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The Global Growth Agenda
THE GLOBAL ECONOMIC PROGNOSIS
Arena

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Moderator:

Thomas Mayer, Senior Advisor to the Management Board, Deutsche Bank

Panellists:

George Magnus, Senior Economic Adviser, UBS Investment Bank; Author, ‘Uprising’

Vladimir Mau, Rector, Russian Presidential Academy of National Economy and Public Administration

Roland Nash, Senior Partner and Chief Investment Strategist, Verno Capital

Oleg Viyugin, Chairman of the Board of Directors, MDM Bank

Andy Xie, Independent Economist, China

Yu Yongding, Academician, Senior Fellow, Director, Institute of World Economy, Chinese Academy of Social Sciences (CASS)

T. Mayer:

My name is Thomas Mayer, and I am a senior advisor with Deutsche Bank. It is my great pleasure to welcome you here to this economists' round table on the global economic prognosis. I think it is a very pertinent topic to discuss at this point in time, in view of the many news items we have heard over the last few weeks on the state and shape of the global economy.

Fortunately, for now, the consensus forecasts that we have around us are moderately optimistic. When I use the prognosis of my own company, which is not that different from what you see from international organizations, we see global growth for this year at around 3% – so a continuation, more or less, of what we saw in 2012. But the good news is that we, like many others, see an acceleration of global growth next year to around 4%.

The main driver according to these forecasts, which, as I said, are pretty much consensus forecasts, is again emerging markets. The Deutsche Bank forecast, for instance, sees growth for that group at a good 5% for this year, accelerating to almost 6% next year. Industrial countries continue to lag behind, with about 1.25% growth expected for this year, unchanged from last year, but there will also be an acceleration to around 2% next year. In this cautiously optimistic picture, inflation remains well-contained at about 3.25% globally this year, accelerating to about 3.5% next year.

Overall, as I said, when we look at the surface, the consensus forecasts paint a fairly encouraging picture, but I think behind this seemingly reassuring data lies significant divergence in economic performance among the different groups, and also considerable risks.

To discuss what is behind these figures, I am very pleased to have an expert panel here which will go into all the aspects of the global economy, as well as the policy developments that we see ahead.

Let me introduce them. Starting on my left, we have Professor Yu Yongding. He was the Director of the Institute of World Economics and Politics (IWEP) of the Chinese Academy of Social Sciences, and he is a well-known commentator in the international media.

Next to Professor Yu we have George Magnus. He is a Senior Economic Advisor to UBS, another major bank, and, I may perhaps say, a fellow advisor, as he has a similar position at UBS as I have at Deutsche Bank.

We also have Oleg Viyugin. He is Chairman of the Board of Directors of MDM Bank, which was founded in 1990, and which, as I understand it, was one of the first privately owned banks in Russia.

On his left is Professor Vladimir Mau. He is Rector of the Russian Presidential Academy of National Economy and Public Administration.

To his left is Roland Nash. He is a Senior Partner and Chief Investment Strategist at Verno Capital, which is a hedge fund. I understand that Roland does not live in the United States but here in Russia, in Moscow. During his whole career, he has dealt intensively with the Russian economy and the financial situation here.

Last but not least, on my right is Andy Xie. He is an independent economist from China and is also very well-known to those who follow the international media, through his commentaries on economic and financial developments, especially in Asia. I think he has written and spoken a lot about the upcoming financial crisis, and has given us a lot of analysis about what went on in Asia.

Let us start the discussion. We want to keep this very open and interactive; I think this setting that we have here is rather extraordinary and very good. Normally you sit around on a stage or at podiums, which makes interaction more difficult, but this arrangement is ideal for having a true economists’ round table.

Let us start with the economic outlook. Perhaps I could ask Roland about the US, because after yesterday’s performance by Mr. Bernanke, the US Federal Reserve Chairman, which was widely anticipated by the financial markets, everyone was almost in a feverish state of expectation as to what he would say on the economy, and of course on policy. He came out with a fairly constructive economic outlook for the United States. What is your take on this? Can we be reasonably sanguine that the US is on course for about 3% growth in the coming year?

R. Nash:

Thank you, Thomas, and thank you for the introduction and for inviting me to speak at this fantastic round table. The feverish excitement that surrounds any comments by Mr. Bernanke is, I think, actually part of the issue that exists today in financial markets in general and the US in particular, and I will come on to that in a second. The US economy is a magnificent, exceptional beast. The excesses that built up in the US economy before 2008 were instrumental in creating the crisis that we have been trying to recover from over the last few years. The excesses in terms of the scale of the borrowing, the sources of that capital coming from abroad, the intermediation of capital, and the misallocation of resources that resulted from that process created asset bubbles in the US and elsewhere that, when they collapsed, were a major cause of the US crisis and therefore the global crisis.

However, at the same time, the US is an economy which has the sort of market conditions that are able to generate truly world-beating companies and world-beating technologies continually, and this has been happening over a very long period of time now. For example, you have only to look at the revolution in shale oil and shale gas, and not only that but also in biotech and all of the other industries that have come back after the crisis. The creative destruction in the US is a model, I think, that could be exported anywhere in the world, so there is this very fundamental underpinning of the growth rates in the US.

But at the same time, one of the major responses to the crisis in 2008 has been an excess flow of funds into the US. Quantitative easing (QE) may have been a necessary response to prevent the sort of impact that you could have had otherwise: proving the counterfactual is very difficult, but the impacts otherwise could have been much worse. However, one result of that is a long period when capital has been available at very low levels, and, given our experience in 2008, I think it would be a mistake to assume that you would not have the same misallocation of resources that caused the crisis in the first place in 2008 building up in the US again. If we have learned any lessons, then that, presumably, is one of them.

In conclusion, I think that, in terms of the outlook for the US economy of 3% growth, it feels like it should be around those levels because of the huge competitiveness in the underlying US economy. However, I think that the sustainability or surety of that economic growth is now much lower than perhaps it has been in the past. There are time bombs building up in the US economy.

