

OUTLOOK AND KEY ISSUES FOR EUROPE'S FINANCIAL MARKETS IN 2010

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The world spent the closing months of 2008 in what Alan Greenspan described as a “*state of shocked disbelief*”, collectively recoiling from the swift collapse of Lehman Brothers and the brutal and nerve-shattering turmoil which followed. In Germany, the value of exports declined by over 10 per cent in the month of November, while in the UK Mervyn King bleakly stated that “*not since the first world war [had] our banking system been so close to collapse*”. And now we know just how close we had come.

As we approached a new year, we did so with trepidation and many unanswered questions. We found ourselves, suddenly, in uncharted waters: was this the end or just the beginning of the world's worst peacetime recession; would the unprecedented fiscal stimulus package work; and could our financial markets ever recover?

At the end of 2009, we are breathing a collective sigh of relief. Most European economies are officially out of recession, fiscal support packages – including previously untested measures – seem to be working, and a full and thorough debate on regulatory policy is taking place in response to the crisis. Furthermore, the fact that Europe is on the road to recovery is not down to luck; it reflects good judgement – judgement which means we avoided the mistakes our forefathers made in the 1930s, when fiscal support was withdrawn too early and there was a retreat to closed markets.

By these measures, 2009 has been an important, even a successful year. Historians will record a positive verdict of a crisis handled well. But 2010 could, in many respects, be a more significant, even a watershed year for Europe and its financial markets.

2010 will be the year in which we move from crisis management to planning for the long-term, and in which we progress from talk to action. Certainly, if we are serious about building a

Europe which is stable and prosperous in the long-term, we are going to have to make some tough decisions in the months to come.

These will not be decisions taken staring down the barrel of a gun, as in late 2008 and early 2009. They will be decisions debated and weighed in the full glare of political and public scrutiny, making them all the harder to take, and the responsibility of getting them right even greater.

First, as the reality of a slow and bumpy recovery unfolds, Europe must make the economic decisions which support sustainable growth and avoid plunging the world into another deep recession.

Second, as we learn the lessons from the crisis, our decisions on Europe's supervisory structure must not only address past failure, but also be flexible and far-sighted enough to respond in future crises.

Third, with the Lisbon Treaty finally in place, Europe needs to prove it is ready to confront the reality of a rapidly changing world, and cast a new vision for its future on the global stage. I will take each of these areas in turn.

First, our decisions must reflect the reality of the economic outlook for Europe in 2010 and beyond.

I began on a positive note: the worst of the recession is almost certainly behind us. But the technical criteria for what constitutes a recession seem optimistically weighted towards recovery and out of step with the current economic reality: it takes two successive quarters of negative growth to enter one, but only one quarter of positive growth to exit again.

Moreover, after recession of the scale we have seen in Europe, it will take more than a few consecutive positive statistics to restore us to growth in real terms. By HSBC's forecasts, it will not be until 2012 that Western Europe even makes up the lost ground brought about by a fall in GDP

“2010 could be a watershed year for Europe”

of nearly four per cent in 2009. We must be realistic in our expectations: rising unemployment, anaemic growth rates, and a bumpy recovery during which we encounter setbacks along the way will be the reality of our transition to a 'new normal' in 2010.

At the same time, it is likely that monetary and fiscal stimulus in Europe has now reached its peak. Indeed, some measures are even now being wound down. It is clear that European leaders have some tough calls to make in 2010. We are all aware of the risks posed by high public deficits and we know that markets and rating agencies will not be forgiving of those countries which shy away from tackling their swollen debt burdens. But make no mistake: turning green shoots into sustainable recovery must be the primary priority for Europe's governments and central banks in the months ahead.

It will take courage to continue providing the support that the economy needs, especially as the signs of recovery strengthen and as the impact of unprecedented government intervention starts to really hit home with voters. Calls for more rapid monetary and fiscal tightening will increase, but the decisions that Europe's governments and central banks take must be based on economic data, not just popular opinion, and our actions must be carefully calibrated to minimise the risk of plunging the economy back into recession.

Success will depend upon acute judgement and careful timing. But the simple truth is that while the risks of growing deficits in Europe cannot be ignored, the risks of premature exit are greater. As the managing director of the IMF put it a few weeks ago, "*We have to be sure that the recovery is final, that domestic demand is self-sustaining and the peak in unemployment is on the foreseeable horizon.*"

This immediate challenge addressed, 2010 will also be the year when Europe needs to start taking action to correct the imbalances of debt and consumption which built up in the early years of the decade.

