ARCHIBALD COX, JR.: Good afternoon. Abby Cohen I know is on her way but isn’t here, and I think we probably ought to get started anyway. I’m Archie Cox. I’m Chairman of the Foreign Policy Association. I’m glad to see everybody here. I welcome you all on behalf of the Foreign Policy Association.

After the discussion there will be a reception. The reception is going to be down the stairs, behind the reception desk. It’s down one flight of stairs, and everyone is welcome of course to join that reception. I don’t know if we have any representatives of the law firm here today, but we certainly owe them a thank you for making this place available.

With that, I’m going to turn the floor over to Larry Kantor, who is the Head of Research at Barclays Capital. Larry was a colleague of mine for three years, and I have the highest regard for him and know that his remarks will be very interesting. I think what we will do is Larry will say some remarks. If Abby gets here, we’ll then have her say some remarks. Then we’ll have the opportunity to ask questions, and then perhaps some back and forth between them and with the audience as well. That’s sort of how I think we’ll conduct things today. Larry, let me turn it over to you.

LARRY KANTOR: Sure. I have a pretty loud voice. It’s buzzing, isn’t it? Is it just me?

FEMALE VOICE: Yeah.

MR. COX: I think I put it too high, Larry.
MR. KANTOR: You’re taller than me, but I don’t know if that accounts for the buzz. It’s still buzzing, right?

FEMALE VOICE: It’s still buzzing.

MR. KANTOR: Is this okay?

FEMALE VOICE: Yes.

MR. KANTOR: We’re going to skip the microphone. I was making a presentation at lunch today. I was with -- Archie, and just before I got up there it occurred to me. I thought of a joke from about 10 years ago that I sort of switched around to apply here today. I might try it on you. It’s a very short one. The joke goes like this. God calls in President Obama, Premier Wen of China, and President Nicolas Sarkozy from France, and he said, “You know I’ve had it. I gave you this beautiful earth and the human race has just messed it up. I’m starting over. I’m ending the world in three days. Go out, send the word out.” President Obama goes on a nationally televised address and he says,” I’ve got good news and I’ve got bad news. The good news is there is a God. I met him. The bad news is he’s going to end the world in three days.” Premier Wen goes to Tiananmen Square and addresses the throngs. He says, “I have bad news and even worse news. The bad news is despite all we’ve been telling you all these years, it turns out there is a God, and even worse he’s going to end the world in three days.” Nicolas Sarkozy stands outside the presidential palace and calls all the French people around, and he says,” I have good news and even better news. The good news is that God has recognized me as one of the three most important...and even better, I can assure you the European Debt Crisis will be over in three days.”

This was actually a joke Gordon Brown told about the Asian financial crisis over 10 years ago with different characters. It occurred to me when I was sitting in this audience that if you switch it around it comes out and I guess it works.

I actually don’t know how long to speak because it was supposed to be for 10 minutes, and Abby was going to talk for 10 minutes. I guess I’ll start and we’ll see what happens. I think the way to frame this is a little tough going around the world in 10 minutes or even 20, but I think maybe the best way to approach this is to think about the two factors that have really seemed to pick global markets in the last few months. If you look at pretty much any equity market, there was a bit of a break in mid-July. I think it started getting a little hairy, both in terms of most of them heading down and then getting a lot more volatile. I think the two things where one concerns about the global economy, fears that we were going to have a double dip and go back into recession, and the second things was concerns around sovereign debt. I think in the summer it was focused on the United States, and we ended up with a downgrade from S&P. Now the focus has shifted much more to Europe. I think maybe I’ll just address those two things, and then we’ll have some Q and A.
On the global growth question, I’d say this. I’m more optimistic on the first item—the global growth thing—than I am on the second item, that is the sovereign debt situation, although they are interrelated. On the global growth side, it’s no surprise that markets in the world in general got a lot more concerned about the global economy, because in the first half of this year global growth slowed significantly and it was a very broad base. Just about every region of the world showed a significant slow-down, except oddly enough the Euro area. If you add up the Euro area, including Germany, France, the Netherlands, etcetera, actually it didn’t slow very much. Germany continued to grow quite strongly in the first half of the year.

