

## **The Changing Landscape**

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#### **NEW FINANCIAL AND ECONOMIC CHALLENGES FOR A NEW AMERICAN PRESIDENT**

Robert D. Hormats,  
Vice Chairman, Goldman Sachs (International)

Whoever moves into the Oval Office in January, 2009 will have to deal with a global economy significantly different from the one George W. Bush faced just eight years earlier – and will need to forge a very different set of policies to address the challenges it poses. The most dramatic transformations since 2001 are:

- The emerging economies – most notably China, and the major oil exporters – now play a far greater role in world trade and finance than they did in 2001; and
- The US economy is now a great deal more dependent on the financial decisions, economic policies, capital and markets of these countries.

#### **NEW REALITIES**

A few facts underscore the dimensions of the transformative changes that have occurred in the world since 2001:

*First, America's dependence on foreign capital has grown rapidly due to:*

- 1) The collapse in US domestic savings.
- 2) The widening of the nation's trade deficit, driven in significant part by rising oil imports, and
- 3) The enormous increase in borrowing by American consumers, the federal government, and indeed virtually all segments of the US economy.

Savings in the US have fallen from above 6% of GDP in 2001 to below 1% today. Consumer debt has climbed from \$8 trillion to \$14 trillion during this period. Overall outstanding debt of the government, consumers, businesses and financial institutions combined has increased from \$29 trillion to \$49 trillion. A growing portion of US debt is owed to overseas private investors and government institutions. In 2001, they together held 30% of outstanding Treasury securities; now they hold 45%. Then, they owned 17% of corporate bonds; now the figure is 28%. And foreign holdings of American stocks have doubled.

Unlike past periods when Japan and other industrialized countries supplied the lion's share of the capital needed to finance America's borrowing, this time the money is coming largely from the emerging nations of Asia, particularly China, and major oil exporters. Capital outflow from the emerging economies collectively has increased from virtually nothing in 2001 to roughly \$740 billion in 2007.

Consider the irony of this remarkable historical transformation. Europe in the 18<sup>th</sup> and 19<sup>th</sup> centuries, the US after World Wars I and II, and the US, Europe and Japan together during the latter part of the 20<sup>th</sup> century played the key roles in financing the trade deficits of the poorer nations of the world. The financing was mostly provided by banks and other private-sector institutions in the currency of the creditors. Occasionally government support was also extended to these countries, either directly or through the IMF, when they encountered financial difficulties.

Now, in a striking reversal of roles, in the new world order of the early 21<sup>st</sup> Century, the relatively less wealthy nations are financing the wealthiest nation in the world. And much of the money is coming from the governments of these nations – largely in the form of investments from their currency reserves, and increasingly (albeit still far less) from their sovereign wealth funds.

The accumulation of reserves in Asia has been little short of remarkable. During the 1997-98 financial crisis, many Asian governments, banks and corporations nearly ran out of money. Several Asian nations made enormous changes in policy and practice at the insistence of the IMF and the US Treasury in return for financial help. A number of the nations in the region found this circumstance humiliating.

After that period, business and political leaders vowed never to be placed in such a situation again. Sweeping reforms in corporate and financial governance were implemented. And governments and corporations set about building large amounts of precautionary reserves – a hefty portion of which has been invested in dollar-denominated assets.

China's reserves, for instance, have skyrocketed from \$200 billion in 2001 to over \$1.6 trillion today. Its holdings of US Treasury securities have more than quadrupled – to over \$400 billion – making the Chinese government the single-largest holder of US

government debt. But virtually all the other large nations of Asia have accumulated substantial amounts of US government securities as well.

*Second, trade now accounts for a larger portion of US economic activity than in 2001.* In 2001, US exports amounted to just over 9% of GDP; today they amount to 12%. Imports have risen from 14% to 17% of GDP. Both changes represent enormous sums of money in a nearly \$14 trillion economy. But now, unlike in 2001, exports are rising at a much faster rate than imports, and a growing portion of those exports is going to emerging economies.

The US export surge is providing the American economy with a big boost just when it desperately needs it. About one-third of the profits of the Standard and Poor's 500 companies come from activities abroad. Most large American companies, and certainly most of the major financial institutions, now earn more than half of their profits abroad. More and more US jobs depend on exports.