I will talk in a moment in more detail about supervision. But first I want to emphasise that however many detailed proposals are made to improve stability within individual firms, if the

gaps in the framework for macroeconomic management are not plugged too, we cannot build a sustainable financial system for Europe. Discussion has begun, but there is much work to be done at the national, European and international level to ensure that Europe has the macroeconomic framework that it needs for the future.

I have believed for some time that policy-makers need to evolve a new macroeconomic tool that will influence the *supply* of credit as well as the *cost* of credit in the economy. To be clear, inflation targets are absolutely necessary. But they proved an insufficient armoury against a tide of cross-border flows driven by global imbalances, and an addiction to leverage driven by the search for yield. We urgently need an additional tool to tame the credit cycle. It was encouraging to see the Bank of England's recent thoughtful and open-minded contribution to the debate through its discussion paper, and we can only hope this will add momentum to the debate and encourage more tangible action.

A key element to managing imbalances in Europe, I believe, involves adopting a counter-cyclical approach to bank capital ratios, which would be more alert to systemic stresses and which is more closely aligned with key macro indicators in the real economy than has hitherto been the case. This could help us to balance stability in the financial system with the requirements for economic growth. During the good times, banks would be required gradually to increase the amount of capital they hold against assets, whether across the board or in key sectors, 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 a suffering economy.

This particular challenge – how institutions might be able to reduce their capital ratios, as the recession turns, in order to increase lending into the economy – should be a real priority for regulators, because many economists believe that we are talking about now.

This brings me onto my second point: we must now get down to the business of prioritising and responding to Europe's supervisory challenges.

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It is not that long ago that when someone began to speak about supervision, it was only a matter of time before audience heads went down and blackberries came out. Regulation was boring stuff, not for doers. Not today. We have found out what happens when we get regulation wrong; we now have the opportunity to get it right, but we cannot fail this time.

We have begun to grapple with some of the key issues and the debate is reaching a crescendo: higher capital ratios and liquidity requirements, leverage ratios, narrow versus broad banking, “too big to fail” and “living wills” have all emerged as key themes.

However, before we move from proposals to implementation, we need to take stock and tackle three issues which are emerging as a result of this important and necessary debate.

The first is the timetable for change. The cumulative impact of various measures currently under discussion in Europe for the enhancement of capital ratios, if enacted at the wrong stage of the economic cycle, could easily withdraw credit from the economy, and drive a new credit crunch. This, in turn, would sabotage the return to growth. Financial services are the bloodstream of a successful modern European economy, and implementation must be properly calibrated and phased, as we seek to turn fragile green shoots into sustainable recovery.

Europe must get the balance right between leading the world, and working in close cooperation with – and to the same timetable as – other policymakers, so that our financial markets are not placed at a competitive disadvantage. Europe cannot make policy decisions in isolation in our inter-woven world. It is in the collective interest – that of the public, the industry and its supervisors – that Europe gets its regulatory policy right, rather than puts it in place quickly. If we fail to do so, I have no doubt we will end up in the midst of another crisis.

The second issue is that we need clarity over the roles and responsibilities of our new European Supervisory Authorities – or ESAs.

The creation of the European Systemic Risk Board and the European System of Financial Supervisors presents a perfect opportunity to simplify the multiplicity of rules within the EU. It

should help us move towards a single rulebook and to converge on best supervisory practice. The prize of success will be greater efficiency, reinforcement of the single market, and a reduction in costs to firms at a time when the overall intensity of supervision is increasing.

And how do we achieve this? Not of course, simply by creating another layer of supervision, nor by micro-managing either markets or firms. For example, while it is right that the ESRB should consider and take responsibility for issuing warnings on Europe-wide systemic threats to financial stability, it would not be appropriate for the new institutions to supervise individual firms, an activity already performed by home state supervisors. More generally, allowing ESAs to countermand decisions of national supervisors within the EU, or to dominate colleges of supervisors – thereby challenging the clear structures and processes already embedded in EU law – would introduce legal uncertainty, increase regulatory risk for firms and could lead to confusion and volatility for markets.

Third, if we focus too heavily on prescribing narrow initiatives and inflexible solutions we risk losing sight of the all-important big picture.

