Keynote Address

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The Global Economy and the Challenges Ahead

The Global Economy Series Luncheon

of

The Montreal Council on Foreign Relations

and International Economic Forum of the Americas

Montreal, Canada

April 29, 2014

The Global Economic Outlook

As this distinguished audience knows, it was the spring and summer of 2007 when the warning signs of what would become the worst financial crisis since the 1930s emerged. Unfortunately, the implications of the events of the late summer and early fall of that year were largely dismissed in both public and private circles partly on the grounds that the massive housing bubble in the United States was seen to be manageable. Notwithstanding that misconception we should be mindful that it is almost always difficult to anticipate the manner and the speed with which financial and economic contagion and systemic forces unleash their fury. To state it differently, the housing asset price bubble and other forms of financial excesses almost always build up slowly but they tend to collapse in a hurry.

Because of that reality, the economic and human costs of the crisis – particularly in the United States and Europe – remain unthinkable even with the benefit of hindsight. Naturally, these events have raised the critical question of our capacity to frame policies and practices that will sharply reduce, if not virtually eliminate, the risk of future systemic financial shocks. I will return to that subject shortly but will first turn to the global economic outlook for 2014 and beyond. After discussing the economic outlook, I will then discuss some of the major challenges policy makers and practitioners will face in order to sustain robust patterns of economic growth.

In order to provide an appropriate degree of context to this task, I have drawn on the current macro-economic projections of three official institutions. They are the Congressional Budget Office (CBO), the International Monetary Fund (IMF) and the Federal Reserve (the Fed).

Exhibit I provides the IMF’s projections for global real GDP growth for 2014 along with projections drawn from a cross section of advanced and emerging countries I have selected from the global data provided by the IMF. My hope is that the regional and country specific data will provide you with an insight into the national and regional economic dynamics that now dominate the world economy.

Exhibit I

Global Economic Outlook for 2014

	2014 (Projections)
World	4.0
Advanced Economies	2.2
United States	3.0
Euro Area	1.1
Japan	1.4
U.K.	1.5
Canada	2.4
Other Advanced Economies	3.4
Emerging Market and Developing Economies	5.7
Developing Asia	7.3
China	8.2
India	6.2
Asean 5[1]	5.5
Latin America	3.9
Brazil	4.0
Mexico	3.4
Sub-Saharan Africa	6.1
South Africa	3.3

Source: International Monetary Fund; World Economic Outlook, April 2013

[1] *Includes Indonesia, Malaysia, Philippines, Thailand and Vietnam*

Perhaps the most noteworthy insight contained in Exhibit I is the projected 4 percent global GDP growth rate for 2014. If achieved, such an outcome would be the strongest we have experienced in the post crisis period which, among other things, bodes well looking ahead to 2015. Having said that, the projected growth rates for the major advanced economies – other than the U.S. – remain sluggish and especially so in Europe. There are, however, some straws in the wind suggesting that prospects in the Euro area and the U.K. may be gaining some momentum. Those straws in the wind include (1) the renewed access to capital markets on the part of countries in the south of Europe and the improving capital positions on the part of banks in Europe more generally; and (2) the brisk pace of activity in the U.K. It should also be noted that the “Other Advanced Economies” in parts of Europe, and especially in Asia, are expected to perform quite well in 2014.

Finally, it is not at all surprising that growth prospects in the “Emerging Market and Developing Economies” – especially in Asia – are quite strong. Indeed, “Developing Asia” is expected to grow by 7.3 percent although there are uncertainties regarding growth prospects in a few of the more important emerging market countries including China.

I will now turn my attention to Exhibit II which provides information designed to facilitate a broader overview of the expected improvement in the United States this year and beyond. The projections presented by the Fed’s “central tendency” are the projections for growth, inflation and unemployment at the time of the March meeting of the FOMC on the part of the individual members of the FOMC excluding the three highest and the three lowest for each variable for each year. Also, and for perfectly understandable reasons, the FOMC does not provide quantitative projections of interest rates. However, the rise in market interest rates, especially for 10 year Treasuries, projected by the CBO and the Blue Chip group of economists for 2015 and 2016 at the bottom of Exhibit II are potentially quite significant as discussed later.

Exhibit II

U.S. Economic Projections 2014-2016
(Fourth Quarter Levels)

	2014	2015	2016
Real GDP			
CBO	3.1	3.4	3.4
Blue Chip	2.8	3.0	NA
Fed Reserve			
Central Tendency	2.8 to 3.0	3.0 to 3.2	2.5 to 3.0
Inflation: Core PCE			
CBO	1.6	1.8	1.9
Fed Reserve			
Central Tendency	1.4 to 1.6	1.7 to 2.0	1.8 to 2.0
Unemployment Rate			
CBO	6.7	6.3	6.0
Blue Chip	6.6	6.1	NA
Fed Reserve			
Central Tendency	6.1 to 6.3	5.6 to 5.9	5.2 to 5.6
Interest Rates			
Three Month Treasuries			
CBO	0.2	0.8	2.4
Blue Chip	0.1	0.8	NA
Ten Year Treasuries			
CBO	3.4	3.9	4.5
Blue Chip	3.4	3.9	NA

Sources:
- The Congressional Budget Office, February 2014
- World Economic Outlook, April 2013; International Monetary Fund
- Economic Projections of the FOMC, March 2014

The projections contained in Exhibit II all suggest the real GDP expansion in the United States over the 2014-16 period will rise by three percent (or slightly more) with inflation estimates clustering in the range of 1.5 to 2.0 percent while the unemployment rate –based on the Fed's Central Tendency – falls in 2016 to levels that are at or very close to full employment. However, labor market conditions cannot be fully captured by the unemployment rate itself so long as other indicators of labor market conditions such as long term unemployment, part time jobs and depressed labor force participation rates are <u>not</u> broadly consistent with message being conveyed by the unemployment rate.

