Global Economic Trumpism

David Malpass

An exclusive interview by TIE *editor and founder David Smick with U.S. Treasury Undersecretary for International Affairs David Malpass.*

Smick: Your boss is being criticized worldwide for destroying the global order. Some argue that it was already crumbling long before President Trump entered office. What is the Administration's ultimate goal having now shocked the system? Is there a broader long-term game plan? The beginnings of a new global order?

Malpass: The goals are clear and President Trump has shown continuity from the campaign into his policies. Growth should be faster, both in the United States and globally. The President also believes in peace through strength. That means a strong defense is a good and necessary path to a peaceful world, with fewer of the crises we have seen in recent years.

Smick: There has been a lot of criticism of the World Trade Organization, particularly its inability to contain the Chinese in the area of intellectual property theft. How would you fix that system?

Malpass: The system needs to be fixed, but it also needs to be changed dramatically so that it works in a more balanced way that will promote growth. The global system would benefit from substantial change. That can be seen in terms of the weakness in median income that preceded the current administration, not just in the United States, but globally. The International Monetary Fund year after year showed lower and lower growth rates for global growth.

With regard to trade, the need for change is clear in the large and persistent imbalances in trade and the ineffectiveness of the WTO. There needs to be substantial, sweeping change.

Smick: Do you have a crystal ball for the global economy? The U.S. economy is strong, but large parts of the world are starting to weaken. Former

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U.S. Treasury Secretary Larry Summers is now suggesting that the world's governments and central banks are ill-prepared for the likelihood of a downturn. There's worry that the European Central Bank could be behind the curve, particularly given that, unlike in the United States, there was no European bank bailout after the financial crisis. The ECB is basically the lone institution able to come to the rescue in the event of a crisis.

Malpass: Growth picked up in 2017, which was welcome. That was particularly true in the United States, which passed tax and regulatory reform.

We have to be concerned that structural changes in other parts of the world have not been as robust as in the United States. For example, China's movement toward a market economy has stalled, raising concerns about distortions and capital misallocation. Japan needs substantial reform in its retail and agriculture sectors, and also needs to reduce the size of its fiscal deficit and the magnitude of Japanese government spending.

China is trying to aggressively use subsidized finance to gain market share and procurement contracts often without regard for the country it's dealing with.

In Europe, we see important imbalances in the fiscal accounts. The debt-to-GDP ratio in Italy is part of that problem.

Some of the emerging markets have not used capital as effectively as they should have. So, yes, there are concerns in the global growth outlook.

But the good news is the United States can be the engine of global growth, and the world should welcome that.

Smick: To what degree do you see an Italian exit of the European monetary union, or a poorly handled Brexit, or both, becoming a problem?

Malpass: Brexit is a unique and major change in the world outlook, and it poses big challenges. The United Kingdom and the European Union are expending a lot of effort to try to figure their way through the issue. The United States is supportive of a good outcome for both the United Kingdom and the European Union in this process. We just don't have too many guideposts from history on how they should do it.

As for Italy, it has had political and economic challenges for many decades. I would focus there on the urgent need for structural reforms in terms of the labor markets and the banking system in order to find a path toward faster growth. Government spending restraint is also a key challenge there and elsewhere.

Smick: Industrialized world policymakers never seem to see change until it hits them in the face. Nobody predicted Brexit. The Bavarian populist movement that is destabilizing German Chancellor Angela Merkel's coalition came as a surprise. What are the wild cards you see out ahead?

Malpass: There's clearly strong sentiment in Europe for political change. That poses challenges and risks, but it also presents an opportunity for Europe to find a path to faster growth and to improved national security. We don't want to focus just on the negatives and the risks in the political evolution of Europe.

Growth is an important wild card. If countries are unable to make structural reforms to address demographics, debt, and the size of government, they may not be able to accelerate. As for other wild cards, we've already discussed Italy, Brexit, the trade imbalance, and government debt. I'm sure there are more.

As we think about global growth, I want to raise one additional point. The availability of capital in the world is striking. Years ago when I was first working in this field, the primary financing vehicle was syndicated bank loans, which had numerous drawbacks. We now have robust global bond markets that allow more investment and financing. As we think about the vulnerabilities in the world, we should also be thinking about the substantial opportunities we now see due to advances that have been made in global finance.

Smick: Along those lines, are you worried that with the U.S. Federal Reserve tightening and the U.S. growth differential with the world widening, there will continue to be a shortage of dollars around the world? There's so much dollar-denominated debt. This situation is already presenting significant complications for emerging markets.

Of course, China is the biggest emerging market. The Chinese have been masterful at disguising their dollar-denominated debt problem. Yet there is considerable talk of a coming tidal wave of Chinese dollar-

denominated debt defaults if the yuan continues to weaken. Do you have this worry?

