

Return to Growth

Speech to BusinessWeek European Leaders Forum
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Good morning to everyone here in London and to those of you joining by webcast. It is a pleasure to be here and to have the opportunity to open the conference this morning.

Our theme today is 'return to growth,' a subject which, in the wake of the most serious financial and economic crisis for over 70 years, is fraught with difficulty for any speaker.

It seems that everyone has their own pet theory on what the shape of the recovery will be. The letters L,U,V and W seem to be especially popular in our economic lexicon. Martin Sorrell has even managed to use three of them together, and is betting on a "luv" shaped recovery, while others have adopted the square root symbol as their indicator of choice.

Why the big debate? After all, Martin Wolf notes in his book *Fixing Global Finance*, that "*Crises are as old as capitalism itself.*" And it had become received wisdom that deep recessions are always followed by strong recoveries. Milton Friedman thought he had even proven it, based on past US experience.

Yet it now seems abundantly clear that this is no ordinary recession, and the recovery which follows is not likely to be so ordinary either. In short, we need to think differently about growth in the future.

Financial markets have recovered faster than experts expected, according to the OECD in its latest report. The IMF says that the world economy is now growing again. But some commentators are talking about a 'new normal' in which future growth will be subdued.

This uncertainty was highlighted when the UK released its third quarter economic figure recently, which indicated that the country was still in the grip of recession despite expectations to the contrary. It reminds me of Harold Macmillan, when Chancellor of the Exchequer, remarking that the most difficult thing to predict was the recent past.

Predicting the future is no less difficult, of course. But we can be certain of three important ways in which Europe will need to think differently about growth in the future. I shall take each of these in turn, before allowing time for your comments and questions.

First, emerging markets will lead the world's recovery and drive global growth in the generation ahead.

The financial crisis and ensuing recession have accelerated the irrevocable shift from a unipolar world dominated by one superpower, to a multipolar world. As a result, we have now reached a tipping point in global affairs.

I was at the World Economic Forum meeting in Davos this January, when a former senior Japanese official stated starkly, 'the American age is over.' This fact was formally recognised in September when the G20 became the principal discussion forum for global economic issues.

Indeed, how could it be otherwise when we are seeing the rise of Asia, and the re-emergence on the world stage of countries like China and India? This year, China's GDP will grow at more than eight per cent, and India at more than six per cent. The 'growth gap' compared with Western Europe is therefore more than ten percent. And while Europe is already moving back into positive territory next year, this growth gap is here to stay.

There are a number of powerful drivers at play. First, demographics – the working age population of the developing world now exceeds three billion and will increase by another billion over the coming generation.

Second, technological development – which has the power to connect emerging economies to global trade networks even when physical infrastructures are underdeveloped. Who needs fixed-line phones, when China Mobile's customer base stands at half a billion and India is about to reach the same number?

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Third, and importantly, globalisation means that there is no going back this time. Unlike during the rise of industrialised Europe in the 19th century, national economies are now much more interconnected through trade, through our global institutions, through diplomacy, and even through travel.

Twenty years after the fall of the Berlin Wall, it is clear that changes in Europe played their own important part in this: as *The Economist* remarked last week, ‘*globalisation would have meant much less if half of Europe had remained bricked in and many instinctively statist giants of the developing world would have been far slower to open their economies...*’

It will now be very difficult – if not impossible – for nations to retreat into isolation and autarky even if they wanted to, and deeper integration between emerging markets will in itself continue to fuel the engine of globalisation.

Combining all of these three ingredients creates a potent cocktail for change and this shifting paradigm presents Europeans with a challenge at many levels: political, macro-economic management, business, and for each of us individually.

Jacques Delors once asked rhetorically and I am sure with tongue in cheek “*Who can fall in love with a common market?*” But the principle of open markets and a level playing field is something which underpins our European institutions and our business strategies alike.

But in practice this principle may be “more honor'd in the breach than in the observance”. Recently, I think it is fair to say that our focus in Europe has been somewhat introspective. With the Lisbon treaty now ratified, our challenge is now to become more externally focused, to drive forward our global trade agenda, and to think strategically and internationally because the momentum in emerging markets is unstoppable.

