Letter from the President

Economic Growth: How to Renew it and Sustain it?

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Leading economists from around the world confronted the theme of “Sustainable Growth in a World of Change” from an Asian perspective at the Asian Financial Forum in Hong Kong January 19-20.

Once again I was invited to lead the Canadian delegation to the annual conference, which this year focused on three issues:

1. The inability of the global economy to achieve sustained rates of growth over the six-year period since the 2008 global financial crisis;
2. The impediments to renewed growth; and
3. The remedies for restoring growth.

Different conditions in different economies

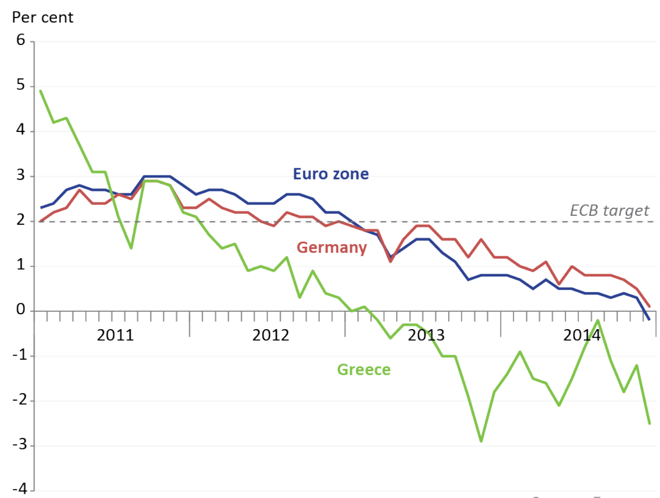
IMF Chief Economist Olivier Blanchard said the past and the present have conspired to create an economic malaise across the global economy. He diagnosed protracted weak growth in the global economy as the legacy of over-indebtedness in the years leading to the financial crisis, with the subsequent deleveraging by corporations, individuals and government in the last six years – cutting back on spending, combined with widespread expectations of continued weak growth and poor investment prospects – dampening investment spending.

The discussions at the conference, however, made it clear that weak conditions were uneven across the global economy. Japan has long been mired in deflationary conditions, since the late 1990s. Europe has fallen into a growth funk, with intermittent recessionary periods, since the financial crisis. The steady decline in inflation rates, well below the ECB-targeted 2%, has raised the spectre of deflation and a spiraling collapse in growth rates across Europe.

By contrast, Asian countries, notably China and India, missed the worst of the crisis as their financial sectors avoided most of the excesses of over-leverage and excessive borrowing. Economic growth may have been better in these countries, but were still caught by the growth slowdown in the developed world. For example, economic growth in Mainland China has steadily decelerated, from a blistering and fairly consistent 10% annual growth over the 30 or so years since the opening of China in the late 1970s, to an estimated 7% in the past year. This slowing portends negative implications for the global economy in the near term, given the growing impact of the Chinese economy on the rest of the world.

Deflationary Pressures in Europe

Germany, Greece and Euro zone

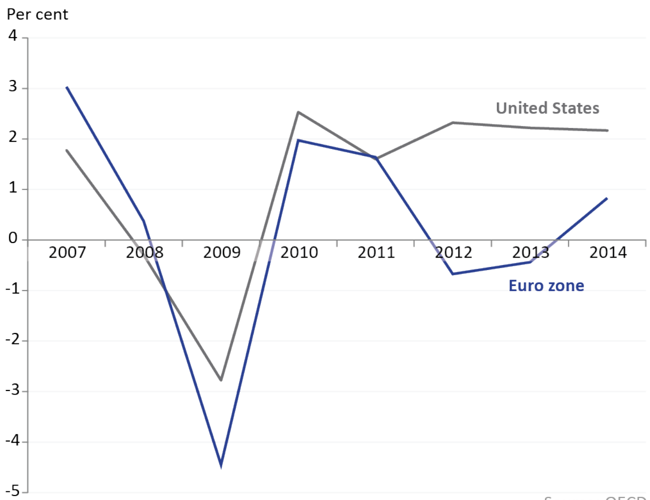


Source: Eurostat

The U.S. economy was identified as the bright spot on the global scene, reverting to its traditional role as the locomotive of global growth. There too, however, concerns were expressed about the sustainability of recovery, particularly if Fed policy responds to labour market growth and inflationary pressures. The emerging countries worry about the reversal of capital flows from their markets into the U.S. and the adverse impact on future growth. In this context, Paul Krugman, Nobel laureate, made an insightful comment. He contends policy-makers have been fixated for far too long on resurgent inflation and bond yields, in a global environment characterized by deleveraging and secular stagnation, mainly from aging demographics. While this view conveniently fits his thesis for more stimulative macro policies, it is clear that policy-makers are shifting gears, triggered in part by the oil price decline. Krugman was not convinced Fed policy has a tightening bias.

