

## **The World Economy at a Time of Monetary Experimentation and Political Fracture<sup>1</sup>**

Charles Dallara  
Former Managing Director, IIF  
Executive Vice President, Partners Group

I am in no position to talk about mature democracies after the US presidential campaign. But we do have mature institutions. We have institutions in our Executive, Legislative and Judicial branch. They have developed their practices their standards over 200 years. We have a federal structure which has developed and grown over 200, nearly 250 years. And this is what I see taking place here in Korea with some quite remarkable achievements. It is not just size of your economy but the per capita income is in the top thirtieth of the world now.

And I must say I looked at other governments which emerge from military in the 1970s and 80s. Many of them have not made anywhere near the progress you have made here in Korea and I hope you realize this. Earlier this year I was in Argentina. Government dictatorship became a democracy first in the seventies then it had to become a democracy again in 80s. Brazil has been in political and economic chaos. The recession this year in Brazil, I think, is well over 4 percent. Yes, your growth is moderate and your challenges are significant. But on a global scale your achievements resonate impressively to me.

Of course, we are in a century which so far has been dominated by two somewhat competing forces: the forces of globalization and technological revolution intertwined on the one hand and the forces nationalism on the other hand. I do share the concern that the liberal fundamentally democratic post-World War order created in the second half of the 1940s is at threat. That order which was built around the concept of respect for nation's borders, around the concept of integration and collaboration, around the concept of gradual globalization with the creation of global institutions, and then the gradual opening of markets, both trade and services.

This concept has served us very well. Largely not exclusively, the world has been at peace for over 60 years. There have been times like in the Balkans where this has not been the case, most recently in Ukraine, and in the late 1960s in Vietnam. But on a global scale, the world has been much more stable and peaceful than in previous periods of history.

Yet today we seem to be increasingly dissatisfied with globalization and we seem to be failing to understand that globalization and technological revolution have gone hand in

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<sup>1</sup> This is the transcript of the speech by Mr. Charles Dallara at the IGE/KITA Global Trade Forum on October 21, 2016. The views expressed here are the speaker's.

hand. I know that today is not an easy time for one of your large companies, Samsung. But I think we would all agree that Samsung has been at the forefront of globalizing technology for Korean companies, investors and citizens. Your entertainment industry is renowned throughout Asia and the world. You have many other companies which have now become main pillars of the global trading system.

And even here in Korea today I see a much more international population in your 50 million than I did 30 years ago. I see the benefits as we do in America, being able to import a wide range of goods and services that are available in a much more efficient, cost-effective fashion than that ever could be in a world of close borders. It was not that long ago, in the mid-80s, that the Korean culture regarding imported goods was still quite protective. I remember, during one of my first visits, seeing a pamphlet which shocked me. It was being distributed in the schools for your young children. This booklet was more or less like a cartoon, so the young children could understand that. The pamphlet had a young Korean boy picking up a pencil and it had a pencil made in USA. And his neighbor in the cartoon said 'no, my mother said you cannot use an American pencil.' Well, we have all gone through these phases but I would challenge you're not going to find anything like that today in Korea because the benefits of globalization are so evident. I would say at a time when the nation state seems to be resurrecting its energy and globalization is under such threat, think tanks like IGE are so crucial to providing fora for open, frank but constructive and civilized debate and to providing a framework for analysis and research and discussion and debate across borders.

Dr SaKong was telling me this morning how many distinguished speakers the IGE has had over the years. That is no surprise to me because he has built an organization that has a world-wide reputation. And I think it is so important that organizations like this continue to prosper because the quality of the debate has deteriorated so substantially in our political circles.

I have to be honest that I will never be embarrassed by my country or for my country, but I am embarrassed by this presidential election process. As a US citizen, we have a right to expect more from our political system. We have a right to expect quality candidates, honest candidates, and candidates who are willing to debate the issues. In my own mind, to be honest, neither candidate measures up to those standards today. Fortunately, we do have strong institutions and we have strong dedicated civil servants. It is not often that we pray civil servants because everyone wants to throw bricks at Washington. Everyone wants to throw stones at the establishment. But every country – Korea understands this – needs a very capable set of institutions and public servants that can serve their people when maybe the political system is not providing the best leadership available.