Needless to say, weather conditions in much of the United States (to say nothing about Canada) will have curtailed growth in the first quarter of 2014 but recent developments are distinctly encouraging. Indeed, indicators including private investment spending, retail sales, industrial production, labor market conditions, and first quarter data on commercial and industrial lending by major banks are all positive. However, these developments are not yet sufficient to insure that growth for the year will reach three percent.

Nevertheless, if the U.S. can achieve growth at the rate of three percent for the 2014-16 period we will have gone some distance in mitigating many of the persistent economic and social problems of the past while providing a potentially powerful growth locomotive for the rest of the world.

Recognizing that there are few, if any, sure things in economic projections, there is a relatively short list of major uncertainties which must be monitored and mitigated in order to enhance economic and financial prospects. In my judgment, the two most important of these challenges are (1) to execute a gradual wind-down of crisis driven extraordinary monetary policy initiatives of the last few years thus returning to a more normal monetary policy framework for the future; (2) to insure that the regulatory reform effort will strengthen the dual policy goals of enhanced financial stability and efficiency while winding down the legacy of "too big to fail."

The Monetary Policy Challenge

The importance of this challenge applies broadly to the community of nations but in the interest of time, I will focus my remarks on the U.S., while keeping in mind that much of what I have to say about the U.S. would apply to other major industrial economies.

We are all broadly familiar with the extraordinary post crisis initiatives of the Fed – and other central banks – to stabilize the economy while promoting the dual objectives of price stability and maximum employment. At the risk of considerable oversimplification, the intended consequences of those policies included, among other things, (1) modest but sustained economic growth; (2) a gradual but significant reduction in the unemployment rate; (3) a huge increase in the Fed's balance sheet; (4) the increased reliance of the Fed on forward looking communication practices and policies; and (5) an extended and ongoing interval of essentially zero short term interest rates.

While the Fed's crisis related policy efforts have been largely successful and well received in political, business, and public circles, some observers – including myself – have been concerned that the wind down of these extraordinary policies could prove to be both difficult and risky. For example, during the past several years, abnormally low market interest rates have triggered a large scale "reach for yield" on the part of virtually all classes of investors. However, the day will come when market rates on ten year Treasuries will begin to rise along the lines projected in Exhibit II. Such a turn of events could imply potentially larger rate or credit spread increases for lower credit quality debt instruments even if the Fed is still holding the line on the near zero Federal Funds rate. In these circumstances, the risk of a disorderly adjustment in credit markets may be low but it certainly is not zero especially if market liquidity is in short supply.

Judging by what I read and hear and by my personal knowledge of the leadership skills of Chair Yellen and soon to be Vice Chairman Fischer, I am confident that the Fed is already highly sensitive to these risk factors. I am also confident that the Fed – relying primarily on the New York Fed – is actively exploring the use of new policy instruments such as fixed rate reverse repos as a part of their “new normal” tool kit for monetary policy. Having stated my confidence in the Fed, I want to again emphasize that even under the best of conditions, this transition will not be easy or risk free.

However, when all is said and done, the success of the wind down of the post crisis monetary policy initiatives will usher in a more traditional framework for the conduct of monetary policy. As that policy framework emerges I will not be heartbroken if the future mandate for Fed policy were framed in terms of price stability and financial stability with some extraordinary policy flexibility only in the most extreme of circumstances.

The Challenge of the Regulatory Reform

As this audience knows, the scale and complexity of the regulatory agenda in the U.S. and around the world is truly staggering. For example, as of early March, a sizeable fraction of the rule making requirements contained in the Dodd-Frank statute have not yet been finalized. Yet, as things stand today the safety and stability of the banking and financial system in the U.S. is substantially stronger than it was in the pre-crisis period. Nevertheless, the task is not yet finished, keeping in mind that there will never be a failsafe system of financial regulation.

In my judgment, the most important pillars of the post crisis regulatory agenda include the following:

- The human resources devoted to supervisory and regulatory matters are substantially greater in both quantity and quality

- Despite a few missteps, the Basel III standards for capital and liquidity adequacy may emerge as the single most important improvement in supervisory and regulatory policy. Indeed, the magnitude of the new capital and liquidity standards for systemically important financial institutions -- when fully in place -- will represent a major step in the direction of the wind down of the legacy of "too big to fail."
- Consistent with that objective, over the past couple years, substantial progress has been made in the extraordinary difficult task to develop both recovery plans and regulatory resolution plans directed primarily at systemically important financial institutions that would permit either the recovery of troubled institutions or the orderly wind-down of failing institutions.

While these, and many related enhancements in regulatory policy are encouraging, I believe it could easily take another 3 to 4 years before we can safely judge the success of the regulatory reforms. I say that in part because some elements of the agenda will be phased in over time but, more importantly, it will surely take time and patience to sort out the cumulative impact of the workings of dozens, if not hundreds, of new or modified regulations. In that regard, experience tells us in uncertain terms that the implementation of at least some of the new or changed regulations will require future modifications as the inevitable “bugs” and flaws are discovered in our quest for a safer, sounder and more effective system of financial intermediation.

In conclusion, I believe that the economic outlook is encouraging but it is not without downside risks including the deeply disturbing implications associated with the Ukraine/Russia situation. Beyond those uncertainties and challenges, there will always be bumps in the road to greater prosperity growing out of periodic disappointments in information flows such as the first quarter data on the housing market in the United States. The inevitability of setbacks on the road to greater prosperity reinforces the already compelling case for discipline and vision particularly on the part of policy makers and business leaders. With that philosophy of leadership in mind, I believe it is within our collective capacity to achieve the gains in economic performance discussed in these remarks.

Thank you.