At the same time, a growing portion of the US economy, including services, is subject to international competition. And the growing role of trade in the economy makes a greater number of products and companies – along with virtually all consumers -- more sensitive to the gyrations of the dollar.

*Third, the dollar must now contend with a world-class challenger – the Euro.* In 2001, the Euro accounted for less than 20% of world reserves (based on IMF data), the dollar accounted for 72%. Today dollar reserves are down to 64%, and that share is declining; reserves held in Euro, on the other hand, are approaching 27% and its share rising, as central banks – including the vast majority of those in Asia – diversify their foreign exchange holdings. An increasing number of international transactions, some oil included, are invoiced in Euros; very few were a decade ago.

In the eyes of many, it is far less desirable to do business in dollars than it was a few years ago. And the weaker dollar, in turn, has been a significant factor (although less important than rising global supply and demand imbalances) in higher oil, raw material and commodity prices.

The ability of the US to finance large deficits, and have its trade invoiced in its own currency, has been an enormous American advantage for decades (de Gaulle called it an “exorbitant privilege”); a sharp diminishment of these advantages would impose significant costs on the nation's economy

*Fourth, the US share of world GDP has fallen from 34% in 2001 to 28% today, while that of Brazil, Russia, India and China (the BRIC countries) has doubled, from 8% to 16%.* And other dynamic emerging economies in the Asian region, such as South Korea, Malaysia, Singapore, Thailand and Vietnam, are rapidly increasing their share of world output.

Today, ninety five percent of the world's consumers live outside the US. Many of those living in the fast-emerging economies of Asia have become very affluent in recent years. As noted earlier, virtually all big American companies, and increasing numbers of small and medium-sized ones, rely on exports for a large share of their growth and profits – and need this process to continue to generate additional revenues and jobs.

*Lastly, in 2001, oil cost \$26 per barrel; now it costs five times that.* Half of the oil consumed in the US a decade ago was imported; now around 60% is imported. During this period, world energy consumers have transferred \$3 trillion to oil producers, enabling many of them to accumulate enormous financial strength in a very short period of time. Oil production has lagged well behind sharp increases in world consumption, which has taken place in many emerging economies, in the US and in the oil exporters themselves. Indeed, a similar phenomenon has occurred with many strategic raw materials and many agricultural products as well – another sharp departure from 2001.

And it is not just Middle Easterners who have accumulated massive reserves because of higher energy prices. Russia's foreign exchange reserves have climbed from \$35 billion to \$500 billion during this period. Russia, it is worth noting, is the world's second-largest oil producer, and the world's leading producer and exporter of natural gas – so its reserves and economic power will increase considerably in coming years if prices for these resources remain high. Along with China and its neighbors in the Far East, Russia and the big oil exporters of the Gulf have become major global financial, as well as commodity, powers.

Among other things, this shift means that the influence of Washington – through the Treasury and the IMF – has diminished. No longer can the US or the Fund credibly withhold funds from a country to obtain changes in economic policy or in foreign policy; a call to Moscow Tehran, Caracas or capitals of several other countries with large reserves often can secure money quickly with fewer foreign policy strings – or at least not strings attached to conditions insisted upon by the US.

## POLICY CHANGES NEEDED IN WASHINGTON

In light of these striking transformations, the incoming US administration will need to make important policy changes to take advantage of new global opportunities and meet new global challenges – and also must come up with a fresh, and more collaborative, approach to reform the institutional architecture of the global economy.

*First, America's political leadership must recognize that unless recent improvements in the US trade balance can be sustained, and accelerated, and domestic savings rise sharply, the US will remain heavily dependent on foreign capital in the form of purchases of government and corporate bonds, stocks and direct investment.*

These will need to come from individuals, corporations, foreign central banks and, increasingly, sovereign wealth funds. Whether they do, and on what terms, will depend on potential returns, prices and government policies. Americans are not used to such

dependence, and the government will have to sort out the economic, financial and security implications of this dramatic shift.