Let me talk a little bit about what I think is going on in the global economic landscape. The world has been for a number of years in a period of monetary experimentation. You don't see it so much here in Korea where the central bank still uses largely traditional tools and instruments. But in my country the world of quantitative easing

has become a huge phenomenon. In Europe, the world of negative interest rates and some forms of quantitative easing purchasing government paper in the markets has become a widespread and painful phenomenon. I just came here from Tokyo where the Bank of Japan is out in front of everyone with the experimentation.

I don't mind experimentation when it is necessary but what I don't like is in the experimenters do not acknowledge the experimentation. They proceed as if we are in the world we fully understand. They proceed as if this is a very light path, full of light and sunshine. It is not. We are walking in some rather dark tunnels now when it comes to what the ultimate effect of this extraordinary monetary expansion would be.

And I would feel much better if the central bankers would acknowledge these questions and these uncertainties because to a certain extent, this new world of monetary experimentation has been accompanied by a private investor world that has become obsessed with this experimentation. We hang on every word. We follow every note from every minute we release from every central bank gathering. We presume and we try to convince ourselves before we go to bed that they know what they're doing. They are dedicated central bankers; I don't question this. But there is no one to really know with confidence the ultimate effect of this huge expansion of monetary policy and this move into negative rates.

In Japan today the Bank of Japan holds just under 40 percent of all existing available government of Japan bonds. This is a phenomenal intrusion into the functioning of the marketplace. In the US, the Federal Reserve has continued to roll over all the debt coming due that's on its balance sheet rather than allowing it to expire and allowing some of this distortion in financial markets to moderate and ease. We are living in a world of hugely distorted asset values. In Partners Group we call that "asset-flation". It's not a very pleasant word to the ear, asset-flation, but it is a compelling concept because we see asset values all around the world being inflated and distorted by the central bank policies.

It almost reminds me of something that happened over a century ago in Nova Scotia. In the late 19<sup>th</sup> century there was a young Hungarian-American magician. His name was Harry Houdini. Harry Houdini was an escape artist. They would tie him up, his hands and legs, they would drop him in the water, and suddenly he would miraculously emerge. But before he became an escape artist, his special trick which made him a lot of money was levitation. It is the concept of taking a physical reality and lifting it with no apparent support. So we had his partner who became his wife and he would have her suspended in the air levitated. In Canada he was very popular, making a lot of money and thousands of people came to see him. But unfortunately he ran out of time and had to go back to New York. He went back on a ship. Nova Scotia was on the eastern sea board and part of the Atlantic Ocean. The weather was very rough and the levitation equipment that he was using to fake his fans was lost over board. So when he came back to New York, he couldn't levitate best anymore.

Is Janet Yellen losing her levitation equipment? Is she losing the ability to levitate asset prices? I think so. I think that we are at the edge, at an inflection point where asset prices will gradually converge back toward fundamentals. This will be a somewhat painful correction, I'm afraid. If the Federal Reserve has its way, it will be gradual and not too painful for equity investors or fixed income investors, although I would not want to be sitting on a huge pile of US government paper today.

But markets have a way of deciding on their own what the right pace of monetary tightening is. The markets decide that if the Federal Reserve is moving too slowly, then they can tighten on their own by pushing up the 2-year, 5-year, 10-year and 30-year rates. This could have a dramatic effect not just in the US but in all global debt markets because what is important for borrowers is not just the base rates but the spreads. In the spring of 2014, even though the Central Bank in Europe was moving toward lower and lower rates, the cost of credit went up quite dramatically for many borrowers because of the spread effect of the rising US rates. This was the so-called taper tantrum. I do not rule out this phenomenon.