Let me give two examples. An important debate is now taking place about the size of individual systemically important financial organisations. This is a complex subject, and in an understandable desire to make things simpler, it has been given the shorthand “too big to fail”. But this is really a rather unhelpful term: all banks are too big to fail in the strict sense, and in any case there was no common denominator of size or structure amongst the institutions which collapsed as a result of the crisis. Indeed, any efforts to reduce diversification by geography and business line could lead to more individual failures, with a corresponding adverse impact on economic and market confidence.

Calls for a return to some earlier age of “narrow banking” miss the point that both markets and their customers are now global, with complex and multiple financial needs. It would be unrealistic – and also highly inefficient – to demand that business customers, for instance, use a range of institutions for these services. Nor would it, in practice, reduce risk to the system. The reality is

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that it is impractical and undesirable to prescribe some ‘ideal’ size or business model for a bank, and it is unrealistic to think that there is some magic formula to reconstitute the industry in a way such that individual institutions are no longer systemically important.

We can, however, give consideration to how certain organisational structures may provide greater protection if the worst happens. A structure based upon separately capitalised local subsidiaries, for example, enhances security for depositors, regulators, and investors.

However, recovery and resolution is a complex subject and policy must be developed with a large dose of common-sense, and a focus on what is realistic and achievable. The concept of the “living will” – the idea that institutions and their regulators should be able to produce discrete and actionable plans which set out how the bank will be reorganised or wound down if the worst happens – certainly deserves closer consideration. But it can never be a panacea. And, as ever, the devil is in the detail. There is a real danger that a simple concept which is in the public interest, could become a complex and unmanageable process, which certainly would not be, with all the adverse costs and consequences this would entail.

As we approach 2010, full and constructive debate on the future of the regulatory landscape must continue, and we must prioritise amongst the vast range of proposals and implement those which will be most effective in delivering a stable and sustainable financial system for the long-term. Our focus should therefore first and foremost be on liquidity management and capital adequacy, and upon delivering effective international co-ordination.

Above all, as we adjust our architecture, develop our thinking and progress our processes to prevent a recurrence of last year’s crisis, we must remember that the next crisis – and there will be one – will probably be caused by something we have not yet even identified. In 2010, Europe’s challenge will be to develop a forward-thinking, flexible architecture, which we can adapt and evolve in response to the changing environment. It must also seek to be part of an international consensus, since the markets are inevitably global.

No economy or market – even one as big as Europe – can be an island in the 21st century. Which brings me to my final point.

Third, and finally, Europe needs to develop a clear vision of its future role on the world stage.

The financial crisis threw into stark relief the enormous and irrevocable shifts taking place. We are now leaving a brief era in which our unipolar world was dominated by one superpower.

We are now entering a new phase of globalisation, in which emerging markets will drive growth, and a truly multipolar world where old and emerging great powers and regional blocs vie for influence, power and market share.

The G20 has proven its value as a serious decision-taking institution, and has emerged as the primary discussion forum for international economic affairs. On economic issues at least, the G7 and G8 have been marginalised. This trend will continue; it is a reflection of wider reality. Over the next 40 years, total G20 GDP is expected to surge from 38 trillion to 162 trillion dollars, but nearly 60 per cent of this growth will come from Brazil, Russia, China, India and Mexico. These five economies, currently accounting for less than a fifth of G20 GDP, will represent nearly half of the total by 2050.

Over the same period, the G7 will shrink from over 70 per cent to 40 per cent of the total.

The pessimist might conclude that Europe faces terminal decline in this rapidly shifting world. Yet I am far from pessimistic: we often talk about the potential of the demographic power of countries such as China and India, but the EU, with nearly half a billion citizens, would rank as the world’s third most populous nation were it a single entity. Even by 2050, when Europe’s GDP is forecast to reach 26 trillion dollars, it will continue to qualify as one of the top three economies in the world.

But this is no time for Europe to be complacent; we need to take action now to secure our future. The Lisbon Treaty was driven by recognition that influence is shifting in the world and Europe needs to build a new agenda in the face of growing competition, from the East in particular, but not exclusively so. From that perspective, the results so far have been less than impressive. For the past few years, European leaders have been caught up in a debilitating process of introspection.

“Europe needs to develop a clear vision of its future”

With a strengthened institutional framework and a new, expanded team taking shape, Europe can and must open its eyes to the rest of the world and build a more dynamic and externally-focused agenda. There are, I believe, three specific areas where we must achieve progress in 2010 if we are serious about preparing for our future.