Foreigners have a wide range of choices about where to invest. Domestic policies or market developments -- or even hostile political rhetoric -- that discourage foreign investment and the willingness of central banks to hold dollar reserves could cause US financial markets and the dollar to plunge, severely weakening the American economy. Frequent financial crises, large trade imbalances, a series of outsized budget deficits, and failure to put Social Security and Medicare on a sounder financial footing could undermine investor confidence. Continued indulgence in the fiscal practice of making promises that will have to be paid for by future generations will hardly improve the outlook.

If US policymakers want to reduce dependence on foreign capital, they will need to find ways to increase domestic savings, shrink the federal deficit, reduce the heavy reliance of American consumers on credit and curb oil imports. It is worth noting that in the 1980s the personal savings rate was in the 10-12 percent range -- and as late as 1990 it was still around 7-8 percent.

Without these measures, large amounts of foreign capital will be needed for years to come; this is not a matter of politics, but of arithmetic. In such circumstances, the US will need to remain attractive to foreign capital or suffer adverse consequences. Sound finances, enabling the US to borrow on reasonable terms, will remain an important factor in national strength.

And American leaders must recognize that when it comes to international economic policy, as with foreign policy, no small measure of humility is in order now; relative financial power has shifted -- as we have seen -- and the US now needs large amounts of money from abroad. Recent infusions of capital by Sovereign Wealth Funds into our financial institutions are vivid reminders of that.

If Washington, either directly or through the IMF, could call the shots regarding management of the global financial system a few decades ago, it cannot today. Nor can the US expect other nations to continue to buy Treasury notes but not other types of securities; they will naturally want to diversify, as any large investor prudently would wish to do.

A consensus on the benefits of an open and market-oriented global financial system and responsibilities of capital importers and exporters is needed to ensure that this system remains strong and that regulations are exercised in a way that minimizes distortions and politicization. SWFs, many of which have been around for decades, have pursued profit goals much like other large investment funds and played a responsible and constructive role in the global financial system. These older funds should serve as good models for the newer ones, in large measure because of their financial success and the respect they have earned in the financial community.

Any efforts to obtain more formal assurances from SWFs regarding transparency and openness will be more effective if accompanied by similar assurances from the US and Europe that their investments will be treated in a fair and non-discriminatory fashion. Several discussions to improve understanding and cooperation are now underway: these include the work by the US Treasury directly with some Sovereign Wealth Funds and the collaborative effort underway within the IMF.

We in the US will also have to get used to the fact that emerging economies are spawning a large number of world-class multinational companies; Accenture reports that there were 20 emerging-market multinationals in the Fortune Global 500 in 1995, and that there are 62 today, with that number probably rising to 100 within 10 years. These companies will want to invest here and buy companies, just as American companies wish to invest broad.

*Second, with foreign competition intensifying, rapid growth taking place in many other parts of the world, and large numbers of American jobs and corporate profits dependent on expanding exports, the new administration will need to take measures to boost US competitiveness.* It will also need to reassert American leadership in the currently stalled global effort – the Doha Round – to further open global markets for goods, services and farm products, as well as to continue the process of developing effective international trading rules and ensure compliance with them. If the Round falters, then the US and other trading nations would do well to devote their efforts to improving – and ensuring firm adherence to – existing rules and dispute settlement procedures.

American policymakers can neither deny the intensity of the dislocations and job insecurity resulting from foreign competition, nor ignore the enormous global market opportunities for American businesses and workers, and the significant benefits for US consumers, that more open world trade provides.

US officials can and should be tough negotiators, and insist on foreign compliance with the commitments they have made (just as the US should adhere to its commitments). As they do so they must also recognize that this country cannot, without a huge cost, insulate itself from these new and powerful forces or abandon its longstanding leadership in the quest for a more open, rules-based trading system. Turning inward in an era when exports are critical to a prosperous American economy would be deeply counterproductive — especially so because some of the targets of new restrictions would likely be countries supplying the US with large amounts of capital and buying growing amounts of American exports.

But it would be equally counterproductive to ignore the measures needed at home to enable greater numbers of Americans to benefit from trade and to boost the nation's overall growth – as well as to reverse the growing income gap in this country.