Now to give central banks credits, they are trying to shift the focus to the governments. When I was just in Tokyo, I saw some key officials there, including the Central Bank governor. Without revealing the details of any conversation, it is clear that the sentiments of the Japanese people and the tone of the debate is now shifting somewhat, saying the central bank has done a lot to create the conditions for easy money. Now it is time for government reform, structural reform, and perhaps some fiscal stimulus. This is a little bit with different intonations and this is a little bit of the message that is moving through global markets today.

But can governments really do a great deal? In the US, again, it's very disappointing to see the quality of the debate on economic issues. Are we really debating the serious dimensions of tax reform and infrastructure spending in this country? No. We're just debating whether you should tax the wealthy or cut tax rates. In Europe, the circumstances are very dysfunctional, to be honest with you, that there is no European-wide debate about how to use fiscal policy more effectively to stimulate growth. Unfortunately, in both countries, especially in Europe, regulatory policy has been a part of the problem more than it has been a part of the solution in the last two or three years.

As you all know, after the global financial crisis, there was an intense wave of tighter regulations on financial institutions. Much of that was needed. Because the risk management and governance structures of a number of large financial institutions in the US and Europe failed, failed them, and failed us. With some very misguided decisions in Washington, we ended up in this global economic crisis. So there needed to be tighter regulations.

But the regulatory pendulum has gone too far. It has become much politicized. It is everyone's favorite thing to beat on the banks. One of the few things that Hillary Clinton and Donald Trump agreed upon is "Wall Street is bad" and "money-centered banks are bad".

And this debate has become further inflamed by the recent revolutions of some extremely unfortunate and perhaps illegal practices by one of our large financial institutions. This regulatory pendulum has unfortunately prevented the flow of credit, especially in Europe. And we are not only having this functional physical system but I am afraid we are having the regulatory and other measures which are making it very difficult for the European economy to grow.

Last Friday, I was in Boston giving a speech on Greece. Four years ago, I spent over one year and a half of my life working around the clock to restructure the Greek debt. It became and still is today the largest debt restructuring in history by percentage terms and by nominal terms. We wrote off 107 billion euro of claims on Greece held by banks, insurance firms and pension funds. It was very painful for the creditors. But it gave Greece a window of opportunity to move into a new phase. When Korea had a sovereign debt problem in the late 1990s, it was painful but you moved through it steadfastly and courageously. You did not toddle. You had the benefit of an exchange rate as well as other policy instruments.

Today Greece has been in recession for going on seven years. And we are not talking about the kind of recession the Japanese economy has been in where growth has been flat. We are talking about a contraction of the Greek economy of 25%. This reflects not just the fundamental weaknesses in the Greek economy but I'm afraid it reflects the dysfunctionality of the euro and increasingly the fracturing of Europe. I talked earlier about this competition between globalization and technological revolution on the one hand and nationalism on the other hand. Even though I'm concerned about the rise of nationalism and populism in my country, where it is most dangerous for the liberal world order today actually in my view is Europe because we are seeing the fragmentation of Europe before our very eyes.

With all respect to my British friends, the most frightening speech I have heard in the last two years was not made by Donald Trump or Hillary Clinton or Vladimir Putin or Xi Jinping. It was by Theresa May. Read it and you will whip her speech to her conservative party gatherings. It was nationalistic with a capital N. I hope you know what I mean by that. It was divisive and it runs against this liberal order that we have. If she wants a hard Brexit, she will get it. Now you have President Hollande saying "Come on, come on into the ring. Let's get going here. Let's take off our coats and let's put on the gloves". This is what is happening in Europe today. Meanwhile, you have a man running Hungary and you have a new team running Poland who is very proud of their sense of nationalism.