Malpass: I'm concerned about China's debt buildup, and also the way the credit is allocated—primarily by arms of the Chinese government and by the Party. Elsewhere, there's the challenge of maintaining profitable cash flows in a world that's had a very long expansion. That in turn hinges on whether countries can improve their systems fast enough to keep up with rising interest rates and also with the competition from the improved U.S. economy.

China is a big part of this growth challenge. China is a large economy that's soaking up a lot of capital. They are allocating portions of that capital in non-market ways, so much of that capital is inefficiently deployed there, creating a drag on China's economy but also on the rest of the world because of China's size. You've got this big non-market player that represents a large chunk of the world's GDP, creating a drag on global growth.

Smick: With a strong dollar, global bank stocks have really taken it on the chin during the last year. The theory goes that dollars are used for lending and backed by non-U.S. collateral. When the dollar's value rises, the value of that collateral drops, weakening the banks. Is that too pessimistic? The lending power of the banks seems to be decreasing because of unrealized losses from bond holding and increased bad loans. The unrealized capital loss from bonds is getting very serious. Fed data shows a drop of 2 percent to 3 percent in shareholder equity for the big U.S. banks. The European and Japanese banks are in a far worse position. Are you worried? Or are market participants worrying too much?

Malpass: Anxiety is necessary if one is involved in financial markets and thinking about international finance. Those are fair concerns for you to raise and for people to be aware of.

But the United States continues to grow solidly. I'm pleased by the increase in the labor participation rate. We're showing that we can bring more workers into the labor force, which is helpful in this environment and will pay lasting dividends. But it also means that keeping cash flows positive, especially outside the United States, will be a challenge.

That brings me back to China. Our focus there is that China has been an aggressive user of debt, and to some extent an inefficient user of capital.

Smick: One of the great unreported stories of our time is the speed with which China has accumulated debt. It wasn't that long ago we were talking about Japan as the global king of debt. China has swiftly caught up. How worried are you that China's growth has been too fueled by overinvestment with an explosion in both its public and private debt?

Malpass: While we tend to emphasize China's success in raising its GDP, we should remember that they've also gone through numerous debt crises in part because they don't yet have enough of a rules-based framework for their financial system. I remember a 1993 *Wall Street Journal* article I wrote about the GITIC crisis, one of the several waves of debt crises in China. This one involved provincial institutions that had over-lent and become illiquid. It went on for months.

Certain areas of the Chinese financial system might be over-extended right now, but isn't that par for the course looking at China's history over the past thirty years? From their perspective, they didn't have as deep a downturn in 2008 as others had. But China is facing a lot of financial challenges, many due to its debt structure. However, China has shown an ability to adjust in the past.

We have challenges facing the multilateral institutions. They're often dominated by inertia.

Smick: I know it's not your direct territory, but China seems to lack both the willingness and ability to come up with solutions to global complaints about intellectual property theft. Agree? There's also demand for deeper structural changes to make trade more reciprocal, particularly in financial services. Are you optimistic or pessimistic about the outcome ahead? Tell me if I'm wrong, but the Administration's China strategy seems to be as follows: China doesn't import enough from the United States to match the tariffs dollar for dollar. So eventually, the Chinese are going to lose the trade fight. But will China's next step be to pile on non-tariff barriers such as holding up licenses and initiating bogus safety inspections?

Malpass: I'd rather focus on the challenge within their political structure of finding market-oriented reforms and having that process become more robust.

You're right to ask why they are so unwilling to change in those areas. But that goes to the core of their system, one that is still based on state-owned enterprises. China needs to realize that that's simply not a profitable way to operate in a global economy that's beginning to recognize their non-market policies.

I gave a speech to the Foreign Policy Association in March 2018 that went into some detail on this aspect of China's system. They seek monopoly power. They provide subsidized financing. They select industries where they want to dominate, and that means state control of industrial policy. They often supply export financing at deeply subsidized rates. This connection between their banking system and their industrial sector challenges the rest of the world. It hurts workers around the world when China creates excess capacity, such as in the steel sector. China should see that their system simply isn't working fairly within world institutions such as the World Trade Organization.

Smick: Given the U.S. macro picture, is the timing perfect for the United States to lead a new values coalition of the willing? China will only change—and probably slowly—if it knows that the rest of the world is serious about these questions of subsidies and intellectual property theft. Isn't there strength in numbers if Germany, the United Kingdom, France, and the United States stand together as a united front in demanding reforms of the Chinese? If so, where's this united front?

Malpass: There have been numerous constructive discussions in the G7 and even in the G20 about this common problem of a major world economy operating with non-market principles. U.S. Treasury Secretary Steven Mnuchin has led in the G7 and G20 on the issue of recognizing the investment and national security challenges China poses. Other countries are recognizing the challenge of China taking control of critical technology. Most of the world recognizes that there needs to be a sense of values that creates a constructive world order pointed toward market-oriented growth.

There's clearly strong sentiment in Europe for political change. That poses challenges and risks.