It was very broad based, but the reasons for the slow-down differed across different areas. Just to generalize, the emerging markets—including and even lead by China but also Brazil and other places—it really was mostly policy induced. This business cycle was unusual. Every business cycle has its own idiosyncrasies, but one of the big ones…and this one was that it was the emerging markets that really led the way in terms of recovery. China was really the first out of the gate, and these countries have grown so far in the recovery—so, things bottomed around March 2009—much more rapidly than the developed markets like the United States and the European economies. Usually it’s the other way around. As a result, they not only regained the loss output from the recession quickly, but way beyond that and got pretty much overheated and there was inflation. They started tightening monetary policy. In China it’s a little different. Rather than just raise interest rates, they actually exerted a large degree of control over what banks were doing. They encouraged the banks to reign in credit. The economy slowed in the emerging markets as a result.

In Japan—actually probably everybody knows this story—they had a terrible natural disaster, and earthquake and a tsunami, and output collapsed. In the United States I’d say there are a lot of things going on, but the two big things that happened in the U.S. in the first half of the year is one, oil prices surged that were associated with the Arab Spring. Gasoline prices as a result rose a dollar a gallon, which is a very, very big increase in the U.S., and this really hit consumer spending. The other thing that happened is the Japan collapse had a very big effect on other countries, including the United States. Just for example, U.S. production of Japanese automobiles—and you probably know almost all the Japanese automobiles that we buy are now produced here—fell 50% in the five weeks after the Japan earthquake and tsunami. That’s a dramatic drop. It’s interesting that it coincided exactly with the rise in jobless claims.

Looking forward, we’ve been arguing—and it’s actually panning out in the data—that rather than cumulating into a recession, a new recession, that things would actually get somewhat better in the second half of the year. Going in reverse order since I just talked about the U.S., what we’ve seen is that gasoline prices have actually come down because oil fell, has not retraced the full dollar a gallon, that’s for sure. We went from just roughly speaking $3 a gallon—this is unleaded regular—to $4 a gallon—it’s also a national average—and we’re now running about
$3.60. That is a big help to consumer spending, and you’re seeing that in the auto sales and you’re seeing it in retail sales. They’re doing better.

The second thing is that Japan after that collapse, there was the other side of the V, output recovered as power was restored and so forth. You’re seeing output now rising in exports. Trade with Japan is going up. Then when you throw in the plunge in interest rates we’ve had—a little more stimulus from the Federal Reserve—it’s pretty easy to get back to a little faster rate of growth. By the way, in the first half of the year in the United States, GDP growth averaged less than 1%, which is very, very weak. The third quarter—we’ve got two-thirds of the data from the third quarter even though we’re already in the fourth quarter—it’s right now adding up to about 2.5% GDP growth in the third quarter, which I’m not going to stand here and say this is great, because in the context of the scope of the recession we had and given that the unemployment rate is over 9%, two-and-a-half is terrible. It’s just that relative to the first half of the year and relative to expectations which have really been depressed, it’s much better than everybody expected.

In the emerging markets, what’s happening there, Japan again is a simple story; maybe not so simple in the sense that...actually in real time we’ve probably already seen the bounce, and things are again going up but they’re at a very slow pace. It’s just that there’s a data lag there, so we haven’t even gotten third quarter GDP in Japan, which is going to look quite strong. It’s going to come out soon. We’re no longer—at least by my reckoning—growing that rapidly. We’re already slowing back down in Japan.

In the emerging markets, what’s happening there is countries are not only not tightening anymore, but they’re actually moving toward easing. Brazil has cut interest rates. Israel has cut interest rates. Turkey has cut interest rates. Indonesia has cut interest rates. The emerging markets are starting to move the other way. China is also starting to ease kind of quietly. They’ve given some tax breaks to small and medium sized enterprises, and also are telling the banks to start loosening credit. They mostly have stopped tightening, but they’re easing a little bit. As a result, you should see at the very least in emerging markets growth stop decelerating. There was very rapid growth at the beginning of the year in the emerging markets. It slowed something like three percentage points if you add all of the emerging markets up. We think it’s not slowing anymore. It won’t necessarily rebound depending on how much they start easing, but it’s not slowing anymore.