First, Europe needs to build long-term, sustainable relationships with emerging markets. Looking ahead a generation, it certainly seems that the world's financial map will be redrawn. Centres like Hong Kong and Singapore are flourishing, with others closing the gap. Where will all this leave London, Frankfurt, Paris, Geneva, Zurich and Milan? The prerequisite for building sustainable relationships is moving away from a 'zero sum' mindset, of Europe versus Asia, for example. And building these mutually beneficial partnerships will be possible and necessary at many levels – between authorities, between financial centres, between individual institutions. The litmus test will be – can we nurture relationships which provide new streams of revenue and business for Europe, while allowing us to share expertise and technical skills in a way that supports local market development, and ultimately improves quality and choice for emerging market customers?

In thinking about emerging markets, we should also not forget about the 'BRIC on our own doorstep', if you will. The collective size of the new EU member state economies is now not dissimilar to that of Russia or Brazil. Perhaps nowhere are the opportunities greater than in financial services. The potential to develop and deepen financial systems and markets in many new member states is as great as in some other emerging regions. Moreover, the future strength and competitiveness of the European economy will in no small part be shaped by the dynamism and innovation of these new member states and their people. Look at Poland: the only EU state expected to record growth in 2009, with a talented and skilled pool of human talent.

This brings me on to a second important point: it is now time for Europe to shape a clear vision of its future. The world is entering a new phase, in which growth will be driven by emerging markets. We must respond by reinvigorating the debate on

EU enlargement and reassessing our economic relationships with our neighbours.

The opportunities to forge stronger trade and cultural links with regions such as the CIS and Eastern Mediterranean should certainly be on the discussion table. Meanwhile, the future of Turkey in Europe is perhaps the most obvious question we must address. As an aside, Turkey is already an integral part of European operations at many companies (including at HSBC). It is also a country which HSBC identifies as one of Europe's 'Super States', with potential for high economic growth ahead and a high degree of dynamism.

We should not mislead ourselves that enlargement can reverse the direction of the shifting world economy, or that more formal economic relationships would solve all our problems. However, we cannot escape the fact that a larger Europe would undoubtedly be a stronger Europe, and any meaningful discussion on our future must address these issues.

Third, the important discussions taking place in Copenhagen this week only highlight the opportunity for European financial markets to show real international leadership next year by proving the contribution they can make in response to climate change. The idea that we can create man-made solutions to our man-

made problems is not only appropriate but necessary, and I have great faith in the ability of markets to harness the human capital needed to do so.

Effective market mechanisms to encourage – and to finance – the shift to low-carbon economic growth will be essential. Clean technology developments have to be funded, investments have to be financed and carbon has to be priced properly, if this greatest of human and economic challenges is to be met. There is no way we can do it without the help of the financial market, and Europe is well placed to lead the way.

Of course, if we are to be credible in the eyes of the world, and to secure Europe's future on a changing global stage, we also need to be clear about our commitment to working together as 'one Europe'. We have seen a rise in 'economic nationalism' in Europe in recent years, something which is in danger of being ignited once again by the impact of recession and the creation of new

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roles under the Lisbon treaty. But as we face the future, we must do so with the recognition that a successful financial services industry is not only the lifeblood of our modern European economy, but a core strategic asset for Europe. We must be careful not to unravel the good work of our journey thus far towards a single market for financial services and it is vital that we work as one to build a world-leading and sustainable financial system for the future, which will allow us to take advantage of the emerging opportunities in the shifting global economy.

In closing, it seems appropriate to reflect on the words of TS Eliot, who accurately captured the inevitable reflections that a year end brings: *“For last year’s words belong to last year’s language, And next year’s words await another voice.”*

Twelve months ago, phrases such as “falling off a cliff”, “collapsing confidence” and “deep gloom” abounded, as the downturn tightened its grip on Europe and the rest of the world.

The language of hope, even if it is cautious, is slowly creeping back.

But this does not mean that Europe can be complacent; some of the toughest decisions we will face as a result of this crisis still lie ahead.

We must have clear heads, and the ambition and strength to pursue our convictions, as we take decisions which will impact the next generation.

Every new year is, by its very nature, one of fresh opportunity. As we leave 2009 and approach 2010, Europe’s decision makers can and must leave behind the language of failure and recession and find a new, bold voice which leads us, with conviction, on a course towards sustainable economic growth, supervisory vision and international leadership and co-operation.

Thank you for listening and I am happy to take your questions.

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