A robust response to these concerns requires vastly improved training and education, especially in math, engineering, physics and science. And more than ever this must benefit minorities and immigrants, who constitute the fastest-growing portion of the American work-force. Education has been the “great equalizer” in the US for many decades; if it falters, then the wealth gap and the discontent gap in American society will grow. Public support for open trade **will be only one of many casualties; others will include greater social discontent and a fragmentation of American society.**

Critical also is acceleration of government and private-sector investment in research and development, which is needed to create competitive new jobs, products and industries. This is especially true in energy, where larger amounts of money are required to develop new technologies on the massive scale needed to reduce oil dependence and the attendant enormous outflows of funds, and to sharply curb greenhouse gas emissions.

And more broadly, the financial system and tax code must encourage greater domestic savings and investment, and channel funds to the most productive sectors.

Washington also needs to invest, and incentivize the private sector to invest, in physical infrastructure (which emerging countries are doing on a massive scale to boost their competitiveness). And it must provide more reliable wage/pension/health-care security for individuals displaced from their jobs by imports as well as other causes.

If large numbers of Americans remain insecure about their jobs, health-care coverage and pension benefits, and if workers cannot change jobs without losing important benefits, and low-income households cannot participate in the overall prosperity of the economy, restoring a consensus in support of a more open trading policy will be extremely difficult.

*Finally, the new administration must lead the world to a more representative and realistic global economic policy architecture to reflect the ongoing shifts in financial wealth, commodity power and trade flows.* North America, Europe and Japan need the cooperation and support of the dynamic new powers in the world economy on issues relating to finance, trade, oil, the environment, control of infectious diseases, and improving opportunities for those in all nations left behind by technological change and globalization.

The post-World-War-II institutions have served well, but they are not able to encompass or effectively address all of these issues. Just after World War II, a period of inspired institution-building took place, led by the US. These institutions helped to produce over half a century of global prosperity and security. That was a period when the major actors on the world economic stage were national governments – almost exclusively those industrialized democracies.

Now, while governments of these large industrialized nations, continue to play a major role, those of the emerging nations – as well as global financial markets, large corporations and financial institutions -- are increasingly powerful forces, and are driving much of the change taking place in the world economy. Internal financial, environmental, disease control and regulatory policies in these countries have an enormous impact on other nations and on the entire system.

The changing global landscape demands new institutions, new patterns of cooperation within existing institutions and new ways of ensuring that greater cooperation among institutions takes place when their responsibilities overlap. Helping countries address internal issues – for example by more extensive cooperation on research on alternative energy sources and infectious disease control – can be in the vast mutual benefit of all.

In shaping these changes, the BRICs and other dynamic emerging economies need to be provided a greater voice in developing rules and the practices of the global economy, while also ensuring that they assume greater responsibility for it as major stakeholders. This means continuing to increase their roles in the IMF, World Bank and WTO, as well as enlarging participation in the G-8 to include China, India, and in time others.

There are enormous opportunities for intensifying environmental and energy cooperation in North America, under the umbrella of NAFTA, and promoting closer ties within APEC on similar issues. And elevating the roles of global institutions such as the World Food Organization and the World Health Organization could empower them to take more decisive action to deal with the compelling issues they are facing.

There is also a need to better integrate the work of many of these institutions; for example, greater government intervention to reduce pollution could lead to demands for the imposition of barriers on the goods of countries that do not impose higher environmental standards -- generating intense trade disputes. Ground rules will need to be worked out to avoid this potential new source of tension taking hold in the global economy, and to ensure the maximum level of improvement in environmental practices and trade cooperation.

## CONCLUSION

Economies around the world have reached a new level of integration, and the emerging economies have achieved a new level of participation and influence in the global economy. The incoming administration in Washington should reflect these facts by pursuing policies that sustain investor confidence, increase trade opportunities and the number of Americans who benefit from them, more effectively mobilize America's human and financial capital to boost competitiveness, and engage in a collaborative effort to restructure the global policy architecture consistent with US interests in a well-functioning, market-oriented and rules-based global economic system.

The drive towards increased global integration of commerce and finances is unlikely to come to a halt; too many countries, businesses and people have a large stake in its continuation. And if it were to be reversed, the disruptions in all the world's economies would be enormous. So the big challenge for the next president will be to find ways to enable far greater numbers of Americans to derive more benefits from this process, and from American prosperity in general, and to seize the enormous opportunities it provides.