T. Mayer:

That is interesting because I have to say I am always impressed by the ability of the US to react very flexibly to new challenges, and I am hearing a lot of talk about the re-industrialization of the US, the comeback of manufacturing and industry, helped, of course, by cheap energy from new discoveries. I find it very interesting that you say that there may be dislocations building up. Can you already see where these might emerge? To me, it seems that the situation there could be perhaps not more buoyant but more solid than it was when it was just built on huge credit expansion and financial services and housing. What do you see as a potential tripwire?

R. Nash:

The wonderful thing about financial markets is, if we could actually see that there was an inefficiency, it probably would not exist. Almost by definition, we do not really know where these problems are likely to build up. But when you have a period where the cost of capital is being defined – for all the right reasons, perhaps – by a governmental body, during extraordinary monetary conditions, history very strongly suggests that that capital finds its way into asset clusters.

If you look at the historical highs that we are seeing in certain debt classes, it is at least suggestive that in some of those debt classes, there may have been a misallocation of resources and mispricing. Mispricing on the kind of scale that we have seen over the last three or four years suggests to me that you will have negative results.

T. Mayer:

So this could be the dark side of QE, so to speak. Probably the initial stabilization of the banking system was very important, the replacement of inside money which was destroyed. The private sector credit and money contraction as a result of the Federal Reserve balance sheet expansion was probably a good thing, but your concern would be that perhaps they have overdone it, and now they are trapped?

R. Nash:

Yes, we have lived through the crisis, and I think the next stage is living through the response to the crisis.

T. Mayer:

Very good. Moving on, China is also going through lots of change, but of a different nature. China is trying to curb its export orientation and strengthen its reliance on domestic demand; in other words, to find a more balanced growth model. I am struck, being from Germany, by how China's current account surplus has already come down. I come from a country that seems to be stuck with a 6–7% current account surplus relative to GDP, so I am impressed by how China's current account is adjusting. On the other hand, there is a lot of concern in the market over whether the change in the model will run smoothly or whether we will see a larger drop in growth.

Professor Yu, what is your take on this? Is China on the right track? Can we be reassured that the new leadership in China will keep us on an expanding path?

Y. Yongding:

Actually, I think China is facing a huge challenge at this crucial period in time. Over the past 30 years, the Chinese economy has been truly remarkable, and we have had a growth rate of something like 10% for almost 30 years. I think that the end of this high growth rate has come, because China's growth pattern, although it has been quite successful, is no longer sustainable. China has to shift its growth pattern as quickly as possible.

We actually talked about this necessity more than 10 years ago, but due to lots of constraints, we postponed this transformation for too long. We are actually facing even bigger problems than 10 years ago. Ten years ago, we postponed the launch of the big transformation because, at the time, we thought the timing was perhaps not so good. We were waiting for a better time. Now we have seen that the timing may not be too good in the future, either, even though you just gave quite an upbeat forecast for the US economy. I am not sure; I have been watching the Japanese economy for more than 20 years and during these 20 years, I was convinced by many Japanese economists and government officials that the Japanese economy was rebounding. Then, only one or two years ago, the economy dropped again, so perhaps the economy has entered a new stage of slow growth; I do not know.

Anyway, for China, we need to seize the timing this time to push our reforms through as quickly as possible. I think, from the supply side, that the Chinese economy has to slow down. For example, if you try to draw a Phillips curve using data from 2000–2010, you obtain a rather flat curve. But now this Phillips curve is becoming quite steep, which means there is room for the People's Republic of China and Chinese Hong Kong to manipulate the economy to make it smaller and smaller, because if you want to have a higher growth rate, then you have higher inflation. This is not like it was in the past, when if there was a slowdown in the economy, you introduced stimulus packages and the economy would grow quite strongly. I think this is no longer the case. This is a supply side economy. This is the case because labour costs are rising very rapidly; according to the Chinese authorities, the minimum growth rate for wages should be no less than 13% per year. This is now the law for all regions in China.

At the same time, the Chinese have become more concerned about environmental costs. If you produce goods, and if you disregard the environmental consequences, you will be punished. This means enterprises have to commit more money to ensuring clean air, water, and so forth. Production costs are increasing, so I do not think that China will be able to maintain its very high growth rate. Now we are talking about growth in the range of 7–8%, which is still very good, but some Chinese economists argue that perhaps we will not be able to maintain even 7%, and it will actually be less than that.

Personally, I think that 7% is still fine for China. We will be able to maintain growth of 7%. But at the same time, we have to really change our growth pattern. In the past, we relied on investment. Investment growth rates are usually more than 14% in real terms, much higher than the GDP growth rate. This means that China’s investment rate is more than 50%, which is way too high and which causes many problems.

At the same time, China has been depending on exports too much. In 2008, the current account surplus-to-GDP ratios were more than 10%; that is too high. Of course, over the past several years, we have been making progress. Now, I think that the ratio is less than 2%. I think this is progress, but it also causes problems for employment and so on.

We are facing many dilemmas, but we know that the past growth pattern is not sustainable. We have to really seize this time to carry out reform as quickly as possible to change the pattern. Perhaps we still have a five-year window of opportunity, but if we fail to fundamentally change this growth pattern, then we will face even bigger problems.

T. Mayer:

Now I understand better why the Chinese current account surplus is coming down. Of course, in Germany, where I speak from my own personal experience, we have rising energy costs, given that we have decided to get out of nuclear power, which raises the cost base. But we still have very moderate wage growth compared to China; we are just approaching wage growth of 3% perhaps, as an average for the economy as a whole.

What you say about wage growth is very interesting because I think the world has, for quite some time, benefited from the low cost and therefore low price of exports from China. What I hear you saying is that we have to change our expectations. Chinese exports will get more expensive; there will be higher costs for environmental protection and higher wage costs for industry, so we can no longer rely on China as a deflationary force for the global economy.

Y. Yongding:

I hope so. I think the Chinese government has started this kind of transformation, and of course it will cause problems in the short term. If the government does not have a very strong nerve, they may change their mind. I hope they will not change their mind.

Actually, in my view, we are quite stupid, because we have run current account surpluses and capital account surpluses for more than 20 years. As a result of these two surpluses, we have accumulated more than USD 3.4 trillion in foreign reserves. For what? We are waiting for the Federal Reserve to inflate away this debt burden. That is good for the United States; it is not good for China.