The bad news is the Euro area, which held up in the first half of the year and is now slowing pretty dramatically. Actually, at least in the industrial sectors, it’s probably going into recession, we think. What is happening over there is two things. One is kind of an obvious thing, and that is that because of the sovereign debt crisis there, there’s a lot of fiscal tightening going on, tax hikes and spending cuts by the government. This is putting downward pressure on the economy, but that’s been going on for a long time. The other thing that’s happened more
recently, and I think is more troubling, is the financial conditions in Europe—I shouldn’t say Europe—the Euro area have tightened a lot. Stock prices for example in the Euro area this year so far are down about 15%. In the U.S. they’re down only 3% or 2% so far this year. Moreover, bank funding has dried up there. Corporate issuance has collapsed in Europe. All of these things have real economic effects and it’s really hitting those economies now. Adding it all up, things are actually doing a little bit better, and that’s showing up in the data.

Turning to the sovereign debt crisis and starting with the United States—which this sort of thing broke out in the summer—what I’ll say about that is this. I actually have a little bit of a different view than Ericksine Bowles, even though he’s got a lot more expertise in this area than I do. He’s very negative and I can understand it. I don’t know if you know Bowles was co-head of this commission for fiscal reform with Alan Simpson, and I don’t blame him for being very upset, angry, and depressed about it, because he spent over a year on this commission with others that did a lot of work—in my opinion, very, very good work—and the President kind of ignored it after all of that. What I would say about that is the U.S. right now is not in a debt crisis.

Why do I say that? The Treasury is able to fund itself more cheaply than it ever has. It’s pretty amazing when you think about it. Despite the very large deficit and the large amount of debt outstanding in the United States, they can lock down two year money at something like 25 or 30 basis points, and lock down 10 year money at about 2%. It’s extraordinary. In other words, investors can’t get enough treasuries right now.

There was a crisis over the summer of sorts. I put that crisis in parenthesis because in my view it was a manufactured crisis, manufactured by our friends in Washington. What they did was they attached the serious issue like debt and deficit reduction to a largely technical but time sensitive issue like the debt ceiling. They raised the debt ceiling. They’ve done it I don’t know how many times, 80 times in the last 30 years or so. This happens all the time, but they decided they were going to attach these things. We all know that time was ticking. I have to say that it was a pretty ugly presentation all around in my opinion. I don’t think anybody accorded themselves well, the White House, the Democrats, the Republicans, the House, or the Senate. It was an ugly spectacle. I think it really had a bad effect on the country and the international standard. We ended up at the last minute—as usually happens—they raised the debt ceiling, and interestingly enough cut a little under from the budget deficit over the next 10 years—it was back loaded—and set up this other commission split between Republicans and Democrats that are supposed to decide by late November on another at least 1.5 trillion dollars of deficit reduction.

If you step away from the messy stuff which was in all of the headlines, we actually made progress. In other words, as recently as six months ago the White House wasn’t even talking about deficit reduction, and nobody was talking about tax reform. Now we’ve already gotten nearly a trillion dollars of deficit reduction.
One way or another we’re getting another over a trillion before the end of the year, because if this commission doesn’t come up with something there’s going to be 1.5 trillion cut across the board. Everybody’s now agreed we need tax reform, Democrats, the White House, and the Republicans. If this happens, this would be in my opinion a very big plus.

What is tax reform? The details, of course the devil’s in the details. The White House and the Democrats have a very different idea than the Republicans do, but what they all mean is broader based lower rates, which from an economic point of view, purely economic point of view is a big plus. That would be a big shot in the arm for U.S. growth in the medium term. They’ve all agreed that we’ve got to this. Again, they disagree over the details, how to broaden the base and who pays what rates and all that stuff, but in general they all contain a broader base and lower rates, less loopholes—some people fall in them, others fall in exemptions or whatever. To me we’ve made progress. Looking through the muck, we’ve made progress. We’re not nearly done, and if we don’t do something significant in the next few years in the United States, we probably will go into a real crisis. It’s a little annoying because both sides in my view were unrealistic. If you look at our entitlement systems—especially health care—the simple truth is whatever side of the political aisle you run, we have a health care system that we cannot pay for over the medium term. In other words, if you consider the rising health care costs—and there was nothing in the health care plan that so much political capital was spent on that has anything to do with cost control—but if you consider the aging of the population—the Baby Boomers moving into retirement—and the fact that people live longer, the Medicare/Medicaid prescription drug plan that we have, we can’t pay for that.

