And that is the conflict between the short-term imperatives to minimise recession and the long-term need to adjust to a world that will be fundamentally different in 20 years time.

In the short-term, Keynes has had a renaissance. We are once again, to use Nixon's phrase, all

Keynesians now. The case for adopting Keynesian measures to pump-prime the economy, cope with recession and stave off something far worse is compelling.

Yet in the medium term, we also accept that the imbalances that have contributed to this crisis must be cured. Some of these imbalances are global, others national.

From a global perspective, the imbalances created by the macro-economic triangle of consumers - workshops - resource providers need to be resolved. The world cannot rely on heavily-indebted consumers in mature markets to balance out the tendency to save that is so marked in many emerging economies.

The consumer in mature markets such as the UK has to rebalance his or her personal balance sheet, so to speak, and learn to borrow less and save more. Consumers in the UK are amongst the most over-borrowed in the world. We know we cannot go on like this. And when we look at the changing demographics of Western societies and their pension needs, the case for change is stark.

Conversely, nations with exceptionally high savings need to stimulate domestic demand and reduce their current account surpluses.

We should remember that current account surpluses were as

much a concern for Keynes as current account deficits. He believed it was difficult to accommodate countries with massive and persistent current account surpluses and that the counterpart deficits, if prolonged, always lead to financial crises.

So it is encouraging that some important countries are responding, notably China which a couple of weeks ago announced a 586 billion dollar fiscal stimulus package.

Last year, the UK individual savings rate was under three per cent. The Chinese savings rate is around ten times that. In the long term the Western consumer must save more and the Eastern consumer spend more. There lies real opportunity for UK PLC.

There are other structural adjustments that may need to be made in individual economies. In the UK, I think we need to look at the sectoral balance of the economy. The growth in the financial services sector was unusually rapid in recent years, and this rapid growth is obviously related to the rapid growth of consumer debt. But this is not the way to raise long-term growth in an economy. Maybe there have been too many engineers working in bank dealing rooms. Maybe the UK economy has become overly reliant on financial services. Maybe we need to find ways of rebalancing the UK economy.

There is no easy answer to this. I am not for one minute arguing for a resurrection of the 1960s style planning or for government strategies to ‘pick winners.’ Such a bureaucratic approach would be hopelessly ineffective in the face of a global economy which continues to flex and evolve.

Rather, getting the balance right will flow partly of its own accord, from making sure we achieve a more stable, less geared, financial market.

Another key component will be education policy and the skills base of the population – the long-term health of the economy is dependent on complex and interlocking variables.

But in general it involves us all accepting the challenges, risks and opportunities which are going to present themselves ever more insistently, as the world’s centre of gravity continues to shift inexorably eastwards – with all the implications that has.

There are no easy answers. The policy dilemma is that the Keynesian imperative inevitably, and properly, dominates right now.

The economy is already in recession and the contraction next year will be sharp. Poor GDP figures and falling sales today will translate into unemployment figures tomorrow. Real people losing real jobs. We should be in no doubt of the challenges

ahead for individuals; companies; the financial sector; and for policymakers.

A subset of this challenge faces the banks. How in a recession do you keep lending up, while not becoming an irresponsible lender? It is in no-one’s interest - not consumers, not banks, not government – for banks to be lending in a way that leads to losses. Responsible banks will keep lending. And banks need to work with clients in difficult times as well as good, on the basis of a prudent and sustainable relationship.

It will be genuinely testing to reconcile the pressing short-term needs with the fundamental longer-term imperative of sustainable global growth as the crisis passes: namely a more balanced macro-economy globally, and also in the UK. This dilemma is a challenge for us all – for government, for business and for the financial sector.

There are no quick fixes. These are complex problems and this is not a soundbite issue. It will require debate and careful consideration conducted through institutions like the CBI. And as we debate these issues, we need thoughtful reflection, commentary and opinion leadership.

But of one thing we can be sure, if we care about the economic prosperity of this country, how we change in a changing world is our main agenda. Thank you.