China has been an inefficient user of capital.

Smick: Do you worry about the lack of transparency in China given the interconnected nature of the global financial system? Every ten years we seem to have a financial crisis. Here we have one of the world's largest economic players, but we really know very little about even whether we can trust China's data. Plus we have absolutely no sense of how things would be handled by Beijing in the event of a crisis. Does that keep you up at night?

Malpass: Two points. First, I think China itself is struggling because its policymakers know they don't have good data internally, for example on bank lending or export credits. Second, the lack of good data creates challenges for us. For example, in the Paris Club discussions, China has not joined, and can't provide the data that's needed to get a full handle on its debt in Africa, Latin America, and elsewhere.

China has tremendous self-interest in trying to get a better handle on banking sector data, non-bank financial lending data, data from export credit agencies, and in particular its financial data.

Smick: Will the Chinese resort to further currency depreciation? There's almost a cottage industry of Chinese geniuses who seem to be able to figure out how to move capital across China's borders. So the currency may weaken apart from what the authorities do if people see weakness and uncertainty around them, lose confidence, and move capital offshore. Are you concerned?

Malpass: China's financial authorities were active participants in the G20 and IMFC—International Monetary and Financial Committee—communiqués that point out the benefits of stability for currencies. China saw a taste of currency weakness in 2015–2016. Policymakers there didn't like the impact of that weakness. I think China would not see any benefit in having a weak currency. The world has seen lots of examples of countries with weak currencies, and most of them turn out badly.

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Smick: You have written a lot about debt and its consequences. In only a decade since the 2008 financial crisis, global public and private debt has surpassed an incredible 300 percent of global GDP. And it keeps rising. China's a major participant in the global economy, yet thanks to its lack of transparency we know very little about how it will handle its massive debt situation. What are your thoughts?

Malpass: We are in uncharted territory in several ways. One new factor is Brexit. Second, the bond indebtedness is not brand new, but the amounts are much bigger than in the past. That creates different dynamics in the event of rising interest rates. Third, the world is coming off a period of low and often negative interest rates. Those three unique aspects of the current global financial system need to be watched carefully.

Growth is an important wild card.

On the positive side, there's been a lot of progress in terms of bank capital, especially in the United States, since previous crises. That's a positive factor. Also, there's been a lot of buildup of productive capacity around the world from growth and from the debt that's been incurred. As for China, we shouldn't forget that they've built a lot of useful things, as well as wasted or inefficiently deployed a lot of capital.

Smick: What is your view about any potential complications ahead on the global currency front?

Malpass: In recent communiqués from the IMFC and the G20, there is a paragraph stating that sound policies lead to currency stability, and those factors contribute to growth and investment.

The major currencies right now are relatively stable and that has coincided with a pickup of growth from the lows in 2016. That's a positive.

Applying some of this, I'd like to mention two things I've been working on at Treasury. First, in a world where capital is relatively plentiful, how should the role of the international financial institutions change? We need to think about the effective use of their capital.

Second, I've worked on focusing the role of multilateralism. Until recently, bigger was viewed as better. We want a way to be engaged globally that's effective for American workers and taxpayers. I spend quite a bit of time trying to find ways to restrain multilateralism and channel it more toward growth.

Smick: How do you compare China's Belt and Road Initiative to the ongoing work of the multilateral institutions that Western and post-war economies put together? Will there be problems ahead with the world operating under two separate systems? Will the World Bank end up the big loser?

Malpass: Before the current administration, China's Belt and Road Initiative and the Asian Infrastructure Investment Bank seemed, to many countries, to be tempting and competitive with Western institutions. But there's more clarity now. China is trying to aggressively use subsidized finance to gain market share and procurement contracts often without regard for the country it's dealing with.

Separately, we have challenges facing the multilateral institutions. They're often dominated by inertia. Their role should change substantially because of the new international financial environment.

Smick: In what way? How can these institutions be changed?

Malpass: One of the key reforms that we sought is the World Bank's recognition that they don't need repeated capital increases. They were thinking that this was the latest in a series of ongoing capital increases, and we said no, this is the last one. If you operate effectively, there's no reason for future capital increases. That's a major change.

In the IMF, we allowed the "general agreement to borrow" to expire because there isn't the need for that.

In the multilateral development banks, we are pointing out that their ability to have preferred creditor status creates problems in the global capital structure if it's improperly used. It can create a protected form of debt in a global environment that has plentiful availability of capital. In a similar vein, the AAA rating of some multilateral development banks shouldn't be used as a tool for arbitraging markets unrelated to the mission of promoting development and higher living standards.

One final point is that leverage in the multilateral development banks is tempting to them if the goal is simply for them to grow bigger. But in a world where capital is relatively available, it doesn't make sense to leverage multilateral institutions. They should focus more on the quality of their country programs and loans.

Smick: I agree. Thank you very much. ◆