Last weekend after I was in Boston, I was in a tiny little country in Europe called Serbia. Serbia was at the heart of the explosion of World War I. Serbia was at the heart of massive and painful violence in Europe only 10 to 20 years ago. Throughout the 1990s when Korea was growing, when the US economy was doing quite well under the leadership of Bill Clinton coming out of the Reagan years, and when China was becoming integrated into the world economy, the Balkans were in bloodshed. In Serbia, Kosovo, and Bosnia thousands were killed. I discovered that there are still thousands of orphans from that period who lost

not just one parent but both parents. Why do I mention this? Because the motivation which contributed to so much to both those wars, World War I and the Balkan war of the 1990s, was nationalism. A sense that “Oh, we have Serbians living outside our border. Maybe we should expand our border” is an understandable concept but a very dangerous concept.

I do think that we are at the most challenge period of post-War economic evolution that I have faced in my career. We will need strong voices to continue down the path of globalization. In the US we do not have them. We still can find them because this election is not the end of the day. What to me is most disappointing about the debate yesterday was not the lack of civility. Unfortunately, I’ve come to expect this that sometimes both of them would behave like schoolchildren. But it was the statement by Hillary Clinton that “I oppose the TPP today and I will oppose it as the President.” She knows better. She knows the benefits of the free trade. The speeches she has given to investment banks were not imaginations when she said I am a free trader. But has she given up on this? We will find out. Maybe she can shift gears. Even Trump was modulating his views by saying we will have free trade but it will be fair trade. Of course, he has left a bit of room to move back. The fact that he doesn’t have complex positions with any debt to them on many issues gives him a bit of room for maneuver.

We will need countries around the globe putting nationalism in its right place. There is a very huge difference. I think you know between nationalism and patriotism. I found a quote from one of the greatest scientists in modern science that addresses the issue of nationalism that I would like to share with you: “Today we are facing huge waves of nationalism. Nationalism is unfortunately an infantile thing. It is the measles of mankind.” This is Albert Einstein. We know him for many other brilliant phrases. I’m afraid he’s right. It is a disease, it is infectious, but it doesn’t have to be fatal. I think that we should take some inspiration and love our nation states but not put them at the center of our thinking. If we can find individuals and nation states that are able to be humble about their own role and proud of their country but not obsessed with the beauties of their own particular traits, features, etc., then I think we will find a way forward.

As a former naval officer, I have enjoyed over the years writing a book about Greece and my experiences there and I have studied naval battles. One of the most famous naval battles in history, probably the most famous battle, was the Salamis in Greece for 80 B.C. where the Greeks, not just the Athenians but the Greeks, dealt a fatal blow to the Persians. From that, supposedly, according to the historians, the whole development of the golden era of Greece flowed in the next century.

While I was researching the Battle of Salamis, I discovered that there was another famous naval battle which is supposed to be also one of the most important in history, the Battle of Hansan Island led by the famous Korean admiral, Yi Soon Shin. He prevailed in that Battle much to the dismay of the Japanese. It made a huge difference in the future development of Korea. Unfortunately, he lost his life in the subsequent battle. As he knew he was dying, he said: “The battle is at its height. Do not announce my death.” He subsumed

his own individual priorities and realities in quite a profound, humble way to the good of his country.

I would hope that we could find this as we go forward a new phase of leaders, hopefully not killed on the battlefield but ones who can place their own egos and the egos of the nation states in the right perspective.

## **Q&As**

**Q:** I'm 100 percent with you on many issues. As a trading country with trade dependency ratio of more than 80 percent of our GDP, Korea is very sensitive to changes in the world economy. These days I think populism, nationalism, protectionism and isolationism are prevailing. Brexit negotiations have not even started but we know that Germany and France cannot be lenient to the UK. Otherwise, other European countries may follow. Even Hillary Clinton who was an advocate of free trade said that she was against TPP. Trump claimed that the KORUS FTA took many jobs away from the US. Would we see more protectionism prevail or would the world go back to normal?