T. Mayer:

You are a bit wiser than we were in Germany. You were investing in the US Treasury; we were buying American mortgage papers!

On Japan: Andy, we are witnessing a revolution in Japan. I have been travelling to Japan since I entered the industry in the early 1990s, when there was still a bubble there. I have been coming back year after year, and there was this long phase of misery, but with ‘Abenomics’, as it is now popularly called, it seems that Japan, after a long, deep sleep, has tried to make a leap forward and almost become revolutionary.

We have seen two of Mr. Abe’s arrows being fired: the monetary easing and the smaller fiscal arrow, and we are waiting for the third. Is that going to give the Japanese economy a new lease of life? What is your take on this?

A. Xie:

I am not optimistic. I think talking about a revolution in Japan is a long shot. The Japanese maybe have a revolution every 100 years, so when you bring up revolution, you have to be very careful because the Japanese do not change.

Abenomics has become very popular in financial markets. The stock market almost doubled and the yen went down. A lot of people made money, so they want to cheer it on: “It is a good game; keep it going!”

If you look at what has been going on in the financial market over the last 20 years, anything hot is a bubble. There has never been an exception. Why should this be any different? I think that the Japanese themselves may not know it, but this is really a bubble. Japan does not have an employment problem, so what is the macro stimulus about? They say, “It is deflation, so we need to cure deflation so that the economy will come back.” Deflation is really a symptom of something else, like declining competitiveness. Japan has not had a hot company for 20 years. Their economic decline is related to the fact that the world has moved on and Japan has not changed. I think that trying to use a macro policy to deal with the competitiveness issue is not likely to work.

Regarding the so-called three arrows, the first two are really easy: printing money and spending money. It is the same as what America is doing now. Everyone is optimistic about the US. I am not sure. I think Bernanke is building up this gigantic bubble again. US household wealth is now 20% higher than before the crisis, and before the crisis, that was considered a big bubble. Now it is a bigger bubble.

T. Meyer:

So the Japanese want to join in as well now?

A. Xie:

Yes, basically the Japanese have become envious of what America is doing. They say, “Oh, look, they are happy again. We have been miserable for 20 years. We should do that.” All the hedge fund managers are egging them on, saying, “You should do that; you will be as happy as the Americans.” Abe is trying to cheer everybody up: “Just be happy, spend money, the stock market is going up, right?”

I think what is going on is that the Japanese cannot do a bubble properly. The Americans have been doing bubbles for a long time, so they are very experienced. If you look at what Bernanke is doing, it looks as if he is going to retire in January, so he does not want the bubble to blow up in his face. He wants it to remain intact until he leaves office, so he talks about tapering, “pour some cold water on that”.

There is a Chinese saying: “when you cook a frog, you have to heat the bath slowly.” This is so that the frogs die without knowing that they are going to die. The Japanese do not know that. Looking at what will happen in six months, expectations are very high. You cannot meet these expectations, and then the whole thing blows up.

You talked about the third arrow, structural reform. Structural reform is really about corporate competitiveness. How can the government achieve that? You have to encourage entrepreneurs to create new businesses. That is a long-term process. It is not something that you can make happen in a year or two.

I think, firstly, that Abenomics has really peaked: the situation in the stock market and the currency market shows that. I do not believe the Nikkei will surpass its peak again this year. This is done. Next year, we will see what this really is. It is really about a government deficit in spending. The Japanese government borrows more than 50% of its expenditure. That is already 230% of GDP. How can you keep doing that? The real game should be fiscal consolidation. In the next couple of months, we will see if they have a game plan for fiscal consolidation.

I am really not optimistic about what will happen next year. I think that in the last five years, cheap money has built up so many bubbles. The Japanese bubble is the latest thing. As cheap money recedes, you are going to see a lot of explosions along the way, so do not go out and take a lot of risk in the next year. Hold onto your money. A lot of people want to take your money away.

T. Meyer:

I think you are building up an interesting theme between the US and Japan, and I would definitely like to come back to that when we go on to discuss policy and policy challenges.

Looking at the forecast that my own colleague has for Japan, let us see if you would strongly disagree. He says there will be 2% growth this year and 0.8% next year. Do you think that that is probably still too generous?

A. Xie:

I think the economic forecast is talking about 1% or 1.5%. I am not sure if that is really the real gain. Look at the US: the US economy rose by 2.4% in the first quarter and nominal GDP rose by about USD 100 billion. Household net wealth increased by USD 3 trillion. So what is the real gain? The real gain is in the asset market. GDP is kind of a rounding error. When the asset market is going up like this, GDP is unpredictable.

If you look at Japan, the stock market doubled. We are talking about a couple of trillion dollars in increased asset value, but nominal GDP did not really increase. And people are optimistic about Japan’s economy. If you look at the exports and imports of the country in terms of volume, what is happening? What is happening is that the government is spending.

T. Meyer:

So what we are seeing is a bit of a mirage?

A. Xie:

Yes. As soon as government spending stops, what will we see? Abenomics is no different from what Professor Yu said: this round of fiscal spending has inspired a surge many times before. There is no difference. I do not see anything new happening. It is just the same old fiscal stimulus.

T. Meyer:

I was hoping that we could get some uplifting news from the US and Japan before we turned to Europe, where the outlook is probably very hard to paint in a rosy colour.

Let me turn to George. At least the officially published and forecast GDP numbers for the US and Japan look pretty good compared to Europe, where the euro area overall remains in recession, and it seems that Southern Europe is almost in depression. The consensus is that Europe, ‘the Continent’ – we will come to the UK in a follow-up question – will find its way gradually out of this stage in the second half. Do you see that as well, George? What is your take on it?

G. Magnus:

Actually, I did not really want to be the only bringer of bad news here today, so I am glad Andy came before me, although I have to say that I actually think the US is probably the relatively bright spot on an otherwise troubled horizon for many of the reasons that you mentioned. But obviously there are underlying weaknesses, and labour market problems, and so on.