The acronym BRIC was invented eight years ago and has since been mentioned in almost every business strategy. It is probably already out of date. It is easy to overlook the fact that Indonesia is the world's fourth populous nation, and to the growing list, you might also add Vietnam.

And in the genuine and understandable enthusiasm about what is happening in Asia, Latin America and the Middle East, European businesses should not forget about the opportunities nearer home.

Two decades after the fall of the Berlin Wall, the collective size of EU new member state economies is not dissimilar to that of Brazil or Russia. Add Turkey, and it is probably larger.

At this point some of you may be raising your eyebrows. After all, isn't this the very region which suffered most in the world as a result of the financial crisis and recession?

It is true that several of the Baltic states will see a decline in output in double digits this year. Nonetheless, Poland is the only EU state expected to record positive growth this year. Future prospects for the region will be assisted by inward EU infrastructure investment in the years ahead, while human capital and skills compare well with the rest of Europe.

It would be wrong to make sweeping generalisations. But most new member states will return to growth rates higher than the EU average over the next few years.

And a region of this size, over the medium to long-term, will become an important export destination for products and services. We would be foolish to overlook Europe's BRIC-next-door as part of our wider business strategies.

Second, we need to perform some delicate balancing acts if want to turn green shoots into permanent recovery.

We have probably now reached the apogee of fiscal stimulus around the world, with the benefits starting to show in the real economy, and some of the measures now coming to an end. We are all Keynesians now, and the medicine has worked, but the supply will not last forever.

The challenge for the near- to medium-term is to manage our exit. It's a delicate balancing act. We must be careful not to withdraw our economic stimulus packages too early. Things will take some time to unwind, even under the best recovery scenarios.

With the benefit of hindsight it is easy to say that our forefathers got just about everything wrong in the 1930s. Undoubtedly, however, they

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withdrew the crutches from the economy too early, with disastrous results.

As they say, he who ignores history is condemned to repeat it. Careful phasing of withdrawal will be vital. French economic minister Christine Lagarde said last month: *“It is incredibly difficult to tiptoe out of recession... An untimely exit might prove riskier than continuing to support our economies for a few more quarters.”*

And we should not think that the timetable will be the same for everyone. Last week when I was in Australia, the only major developed economy to escape recession, I visited the Reserve Bank, which was one of the first to raise interest rates. Yet even there, there is a clear sense that there should be no rush to remove stimulus.

Our longer-term challenge is to correct the imbalances of debt and consumption which had built up in the years before the recession.

A few statistics help to paint the picture. Across the five main Asian economies for which data are available, the aggregate savings rate rose from 31 per cent to an astonishing 45 per cent between 2000 and 2008.

On the other side of the equation, borrowing as a proportion of GDP grew in the US by 70 percentage points over the same period, reach an astonishing 42 trillion dollars in 2008. On the same basis, borrowing grew even faster in the UK and Eurozone.

It brings to mind Shakespeare’s Falstaff: *“I can get no remedy against this consumption of the purse. Borrowing only lingers and lingers it out, but the disease is incurable.”* In fact, this particular disease is curable, but we need to treat its causes, and not just the symptoms.

Policy and structural reform will be necessary if the West is to spend less, and Asia is to spend more. This year, domestic consumption has begun to rise in many Asian countries, while saving rates have been nudging upwards in the West, but this is not something which we can solve overnight, and getting the balance right requires all the international co-operation we can muster over the next five to ten years. The good news is that there is now finally official recognition, by the G20, that we need to address these deeper issues.

In emerging nations, this includes the expansion of social safety nets – most notably health

education and retirement benefits. It means active development of more efficient and more sophisticated financial and capital markets – including equity and bond markets.

Meanwhile in the West, we need to recognise that macro-economic demand management is about more than controlling inflation. It is about influencing the supply of credit as well as the cost of it. Interest rates and inflation targets alone are not enough as our armoury of policy weapons, and we need a new tool to smooth the credit cycle.