If you look at government spending as a percentage of GDP, it’s extraordinarily high and much higher than historical averages. If you look at tax revenue as a percentage of GDP, it’s extraordinarily low. It’s got to go up and spending as a percentage of GDP has to go down. That’s just arithmetic. It’s not politics. It’s arithmetic. We need more revenue and we have to spend less. That’s a fact and we have to do something about it, because we’re going to get to a point where the outstanding debt is so big...so, if we did nothing, in something like seven years the interest on the debt alone is like a trillion dollars. When you do some of the arithmetic and you project, it’s kind of scary. We need radical change. The biggest nut on the spending side by far is health care. Social Security right now, the way it’s set up now, we can’t pay for that either, but we can fix that. We’ve been there before. I don’t know if you remember before Greenspan, it was - - who was Head of the...they’ll have a commission because it’s too dangerous politically to do it - - commission. What are they going to do? They’re going to raise the retirement age, which is appropriate. We work longer. We live longer. You’ve got to do that. They will raise the Social Security tax, no question about it, and they’re going to do some other things about how they disperse the benefits. I think eventually we’re going to get means testing. That’s not clear, but I think Warren Buffett won’t be able to get Social Security. They’ll do things, but they can fix that.
You talk to people at the CBO, the Congressional Budget Office, which is independent, and they’ll tell you that they can fix that, not health care though. That’s the thing. If you look at how the budget has evolved over the years, that’s the explosive thing. In the 1980s, it was about 4% of the federal spending. It’s now about a quarter of federal spending. When you project out in 10 years, it’s going to be half of federal spending. It’s like a monster that just keeps growing. It’s enormous. We’ve got to do something about it. I think we’ve got to do something pretty radical about it so that we have a program that we can provide the care that is necessary and we’re able to pay for. There are ways to do this but it’s a very big change from the way we do it now. It’s obviously very, very sensitive politically. It’s going to be very tough. That’s going to be the tough nut to crack, is health care. There’s no question about it.

Europe is the last topic I’ll talk about so we do have time for question. Europe has a bonafide debt crisis. What’s the story here? What’s going on? In a way, this exposed the flaw that kind of everybody knew existed when they started the single currency roughly a decade ago, and that is you can’t have one central bank, one interest rate, one currency, and different debt policies. All the economists said this, and Europe said don’t worry about it. We have the Maastricht Treaty, the stability pact, and this is going to ensure that deficits remain at a maximum of 3% of GDP, and debt to GDP is a maximum of 60%. That’s what these pacts that they all signed said. The problem is that if you look at for example the deficit in Ireland this year is around 30% of GDP—just missed that 3% by just a little—and in Italy the debt to GDP ratio is about double the limit of 60%. Clearly these things didn’t work.

The first to go was Greece, which is not surprising. We did a deep dive on all of the countries in question, and well over a year ago...is that my partner? Come on up, Abby. I’m going to have to finish.

ABBY JOSEPH COHEN: Take all the time you need.

MR. KANTOR: I even threw in a joke to make - - get here on time. When we did a deep dive on all these countries, Greece really did stick out as in much worse shape than any of the other countries, including Ireland and Portugal. I won’t go into detail, but there was just a whole list of problems with Greece that we just...I mean even on paper we could not figure out a way to get Greece back toward a path toward fiscal sustainability in any reasonable amount of time on paper, never mind with all the politics and everything. They have a very big public sector and a very big underground economy, for example. In other words, everybody works for the government and nobody pays taxes. That’s just one of a whole bunch of problems that you see.

At the end of the day, what does it mean? Greece, the debt that’s outstanding now given the structure of that debt, the maturity and the interest rates and all that, Greece can’t pay this. The market has now recognized this and has marked down their debt to less than 50 cents on the dollar, because what it means at the end of the day is either you’ve got to bail them out or you’ve got to restructure that debt,
lengthening maturities, lower interest rates, maybe even principle forgiveness, but one of those has to happen. The market has sniffed this out. It looks like finally over the last month or so, the European policymakers have also recognized this and are talking about how they’re going to manage it, which is very tricky. The reason is that when you do this—and that means that investors are going to take a very big haircut on the Greek debt that they hold—our analysis is that the European banking system as a whole could sustain this. By the way, a lot of banks have already written down a ton of Greek debt, some by at least 50%. The Greek banks could not survive this. They have a huge amount of Greek debt, and the problem there is that the Greek banks have interrelationships with entities outside of Greece, with companies, investors, customers, and so forth. We’ve all seen unfortunately what these domino effects can look like.