But for Europe, what can we say has changed in the last year or so? There are some things that you might find comforting, in the sense that reform has taken place in the Southern European countries, in particular Spain, Greece, Italy, Portugal, and so on. Without the crisis, these reforms would not have happened. Whether they were voluntary or whether they were under the auspices of the troika, Spanish competitiveness is improving, and the primary structural fiscal positions of a lot of these countries have clearly improved quite considerably.

Strangely, to put a slightly grey tinge on this, the IMF predicts that by 2017, every single country in the eurozone, with the exception of Finland, will be running an external surplus. I am not sure what the IMF predictors and forecasters really had in mind. There are only two ways this can happen. One is that there is going to be a global boom which every single country in Europe will be able to exploit. I think we probably all agree that is not going to happen – although, actually, if China continues to slow down in a structural sense, I suspect there may be some benefit for commodity consumers because obviously prices will come down quite a long way, especially in the industrial and metals space. The second way is that the European countries are just going to persist with this deflation and suppression of demand.

The short answer to your question is that I do not really see any relief. From one year to the next, maybe – the intensity of austerity is going to diminish a little bit in 2013–2014, especially as the European Commission seems to be warming to the idea that maybe the pressure has to be relieved a bit. A lot of countries, as I am sure many people are aware, have been given longer periods of time, maybe two or three years of remission, in order to hit these deficit targets of 3% of GDP. That is not to say that the austerity is finished; it just means that the pressure is less immediate, it has been extended forward by a couple of years.

That is a kind of mixed reaction to the question, but if you were to put my arm behind my back and force me to say what I really think, I actually think the reason that the European countries are in the soup is because the banking system is still fundamentally dysfunctional. That is in contrast to the United States, which forcefully recapitalized the banks and obliged the banks to realize market valuations for most of their assets; I know this was not completely crystal clear, but actually it was a much stronger effort than the Europeans have made to date. I think that these problems are highlighted by all of the political issues that the Europeans have over the banking union, about recapitalizing banks and banking resolution mechanisms, which are going to be all the rage in Europe over the next couple of weeks.

Until we fix these problems in the banking sector, I do not really see any traction for the European economy. We could get a small positive increase in GDP in 2014, but I do not think that means that Europe is any different from the Japanese template of 20 years ago. I think the Europeans are much closer to that template than the United States.

T. Meyer:

Unfortunately, I have to say I agree with you on that. I would be happier if I could disagree and say I hear a more positive story for Europe, but for far too long we have lived under the illusion that our banks are safe in Southern Europe and in France because they did not play the American mortgage market to the same extent that the Germans did. Only as of 2009 did we find out that we actually have a sub-prime segment in Europe as well, but it is more concentrated in the sovereign sector. Now we are struggling with that.

G. Magnus:

That is the issue. I was going to mention that, so you have prompted me to complete a point I was going to make, which is that the continuing vulnerability of European banks to their holdings of government bonds could be a big problem. It could be the same in Japan; I do not know whether Andy agrees with that. But if there is substance to the whole issue about tapering and changing Federal

Reserve policy, not at higher interest rates, but just a kind of shift in what people expect about quantitative easing and so on, I think the Europeans could be quite vulnerable.

I think, on average, in eurozone countries, holdings of government bonds are about 15–20% of government debt outstanding, compared with about 3% in the United States, and the leverage of government bonds holdings to the banks' capital is huge. Actually, you probably know this better than I do, Thomas. It is a very big number in German banks, and it is certainly between 100–150% for a lot of Italian, French, Spanish, and Portuguese banks.

So if we do get a change in the interest rate environment, whether it is justified or not, or whether it is maybe just due to a change in asset allocation triggered by the tapering, this could cause renewed pressure in the European banking sector, and we will see interest rate spreads start to rise again. It is quite sensitive, I think.

T. Mayer:

I agree. We will come back to the policy issues when we discuss those. From my perspective, I would just add that, even if we recover, the big question remains: will it make a difference to unemployment, which is becoming really worrisome in the south of Europe? I was in Greece last week, and they are now heading towards 26% unemployment overall, with 62% youth unemployment. Spain is in a similar situation. Italy is also way above 10% general unemployment, and if growth does not pick up, I think that we will get into considerable problems.

By comparison, at least when I listen to my British friends, there seems to be some light at the end of the tunnel in the UK. Would you agree with that?

G. Magnus:

It is all relative. I mean, strangely, the UK has its own central bank. It has, and obviously retains, the ability to print money, and I think if you have that capacity, then you do not necessarily have a sovereign debt problem, or at least it is containable in ways which are not feasible in much of Europe.

But we have chosen to go exactly the same route. Obviously it is a very politically charged issue: how should you use the power of the central bank; is it appropriate, when everybody else is pursuing austerity, to join the party? Do we all join each other in this vicious circle of contraction? For the moment, at least, it looks like the contraction in the UK economy has finished, and there may be a little bit of bouncing along the bottom. A new Governor is about to take charge at the Bank of England on July 1 who is on record, in theory, as having some interesting ideas about what might happen in monetary policy. I personally do not think it is going to make a huge amount of difference unless they decide to do something really radical, which I think is very unlikely.

Again, it comes down to those that can, and I think the UK is one of those that can. You can use the sovereign balance sheet to try to both do structural reform and build infrastructure. The government has not chosen to do that. There is an election coming in two years' time, so watch this space.

T. Mayer:

Do you see some supply side adjustment, as we were discussing for the US a moment ago? Do you see resources moving out of the non-traded goods sector, i.e. services, housing, into the traded goods sector – that is, manufacturing, exporting? Is that happening, as it seems to be happening in the US, or is that not really underway?

G. Magnus:

There is some very good manufacturing; most Brits do not even know that there is a manufacturing sector any more, but actually, apart from motor vehicles and very obvious signs of manufacturing, there are some decent manufacturing companies. Some of them are involved in some of the same advanced manufacturing, 3-D printing and so on, which I think is going to be really important in the future.

But if you are asking me whether there a rebalancing going on in the UK economy, the answer is no, for the same reasons as we have seen in Europe.

Actually, for a country that has traditionally relied on international trade and so on, it is appalling that the UK's share of emerging market exports is still very, very low.