GDP Growth Slowdown

United States vs. Euro zone



Source: OECD

Financial reforms and their impact on economic growth

The conference devoted considerable discussion to the financial reform agenda in capital markets, and its impact on economic growth. Several panel sessions generally concluded efforts to impose financial reforms aimed at stability of markets, and by extension the economy, were a necessary condition for sustained growth, despite some adverse consequences for bank lending and securities trading.

The speakers concluded the most successful reform measures have been implementation of the Basel 3 capital and liquidity requirements, and development of a banking union in the EU to ensure effective oversight, break the link with sovereign borrowing and restore confidence. The Governor of the Swedish central bank, Stefan Ingves, commented that European and Swedish banks, with strengthened balance sheets through new capital requirements, have continued to lend to business in Europe. He indicated little evidence of credit rationing in the European markets as a result of tougher standards. Indeed, he noted the Swedish banks, now with common equity and Tier 1 capital of 12% of assets, higher than the 7% Basel threshold, and with a liquidity coverage ratio (LCR) of more than 100%, have maintained lending at acceptable levels.

It was acknowledged the OTC derivative reforms flowing from the G20 Directives have unfolded across the key jurisdictions in an uncoordinated fashion, effectively erecting barriers to market activity and disrupting global trading, financing and investing trends. It was inevitable that this lightly regulated global marketplace for derivatives, which had evolved in the pre-crisis years and was at the epicenter of the financial crisis, would undergo substantial reform, in terms of oversight, trading and clearing. However, it was unfortunate that regulators failed to develop and implement reforms in a coordinated manner. Regulators now face the difficult, long and drawn-out task of remaking rules, as well as negotiating forms of regulatory recognition, or deferring jurisdiction to other authorities, to limit regulatory duplication, improve efficiencies and facilitate cross-market financial flows.

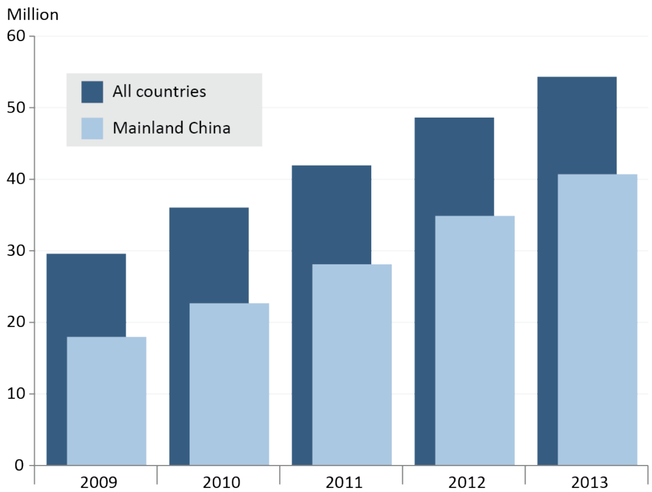
Some regulators spoke about reform efforts to influence structural change to widen the channels of financing and improve small business access to capital, effectively shifting intermediation from heavy dependence on the banking system to the capital markets. The EU just introduced the Capital Union, a package of reforms to encourage market-based financing through increased market transparency to strengthen investor confidence, and reforms to the disclosure process in capital-raising. The objective is to expand the role of private equity funds, securitization and crowd-funding in the financing process. The shift to market–based refinancing, however, is a long-term proposition, involving many factors beyond securities regulation such as taxation, institutional change and investor confidence in the markets and economic outlook.

Economic prospects for Mainland China: Hard or soft landing?

The economic outlook for Mainland China came up in various panels at the conference. It was generally acknowledged that numerous initiatives and policies point to a steady integration of China into the global economy, moving beyond its traditional reliance on the export sector for growth. The new "Stock Connect" that links the Shanghai and Hong Kong stock exchanges will enable investors outside China to access "A" shares listed on the Shanghai exchange, and for Chinese investors to access HKEx listed shares. While the list of allowable shares within the Stock Connect is limited, over time this cross-border flow is expected to build in terms of investor interest and the stocks eligible for inter-market access. The establishment of more than five RMB trading centers, the latest in Toronto, will promote the ongoing internationalization of the RMB market and eventual full convertibility of the RMB. Finally, as part of the ongoing reform program, China has set up several free trade zones in cities across the country, liberalizing regulations within them to facilitate global business dealings. The ongoing reform program was identified among several conference participants, through real-time polling, as one of the key drivers of growth in the Mainland economy.

One of the outcomes of continued economic growth and an expanding middle class in China is the expanding demand for financial services, particularly wealth management services. These services are broadly based, ranging from access to managed investment funds, insurance products, and financial and estate planning. The global investment banks and insurance companies have positioned themselves in the Hong Kong marketplace, rather than on the Mainland, to serve their Chinese clientele. The Hong Kong-based platform has expanded, partly because regulations in Mainland China are complicated and onerous, such as restrictions on foreign financial institutions to conduct business in the Chinese marketplace, limited branching, and required joint venture ownership (typically 50%) of the Mainland affiliate business. It turns out the ease of access to the Hong Kong market enables it to function effectively as the platform for the wealth management business, with the added advantage of an established judicial framework for effective rule of law. It is estimated that daily visitors from the Mainland to Hong Kong totals in the range of 50,000, some 18 million visitors a year.