**A:** It is certainly true that there have been winners and losers from free trade and from the broader process of globalization and the combination of globalization and technological revolution. Unless you are in certain service sectors, it is not easy in Europe or in America and perhaps this goes for parts of the Korean community as well to have limited education and be in the world where your skill set needs to change every ten years because of the competitiveness of your activity is thrown about like a ball in a boat in a storm if you are in sectors exposed to global trade.

We are moving into something that is most humanly challenging and that is in need for almost constant change. None of us find it easy to adapt to the world of constant change but this is the world we are building for our children and grand children and it does not have to be perhaps as constant as it seems today.

I think we'll get better over time in understanding how to manage technology and not let it manage us. In America today we now have many cities and states passing laws against the use of cell phones when driving. 20 years ago, it was only Israel that was smart enough to do this. We have allowed technology to take us over rather than understand how to manage technology. In New York, where I am based today, my first advice to staff is "Do not walk the streets sending your text. You'll get run over." Seriously, we have deaths almost every week in New York because young man and woman walking the streets when they are not looking because they are sending the text.

This is not a complete answer but coming back to your concern, I am quite concerned that we may have to feel a bit of the pain of protectionism in order to remind us of how misguided it is. Let me give you an example. Again, my own experience. I come from

a small state of southern part of the United States, South Carolina. The biggest employer in South Carolina aside from the government is BMW. This is the part of the country that is very Republican. I went to see the head of BMW there. He was very frightened by Mr. Trump's protectionism. He knew that I was in the communication with Mr. Trump on some economic issues. He said, "Please tell them we produce a thousand cars a day. We employ 8,000 Americans directly in our plant and we support another 35,000 jobs in the broader supply chain that exists just within a hundred miles of this plant." But here's the rub. 80 percent of those one thousand cars per day are not sold to Americans. They are sold to Asians, Europeans and Latin Americans. So if we go through a phase of protectionism, guess what happens. Those jobs are destroyed. This is the reality.

As I look at Europe today and Brexit, I was very pleased to see the sharp depreciation of the British pound last month. If you go to London today or if you live in London today, the value of your pound is much less if you go outside London to Europe. The cost of your goods inside the UK is dramatically rising. They are getting a cold shower. Are we going to need a cold shower? I think that the UK will probably and this is partly analysis, partly wishful thinking. Seriously, I think that the UK will probably have to think again about the costs and benefits of a hard exit.

I think in America we will have to think again about the reality of tearing up trade agreements and opposing TPP. The world is too integrated today. It simply has gone too far. Now can it be fractured? Yes. We're seeing this in Europe today with a rise of the extreme left and right. And this is another frightening phenomenon today that has to do with nationalism and populism. It has to do with the global tendency now which I think is one of the weakest spots in our democracies to pretend that there are simple answers to complex questions. This is what is driving me crazy to pull my grey hair out when I listen to the debate. All they want to give the American people simple answers to complex questions but that is not compatible with the 21<sup>st</sup> century.

There are unfortunately tradeoffs in everything that is done today, whether it is trade, whether it is tax reform, whether it is healthcare, whether it is technological revolution, or whether it is the biotech revolution. We have to understand the tradeoffs and discuss them in a civilized way. Obama wanted a broader frame of healthcare, a very legitimate goal. But in doing so, has he raised the cost of healthcare for many Americans in the middle class and many small businessmen? People talk on the issue of abortion in America as if you are either pro life or pro choice. The issue of abortion is a complex issue. It involves complex judgments of a personal and social nature. Surely, there is room for debate here to find the right ground rather than everyone wanting to be pro choice or pro life.

I think is a phase we are in today, and I really think that the power of globalization and the complexity that it has brought will eventually bring us back together but I'm afraid that we may go through a difficult phase where we may have to burn our fingers a little bit before we decide to behave more responsibly.



**Q:** First, the global economy is not in good shape, except the US economy. Should the Fed raise interest rates even against the wishes of many other economies that are struggling? Second, what impact do you think the North Korean nuclear issue will have on the Korean economy and the US economy after the US presidential election?