T. Mayer:

Emerging markets: lately, we have heard and seen some disconcerting news out of emerging markets. We have seen the demonstrations in Turkey for one reason; that was over a park in the centre of Istanbul. Then we saw demonstrations in Brazil for another reason, fears for public transportation. There is concern that the Indian economy is being strangled by too much red tape. There may be similar concerns voiced occasionally with regard to Russia.

Vladimir, what do you think? Is that a more general feature in the emerging markets world that we rely on so much? I am not talking now about China, where we have already seen the reasons for their slowdown. But is there something going on in the emerging markets world, so that perhaps we will have to look towards an era where these countries lose momentum? What is your view on that?

V. Mau:

Thank you very much for this panel. It looks very interesting for all the participants and all of the people in this hall.

First of all, I wanted to state that it is very important to recognize that there are different emerging market economies. It is good that you did not mention BRICS, because BRICS is something artificial; 'emerging market economies' sounds a bit better. But actually, in these countries, you can see agrarian economies transforming into industrial ones. You can see over-industrialized economies with bad institutions, or normal market economies with poor institutions and bad economic histories, etc.

I do not think there is any common cause of these upheavals in the different countries. The countries are different. What they have in common, to my mind, is that they have relatively cheap resources – either human resources, as in Asia, or natural resources, as in Russia – and relatively poor institutions. A lot of resources with poor institutions is quite reasonable; you can compensate for poor institutions with excess resources, and this is something which these countries have in common.

We know that this crisis is global, and this crisis could be compared with the twentieth century crises of the 1930s and 1970s. This is not a cyclical crisis; it is a crisis which transforms economies – the global economy, national economies – mostly on a structural basis. It involves the creation of new balances of forces, new international currencies, and new economic doctrines. The two previous crises in the 1930s and 1970s actually created new economic doctrines and new institutions and mechanisms of economic regulation, and this is something which is emerging from this crisis as well.

From this perspective, I see two important structural trends or important structural challenges which all emerging economies face – including China, by the way, although we have already discussed China. First, it is a crisis of the industrial welfare state. The crisis is deepest in the countries where the welfare state is more developed, and is particularly deep in the countries where a developed welfare state was not compensated by productivity. That is why it is more severe in Europe than in the US and why it is less severe in Russia, because the industrial welfare state was mostly destroyed in the 1990s in this country. It is softer in the Asian emerging economies because they have not yet built an industrial welfare state.

The important question is about the prospects for the welfare state. Again, this welfare state was built for countries with a diminishing agrarian sector. They were demographically and structurally completely different countries, when Bismarck created the pension system in Germany, for example, or Lloyd George in Britain. I often use this very simple example, and it is applicable to all other sectors of the welfare state. When they created the pension system, which was basically the same as it is now, the pension age was much higher than the life expectancy. Now it is upside-down, and it is financially senseless to discuss a pension age if it is not 90, for example.

The first structural and long-term question which emerging economies face is what type of welfare state they will develop. It is clear that with a growing GDP per capita, with a growing level of prosperity in these economies, the welfare state will come, but will it be a reconstruction of the industrial welfare state or will they be able to create something new? It will be very important to respond to all of the financial, institutional, and monetary challenges which the developed world is facing now.

The second source of the crisis in the emerging economies, to my mind, is long-term changes in the structure and competitiveness of developed countries. Roland has mentioned this. If he posits that labour costs are becoming less important in the emerging, post-crisis world, he is correct. This means a complete restructuring of the strategic prospects of the emerging economies. If a new, post-crisis industrial economy is not about cheap labour, if research and development plays a more important role in the cost and price of new sectors of the economy, that means a complete restructuring of the challenges, a complete restructuring of economies, and not only in the United States or Britain; it is to a large extent about the economies which rely on cheap labour. And do not forget that labour is becoming less cheap in these countries as well, and natural resources in Russia are also becoming less attractive in light of the current technological revolution.

It is a complete restructuring of the problem of cheap resources. The resources which we believe to be cheap become either not cheap or not important, and this is a long-term, significant challenge for these economies. This also means that we have to reconsider the very concept of re-industrialization. Re-industrialization is not about bringing traditional iron mills to developed countries. It is completely different, and we mostly do not understand what it means. Industrialization after post-industrialization involves a structure which we still cannot grasp, but this is one of the most important challenges we are going to face.

As a result, we have to relook at the traditional approach based on exportable growth. Exports and domestic consumption are becoming, I would say, more equal than they were before. This means that we have to reconsider the role of cheap natural resources and, particularly, cheap labour. And of course we have to discuss and understand what the welfare state means in the twenty-first century.

T. Mayer:

I think this is a very good observation that somehow generalizes what we heard about China and the old drivers of growth that we have relied upon. We talked about the horizontal Phillips curve of the economies, basically saying you can draw in as much labour as you want without pushing the price up; that gives way to a new world. We have reached a state of development, or catching up, where these countries have to think about new models, and at the moment they are in a bit of a holding pattern in terms of how to go about it.

George, do you want to comment on that?

G. Magnus:

Just a quick comment. I think your comments were very eloquent, and they resonate immensely for me. The issue is that I think what we tend to do nowadays is think, “Well, the last 20 years have been unprecedented. Fantastic”, so we look forward another 10 or 20 years and say, “Well, the future is going to be like the past.” I think you are absolutely right that it is not, because there are certain things you can only do once. You can only join the World Trade Organization once. Obviously, Russia joined last year, so maybe the benefits are still to come. But for China, it is done. You can only transfer labour from low-productivity agriculture to high-productivity manufacturing – which not every country does, by the way, but China has excelled in doing it – once. You can only get 95% of your children enrolled in school once. You can only build basic infrastructure once.

Changing the model, I think, is something a lot of people still do not really get. They do not understand the idea that something has to change. Otherwise, this infamous middle-income trap is going to become increasingly prevalent, I think.