Visitors to Hong Kong



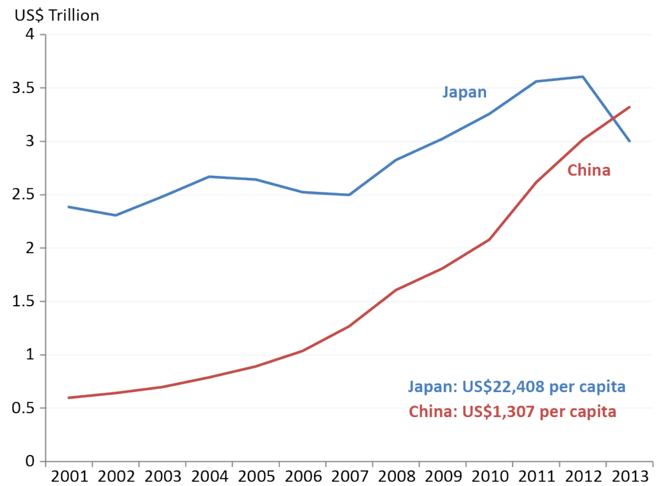
Source: Hong Kong Tourism Commission

There was some discussion about prospects for a "hard landing" or abrupt slowing in the Chinese economy. Most of the conference participants, based on polling throughout the conference, were relatively optimistic on China's prospects, focusing on over-heating in the real estate sector and developing problems in the shadow-banking sector as the cause of potential problems for the economy. In this regard, Paul Krugman made some interesting observations in his keynote speech about risks to the Mainland economy. He noted that sustained growth in China depended on successful transition from an investment-based economy tied to infrastructure spending and the export sector, to greater reliance on consumer spending for economic momentum. The inability to make a smooth and relatively rapid transition to a consumption-based economy risks serious dislocations to the economy and a slowdown in growth.

This transition will not be easy given the weaknesses in the social safety net in China, particularly health care and pensions. It was emphasized in the conference presentations that high rates of savings are not incidental, but bear directly on the need to finance good health care for a rapidly aging population and rising demand for specialized medical treatment and pharmaceuticals. Health care spending in China has skyrocketed, up from $11 billion USD at the beginning of the century to $360 billion today. Increased reliance on wealth management products like insurance will help mitigate the need for cash, but personal savings will still be necessary to fund these needs, as well as support retirement living. All these factors complicate the transition to a consumer-driven society.

Household Consumption Expenditure

China vs. Japan



Source: Federal Reserve, Economist, World Bank, IIAC

Will falling oil prices and currency devaluations turn around Europe and Japan?

While Europe and Japan continue to be the drag on the global economy, the 50% decline in world oil prices and depreciation in the Euro and the Yen were seen as catalysts for renewed growth. These factors are estimated to add at least a one-half percentage point of GDP growth in Japan. At the same time, the collapse in oil prices, coupled with sanctions on trade, has been devastating for the Russian economy.

Structural reform in Japan, the third arrow in the Abe government's quiver, was seen as critically important to complement easier fiscal and monetary policies. The key areas of structural reform include removing barriers to the inflow of foreign investment, and changes in immigration policy to mitigate the profound collapse in population.

Paul Achlieter, Chairman of the Supervisory Board of Deutsche Bank, and Michael Diekman, Chairman of the Supervisory Board of Allianz, expressed optimism about the European economy. Growth will continue to be anemic for the near term, but the economy will be bolstered by lower oil prices and a weaker Euro. The prospect of an ECB QE program will have a countervailing impact on deflationary pressures. Achleiter thought the fears of significant reductions in spending from modest declines in price levels were somewhat overdone. He cited the steady fall in prices for electronic goods, which has not caused consumers to withhold spending.

The need: Stimulate growth in an aging world

Policy-makers confront major challenges in reigniting sustained global growth. It is not just about finding the right mix of macro policies to stimulate demand. The problem is made more difficult by demographic changes that have deepened stagnation within economies, not just in the developed world but in a rapidly aging China. Moreover, the close integration of the global economy requires critical coordination among policy-makers in synchronizing macro policies, harmonizing securities regulation to promote efficient capital flows and ensuring open markets for traded goods. The G20 and multilateral institutions, such as the IMF, OECD, IOSCO and FSB, have played a key role in promoting global growth and market stability in the post-crisis years, and coordinating economic, trade and financial policies. But much more needs to be done.

Special recognition to Eon Song, Capital Markets Analyst, for analytical and technical support.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
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11 King Street West, Suite 1600, Toronto, Ontario M5H 4C7 • T 416.364.2754 F 416.364.4861 E PublicAffairs_AffairesPubliques@iiac.ca • www.iiac.ca