A key element of this, I believe, involves adopting a counter-cyclical approach to capital ratios. This would strengthen both macro-economic management and macro-prudential management. In other words, it would help balance the real economy and ensure stability in the financial system. During the good times, banks would be required to hold more capital against their assets, to discourage excess and to build up their reserves before leaner times. It does also mean that during the bad times, capital ratios could be managed to help offset a dangerous drop in lending to the suffering economy.

This last point is an important one in the current context. As the debate continues about the right way of strengthening the financial system, and the right parameters for gearing, liquidity and risk adjustment, and capital ratios, it is very important that we get the balance right.

Once again, we need to ensure we don’t slip into the mentality of our forefathers in the 1930s. There is, I believe, a real danger that the cumulative impact of doctrinaire policy could have some perverse and unintended effects on the economy and for wider society. The cumulative impact of various measures currently under discussion for the enhancement of capital ratios, at the wrong stage of the economic cycle, could easily withdraw credit from the economy, and cause a new credit crunch. This, in turn, would interrupt and delay a fragile economic recovery.

Without question, we need change. There are many lessons to be learned and the goal must be a strong, flexible, profitable banking system, something which is essential for every market economy, and never more so than when the economy is struggling to return to growth.

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But there are clear risks in some aspects of the current agenda for reform and implementation now could easily damage economies all over again, just as the crisis itself did. We need an approach to implementation which is properly calibrated and phased, and which is co-ordinated internationally across the G20.

Third, and finally, the crisis has highlighted the importance of focusing on sustainable growth. On the anniversary of Lehman's collapse, Nicolas Sarkozy called for a 'great revolution' in the way that national wealth is measured.

He said: "*For years statistics have registered an increasingly strong economic growth... until it emerged that this growth was destroying more than it was creating. The crisis doesn't only make us free to imagine other models...It obliges us to do so.*"

Certainly the crisis has now made clear that Western consumption patterns were unsustainable, and that the 'growth' they created was in part ephemeral. Many had become slaves to a culture which was fixated on material growth and nothing more. And at the corporate level, there is still a danger that focusing obsessively on quarterly results leads us to lose sight of the wider picture and the longer-term.

We must reject a short-term approach to value maximisation, and get back to the real task of sustainable value maximisation. And this means applying the concept of sustainability to all of our business practices.

Some still think that the concept of corporate sustainability is somehow incompatible with shareholder value maximisation, or fear it can be an excuse for poor competitive positioning, operational inefficiency and low returns to investors. They are wrong.

Sustainable business requires the nurturing of customer relationships and providing a consistent, high quality service. This, in turn, depends on engaged employees, who are respected as 'ends' and not just treated as a 'means'. Furthermore, as consciousness of the broader impact of a business on society and the environment grows, how we interact with the wider world must be a

fundamental to how we think about and do business.

This is now vitally important. In the wake of the crisis, and with trust in business and the financial system arguably at an all-time low, it has never been more important for companies to prove the contribution they can make to society.

In a new McKinsey survey, 72 per cent of global executives believe that the public's expectations of business have increased as a result of the crisis. Drilling down into the detail gives some clues as to what this means for business strategy: two thirds believe that the crisis has accelerated demand for more ethically produced products, and even more think that it has led to greater demand for investment in developing countries.

Our own research also shows that recession has not dented consumer concern on sustainability issues: in HSBC's latest Climate Change Monitor research, almost seven in ten global consumers said that addressing climate change is at least as important as supporting the economy in the downturn.

In conclusion, as we enter a new era of social and demographic change, Europe should actively participate in setting the agenda, and European businesses should act as positive role models internationally.

First, this means looking East. Europe needs to recognise and respond to the reality of the new geopolitical and economic environment in which growth will come from the world's emerging markets.

Second, it means performing a tricky balancing act. In particular, Europe needs to bring its expertise to the policy table, to play its part in rebalancing the global economy, and in turning green shoots into permanent growth here at home.

Third, it means thinking sustainably. As we do so, I believe we will find that some of the greatest opportunities for European business will lie in the development of solutions needed to fight climate change and to address the resource shortages that our people and our planet will face in the generation ahead.

Thank you for listening, and I think we have plenty of time for questions.

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