V. Mau:

I will carry on, if I may. To my mind, the middle-income trap is the most important challenge for all of the emerging market economies, particularly Russia. We have two different patterns. Since the beginning of modern economic growth in the eighteenth century, China and Russia have demonstrated completely different patterns of growth. Russia has a standard 50-year gap compared with France and Germany, with developed economies. No matter what happened, with any political regime, with any economic policy, since the middle of the eighteenth century, there have been two generations: a 50-year gap. China was the most developed economy in the middle of the eighteenth century and completely collapsed, and now it is catching up with the developed countries. To my mind, the main economic enigma, the main conundrum of economic development and economic history, is why there are these two cases. We do not know.

T. Mayer:

Can we narrow this down a little bit to Russia? We have talked about all sorts of countries, but now we want to focus a little bit on where Russia stands on this path of development. I would like to ask Oleg, from his perspective running a bank here in Russia, how do you see the economy? Where does Russia stand in this interesting environment?

O. Viyugin:

Thank you. Having a low economic growth rate this year and probably in the coming years also, Russia is actually paying the bills for previous extensive use of windfall revenue since 2008, the first crisis year. This windfall revenue which Russia got from the quite substantial increase in oil prices and increase in export of raw materials was used to increase social and public commitments, for some types of subsidy during the first half of the crisis and some large projects, which are not productive from the point of view of economic growth. As a result there was a very chronic year-on-year appreciation of the currency, which of course created very difficult competitive conditions for the non-raw materials sector.

Also, from 2008, the state-regulated economy or state-owned economy began to grow, and now about 50% of the economy is represented by state-owned or quasi-state companies. It depends on the company, of course, but they are mostly commercial companies with not very well-managed costs and efficiency. We have a state-owned economy, which is not very flexible from the point of view of efficiency, and is not ready to react to completely new conditions and environments. Then we have a private sector which is really suppressed by the very strong rouble, due to the windfall revenue.

At the same time, the situation and economic environment for all countries – developed, BRICS countries, Russia, etc. – has already changed dramatically. We have just discussed the fact that all countries have to find a new model for growth. It is quite clear that this new model could be based just on investment in efficiency, because there is no reason today for many companies to invest in expansion when markets are limited and will be limited for at least four or five years. It is quite clear that the overloaded economies, which are mostly developed economies, will not be in a position to grow fast, and will grow with lower potential. But the emerging markets and the rest of the economies are still so dependent on the performance and growth of the developed countries. It is very difficult to overcome this situation. This means that the debt problem will be solved, hopefully, but not now, and we will see a very complicated and unpredictable environment for some four or five years.

Russia will be in such an environment, and the only response to these challenges is actually to make the private sector react. I hope that the windfall revenue will fall. This would mean that the private sector would be given slightly easier conditions, allowing it to adapt to new things and maybe find a new model for investing in efficiency.

T. Mayer:

Can membership of the WTO help to push the economy forward?

O. Viyugin:

I do not think it is too significant, but it is a push in that direction. Second, I think that Russia also has to make a choice to have a policy to ask these state-owned companies to be more efficient and to impose tougher control on the costs of these companies, to cut any subsidies, and to ask these companies to disappear or to privatize these companies.

The choice has still not been made. We see that the policies go back and forth. There was a big list of privatizations and this list has been reducing; maybe in the future it will be increased again and expanded. But the choice has to be made, at least in favour of very tough control of the companies, asking for investment in efficiency and allowing the private sector to adapt to the new situation. These are mostly questions of institutional regulation, structural reform, and a better legal environment. It is a big discussion, but those are the challenges.

Anyway, I do not think that we will see more than moderate growth of about 2–3%.

T. Mayer:

Much more subdued than in the past.

O. Viyugin:

Yes, but we will see what it will be in the future, because we do not exactly know what will happen with the global economy.

T. Mayer:

Let us drill down a little bit on the theme that we had in the first round of discussion. It came out that there is potentially a risk with the unwinding of the QEs that the Federal Reserve has been engaged in. We are now at QE3; we are now going to wind it down. What are the risks of that for the US and for the rest of the world, and to what extent do the Japanese policies here potentially compensate for the winding down of the American liquidity injection? Could the Japanese expansion perhaps be an offset?

Let us start with Roland. What do you think? You were a bit sceptical about the longer-term consequences of what the Federal Reserve has been doing.

R. Nash:

Firstly, I just want to clarify a point. This hedge fund manager is not optimistic because of the quantitative easing; this hedge fund manager is optimistic about the US because of the creative destruction and the market environment that exists in the US to drive the innovation that has created growth there. Going back to Andy's frog that is being slowly cooked, I think we should fry the thing. There needs to be an introduction of creative destruction into an economy like that.

Taking that further, and thinking about the impact of quantitative easing on the emerging world, the ability of creative destruction to drive growth within the emerging world outside of Europe and the US – though we have all been very negative about the developed world – is still very, very high, I think. Vladimir was talking about agrarian economies becoming industrial economies, industrial economies becoming service-based economies. The adoption of fairly standardized techniques by a large number of people should, over the medium term, still be able to drive a period of economic growth, which can be as high as we have seen before.

What sort of policy response needs to happen? In my experience, particularly in this country, I think it is always quite dangerous to ask a government to choose an economic model. I think that is the sort of problem that has existed in places like Japan and Europe. I think the better response is to open up economies as much as possible to competition and to create the sort of policy environment where you can have this creative destruction, which can drive economic growth.

The problem with quantitative easing, as we mentioned with regard to the US, is that it has driven a lot of poor allocation decisions, as much in the emerging world as it has in the US. When those problems come home to roost, I think that the emerging world is in a much poorer position to be able to meet those challenges because of the structural inefficiencies in its government.

T. Mayer:

So you expect a sort of hangover after we have consumed a lot of liquidity?

R. Nash:

Yes. I hope that the hangover is not more painful than the original reason why everybody started drinking!

T. Mayer:

Andy, what do you think about the Bank of Japan offsetting the Federal Reserve, and how do you see the financial system in the view of these continuous, and now perhaps no longer continuous, liquidity injections?