**A:** Let me give you fairly short answers. First, I would not completely agree that the US economy is doing quite well. We are doing better than Europe. We are doing better than Japan. Perhaps even relative to our growth potential we are doing even better than China today. But still corporate investment is weak. Corporate investment is the weak spot of our economy. Yes, we've had a recovery in housing, and yes, we've had a recovery in consumer sentiment. Exports have struggled somewhat. As corporate earnings have been also affected by the strong exchange rate, our debt to GDP has doubled in the last seven to eight years. So I think that the story from the US is brighter but still a lot of clouds.

Should the US raise rates while the world economy is still weak? I personally think the US does need to raise rates because I think a slight increase in rates will actually boost investment sentiment in the US investment community. I think it will boost consumer confidence to a point if it's gradual because you have savers who would feel more comfortable that they generate some return on their investment, it will also lead to a gradual restoration and more consistency between asset prices and fundamental performance.

One does have to be concerned about emerging markets. So I think the IMF should stand ready to be very active to extend credit lines to emerging markets if some countries get under pressure. Even today Mexico still has an outstanding credit line from the IMF that was put together quite some years ago in the early phase of the global financial crisis. This is prudent management because exchange rates could be affected. Inflation rates, monetary policy and emerging markets could be affected.

This is why I would also argue, though, for much more coordination. Dr. SaKong and I were talking at breakfast about the 'Plaza Accord' 1985 when the US, Japan, Germany, France and the UK agreed an arrangement to depreciate the value of the dollar. But it was much more; it was also about stimulating the German economy; and it was about opening up the Japanese economy. The policymakers today despite the efforts of Dr. SaKong and others in the G20 have lost somewhat the art of policy coordination. This could go a long way, I think, to minimize the damage to emerging markets.

Finally, I am concerned about North Korea and its potential impact on both the Korean and the US economy even today. Even today I feel that it has impacted investment in your country already. And the increasing erratic nature of North Korean leadership is a severe threat. I believe that the US, Japan and China have to accelerate their consultations and cooperation on North Korea. I believe it is a matter of a grave urgency, to be quite honest with you. This is where the priorities have to find themselves. We can quarrel with

China about the South China Sea and we can quarrel about Chinese steel flooding our steel markets, but we have to find some way to work with China and of course with your own government here to find a more consolidated and coordinated approach to North Korea because this could not end well, in my view. And the world has to be prepared, too, to deal with it.

**Q:** I come from a country middle-income country, Columbia and the part of the development was based on trade. We signed free trade agreements with Europe, with the United States, with Canada, and more recently with Korea. Now we are facing this wave of protectionism even before getting the benefits of free trade. So in your view how can a middle income country trying to get part of the global community deal with this new wave of protectionism and what policies can we take?

**A:** I think that is crucial that countries which have built credibility in the global community including your country Columbia use their voice both individually and collectively with other leaders of emerging market countries which are also credible to emphatically express your views to Washington, to Brussels, to Berlin, to London and to work together in small groups as well as individually to make clear that free trade has been an important part of the consolidation of democracy in your country.

I know you have just suffered a painful setback in Columbia which I think was most unfortunate. I am sure that you will find a way forward in your effort to find peace with the FARC. I hope that my old friend, your former President, will be cooperative in the part of that process but my point to would be that the specific alliance countries have built credibility. Of course, you have your own challenges, your own problems, but I would suggest that those four countries – Columbia, Peru, Chile and Mexico – team together and become a strong voice in Washington, in London, and elsewhere because you need to help them understand that this is about lifting the Columbian society and the Columbian economy into broadly framed middle income country, not a country that still has serious pockets of poverty. I think that what these four countries have achieved is quite impressive. Hold us accountable for our trade agreement. Take us to WTO if we don't behave on our trade. You know the post-War institutions were there for purpose. I know it's a bit difficult if you're riding on the back of the elephant to bite the elephant back but still sometimes you have to do that.

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