A. Xie:

I think that the Japanese have a huge home bias in their asset allocation. What has gone on in the last six months in terms of money coming in from the Japanese yen has been done by global hedge funds, by foreigners, not the Japanese. The Japanese should step up to take over from these foreigners, which is what these foreigners are hoping; they are fund-running the Japanese. My view is that the Japanese rarely change. Again, when you talk about big changes in Japan, you have to be very careful. I mentioned that there is one revolution every 100 years; maybe it is really every 200 years. So you have to be really careful. That is why I think that what the Bank of Japan is doing may not inject liquidity into the global economy without the help of foreigners.

On the point of what is going on in the emerging economies, there are essentially two things going on now. One is that commodity prices are coming down, and this is hurting their terms of trade or purchasing power. The other is that the hot money is leaving. These two things are creating tension in the emerging economies. If you look at what is going on in the stock markets, in the currency markets, it looks like the situation is moving towards some sort of crisis. Every time the Federal Reserve tightens, there has been an emerging market crisis, and this time the Federal Reserve has been easing extraordinarily for so long, so it is possible.

I think that over the next six months, we have to be very careful. Big emerging market economies like Brazil and India are running deficits despite the high commodity prices, and are quite vulnerable. They have to tighten up very quickly. Look at what Indonesia is doing: Indonesia is increasing its interest rate despite the economic slowdown. That is the right thing to do, because you do not want to be trapped in this declining currency with rising inflation and eventually face financial collapse. This is the way I see Brazil and India; they will have to tighten up monetary policy soon. Otherwise they are at risk.

T. Mayer:

Just make the adjustment, and do not try to take drugs to avoid the adjustment.

Professor Yu, when I go around the financial community, there is much talk about financial risks in China. People are saying that there is a shadow banking system, they say that there are regional authorities that are over-indebted and it is a house of cards likely to come down, as we have seen it come down elsewhere. What do you tell these people so that they can be a little bit more relaxed?

Y. Yongding:

I think China really is facing serious challenges in all of these areas. For example, China's M2/GDP ratio is extremely high, the highest in the world. I think it is more than 180%, and is now approaching 200%. That is extremely high. That is one thing, and secondly, China's corporate debt-to-GDP ratio is very high. Many people argue that this ratio is something like 100%, and some argue that it is more than 120%, or even higher. I think that this is much higher than in most countries.

Then, local government in China is also a very big issue, and there is a type of local government financial vehicle which is actually a huge advance, and they borrow heavily from commercial banks. Whether those local governments can really repay this money is questionable. You have also mentioned the shadow banking system. Lots of our financial institutions have created so-called financial reverse management projects with quite high interest rates that attract money to invest in other projects. Nobody knows whether they can repay this money.

Another issue is the real estate bubble. Andy actually has very strong opinions on this, so you can ask him about it. I think that this is an important issue.

Finally, China has USD 3.4 trillion in reserves. This is a cushion, but we are waiting for the value of these reserves to be eroded and go down because the purchasing power for assets has gone down, following QE1, 2, 3, etc. The consequence of this would be terrible for us because this is our savings. We can become a victim of US monetary policy.

We are facing a huge number of challenges. But I think at this stage, there is no need for panic because the Chinese economy is a big economy and the Chinese government's ability to control the economy is very strong. In addition, the Chinese economy has been growing very fast, so we can grow out of a lot of problems. But also, as I just mentioned, China's growth rate will really slow down, so we are facing a dilemma. My advice is that we must be careful, and we cannot be complacent, but there is no need for panic.

There is another problem: I have said that external shocks will not bring down the Chinese economy, but the Chinese economy could go down as a result of issues of our own making. For example, there is one very big issue around capital account liberalization. In the current situation, the Chinese economy is still okay because the Chinese do have capital control. But lots of people within China are arguing that now is a so-called strategic time or opportunity for China to liberalize further, so we should accelerate the opening of capital accounts.

Actually, personally, I strongly oppose this view. I think that perhaps in the long run, China probably should pursue full liberalization of capital accounts and they should be fully convertible. But this is not really a very good time. We must be very careful. We should pursue this policy of capital account liberalization gradually and prudently. We do not need to set a timetable, or we will cause trouble for ourselves.

T. Mayer:

Not too many changes at the same time, and concentrate on other things?

Y. Yongding:

Yes, we should put our house in order first, then talk about further liberalization.

T. Mayer:

Could I ask Oleg, from a banker's perspective, what difficulties do you see in the Russian financial system? Are there any hidden risks or problems?

O. Viyugin:

First of all, the financial sector does not exist as a self-sufficient body. The financial sector strongly depends on the general economic situation and economic growth. I foresee that economic growth in Russia will actually be quite slow, for a couple of years at least. I do not think we can actually foresee major difficulties, in the Russian economy or generally. The major risk of the situation as a whole is lower growth, but also lower growth with some completely unexpected events, let us say. Of course the Russian financial sector can be influenced by this.

The current status is not very troubled actually. Capital adequacy is more or less adequate. Transparency is not 100%, but I think that the situation is not so difficult from this point of view. But because of lower growth, because of the very unpredictable future, the growth of the banking sector will be quite slow. That is definite, after the very, very fast growth before the crisis, and – this is very interesting – just after the sharp period of crisis in 2008.

I think that now, a risk mentality and understanding of risk is prevalent, and I think that the financial sector will have very slow growth because of that. In the event of some global turmoil, of course there will be difficulties and capital will be needed, and liquidity will again become quite a serious and substantial issue.

T. Mayer:

George?

G. Magnus:

Just a comment, linking to my neighbours here. It is quite interesting, because here in Russia you have completely open capital accounts. In China, it is pretty closed, not much more open than it was 20 years ago. Of course, in China, the Chinese economy can waste capital without punishment, whereas in Russia you cannot do that properly or in the same way. Professor Yongding's comment that it would be a dangerous time to proceed with capital account liberalization, I think, is absolutely on the button.

T. Mayer:

We are almost at the anniversary of Mr. Draghi's famous remark in London that the ECB will do “whatever it takes” to make the euro irreversible. Can I ask two people here on our panel, Vladimir and George, whether they think that Mr. Draghi has really said something that he can stand up to, or has he overplayed his cards? Vladimir, what is your take on this?

V. Mau:
Yes, asking the question to people who live in countries which are not subordinate!

T. Mayer:
The view from outside is always the best view!

V. Mau:
I would say that we are two frontier European nations. Both consider themselves as not purely Europeans, but still European. Of course, Mr. Draghi said what he had to say, and it would be strange if he had said the opposite, that the Central Bank would not do something, even something that would not save the euro. I would not expect the opposite statement.

The problem is that the European problem is not a purely monetary problem. From the very beginning, it was clear that there was an unbalance between monetary and fiscal policy. From the very beginning, it was clear that the unified monetary policy should be offset by a more or less unified fiscal policy, and later it became clear that the Maastricht Treaty was not enough for full coordination of fiscal policy.

As an outsider, I can be politically incorrect, and I would say that the euro was a surrender of the other central banks to the Bundesbank. I do believe that it is important to surrender fiscal policies to the Bundestag to some extent, and if the other countries de facto accept the dominance of the German government over their fiscal policy, it will work, more or less. The problem is, I think, that the position of other European nations is less important than the position of the German Federal Government.

We have a very strange situation in European history where the Polish are insisting on German leadership in Europe. It is absolutely unbelievable. Yet the Germans are afraid of even the word ‘leader, or in German, ‘Führer’. Even the word is prohibited in Germany. I think that this is to a great extent a political and psychological problem first, and then an economic problem. Of course, again, monetary union should be coordinated with fiscal union. This is important. I do believe that in the very end, it will result in fiscal union, but then we have a number of political issues.

T. Mayer:
George, do you have anything to add?

G. Magnus:
We certainly do have a number of political issues. I think the OMT programme is like a giant insurance scheme. It was necessary; the announcement should have happened a lot earlier, but it has certainly, finally, brought the liquidity function of the European Central Bank (ECB) into line with the Federal Reserve, and the Bank of England, and the Swiss National Bank, and so on.

But I think there are limits to what the ECB can do. We all understand that, and Vladimir has just outlined it. On liquidity, obviously the ECB can guarantee, and has guaranteed, that the banks will not be short of funding. On the issues of bank recapitalization, resolution for the European banking system, and sovereign solvency, I think these are issues which are completely outside the competence of the ECB. I think Draghi understands this, too.

The issue, obviously, of debt sustainability in sovereign states that do not have their own independent sovereign banks is something that people do not really want to talk about. We talk about troika programmes and reducing Greece’s debt to 140% of GDP, but it is probably twice as high as it really needs to be or should be. Ultimately, the acid test will be: would the ECB do whatever it takes if a country like Spain or Italy came calling for a programme? Obviously, as you know, we do not know what the constitutional court in Germany is going to say in August or September.

T. Mayer:

Hopefully they will not come calling before then.

G. Magnus:

They probably will not. But the caveats, the reservations which are underlying it certainly influence the behaviour of the ECB Board, I would imagine.

T. Mayer:

Thank you very much. We are at the end of our session, but before I let you go, I would like to ask a question of each of you, and I would ask that you answer this very briefly so we can let the audience go to lunch or whatever they want to do. My question is: what do you see as the biggest risk for the economic and/or financial outlook in the year ahead? Let us start with Professor Yu.

Y. Yongding:

It is very simple. The burst of the current junk bonds bubble. I think the price of junk bonds is actually highly distorted. For example, in European countries and lots of the Southern European countries, junk bonds can be used as collateral, and those bonds are actually junk bonds. In the United States, the debt-to-GDP ratio is very high and it is increasing continuously, but the yield is almost zero, so the price of these bonds is distorted. I fear that if the bubble bursts, all countries will suffer.

T. Mayer:

So your risk is the potential burst of the junk bond bubble. George?

G. Magnus:

I am torn between the end of tapering and a structural decline in China, which I think is going to go a lot further than we have seen.

T. Mayer:

Oleg?

O. Viyugin:

I think that actually the major risk is a second stage of financial and economic turmoil, which may be similar to 2008 but not very strong. There is a probability. I cannot say that it is definite, but the probability is still quite sustainable.

T. Mayer:

Vladimir?

V. Mau:

In global terms, I would agree with what Oleg has said. In domestic terms, in terms of Russian policy, it is the danger of a shift in policy to fiscal and monetary stimulation of declining growth, instead of institutional reforms. Decline in growth is better than fiscal stimulation.

T. Mayer:

Roland?

R. Nash:

As we have discussed, the time bombs that have been created by quantitative easing that will become apparent as the tide goes out, and in particular, the political implications of those time bombs potentially exploding.

T. Mayer:

Andy, is any other risk left?

A. Xie:

I think that between the OECD government bond bubble and the emerging market hot money bubble that we are seeing, emerging markets are going to be more vulnerable over the next six months. Basically, when the tide goes out, the highest risk stuff gets sold first, so I am worried that we could see another emerging market crisis like in 1998 – unless people have learned the lesson, unless Brazil and India raise interest rates, putting stability above growth. If they still try to protect growth, I think we will have another emerging market crisis.

T. Mayer:
Thank you very much. Do you want to ask a question? We are running a little bit over, but please.

From the floor:
Thank you very much for this opportunity and thank you for your time and the discussion. As we have six panellists here and two are from China, it reminded me of a question at this moment around the world that I have wanted to discuss. With the G8 having just been held, some people have again posed the question: is it time to have China as one of the member countries of the G8? Instead of having a G8, should we have a G9? What do you think of this question? I would like to address this question to Professor Yu and George. Thank you.

Y. Yongding:
Personally, I am not very interested in the G8, so I would not suggest that China should join and become the ninth country.

G. Magnus:
The short answer to your question is that there clearly is something wrong with the way in which we do international governance. The G20 is too big; the G8 is too small, and I am not sure what the right number is or who the right participants would be, but I do think that China must be an integral part of a handful of countries that should be called upon to participate and contribute to economic policy coordination. The question is: does everybody have an interest in doing it? I am not sure that is necessarily the case.

T. Mayer:

Thank you very much. I think we have to leave it at that because we are already a little bit over time. I would like to thank the panel for what I felt was a very interesting and, for me, at least, insightful discussion, and I would like to thank the audience for their attendance and interest. Thank you very much.