What they have to do when they restructure Greece is make sure that they have a plan for the banks, which will consist of either liquefying, recapitalizing, or whatever—which is probably the most likely thing because it’s easier—or some kind of resolution, like the FDIC does with banks when they close them. You take them over and you assign liabilities and so forth to other institutions to prevent a panic so that the customers as opposed to the debt holders or the equity holders are protected and you don’t set off some kind of panic. The second problem is to refinance Italy and Spain. That’s the real part of the problem, because those countries unlike Greece are in a way—you’ve heard the term many times unfortunately—too big to fail. Italy in particular has outstanding debt of roughly $2.5 trillion. The European financial system and arguably the global financial system could not sustain a failure of that. The problem is that—as investors are seeing that Greece is like—they’re starting to sell the debt of Italy and Spain, because they figure if they can give Greece a haircut, they can do it to Italy and Spain. That’s the big thing to happen over the summer. I said it was mid-July at the beginning of my talk that things really broke. Before that, Italy and Spain were holding in there, in other words their debt. Italy 10 year we’re selling for about four and three-quarters, Spain about 5.5. It was staying there. By our reckoning, these countries could get through assuming they did the right things, not only without a restructuring but without even a financial assistance package. Then in the summer, once Germany started talking about what they call PSI—that’s private sector involvement, meaning that they’re going to give the private sector a haircut—investors started selling Italian and Spanish debt. That is scary. Why is that scary? Think about a country like Italy with this massive amount of outstanding debt. The borrowing cost is a critical element of any debt sustainability analysis because they’ve got to roll this stuff over. It’s enormous. It becomes a self-fulfilling negative dynamic because investors start selling it. What happens? The yield goes up and then other investors calculate the probability Italy doesn’t make it is suddenly higher. What do they do? They lighten their exposure and the yields go up. It can be very nasty. What’s happened to try to stem that, the ECB, the European Central Bank, has come in and started buying into the yields. Now they’re going back up again. This is a very troubling situation.
I’ll just leave you with some good news, and that is that unlike the mortgage crisis here in the United States, it is not hopeless. The fortunate thing as I said before is that Greece...Greece is hopeless in the sense that there are losses to be distributed. Italy and Spain are salvageable, meaning that they don’t have to if they do the right things, create the losses. In the mortgage crisis in the United States, as we all now know all too well, there was a lot of mortgage debt extended that depended on to make it work house prices continuing to go up. Once house prices stopped going up, all this debt became bad. Not only that, but there was a lot of leverage on that debt. I don’t know if you’re familiar with the term CVO or CVO squared. There was leverage upon leverage, but it was very clear that this debt was bad. Then the question was only who’s going to pay it? How concentrated are the losses? How much time can we buy to absorb all these losses? It was not true here.

The question is how do you solve it? There are two objectives that have to be met to solve this problem. One, provide access to these countries to reasonable rates of financing. Two, instill confidence in investors that this debt ultimately is going to be good. Those are the two things. How do you do that? Well, right now Europe has got all these individual bond markets. There’s the bond market, the Italian bond market, etcetera. We need a big, large liquid bond market collectively that’s guaranteed by all of the governments. However, to satisfy the second objection and to make this whole thing work and to make sure those financing rates are low, you need some enforcement mechanism to ensure that - - do the right things, especially given the political situation in Italy. How do you do that? You restrict access to the financing based on the fiscal - - - In other words, you can borrow Italy but you’ve got to pass that constitutional amendment to - - - Germany said we’re not doing Euro bonds, but you can do it through an enlarged or leveraged EFSF. There are ways to do it.

That’s good news. It’s very, very difficult because I mean you think we have political problems in the U.S. We certainly do, but you’ve got 17 different EU countries, and even this last plan that they enlarged have actually been passed by 17 parliaments. What does that tell you? It tells me that it’s going to take too long to do this, and I think the ECB, the European Central Bank, is going to end up buying a lot of bonds in the next few months to buy time for them to get to a solution. At the end of the day, this is probably going to get worse before it gets better, and this happens a lot. You’ve really got to put the pressure on policymakers to do things they find uncomfortable. The conditions in all these countries are very different. France and Germany have very different situations. France wants to handle this differently than Germany. Those are the two most important countries. It’s very messy. It’s going to get worse before it gets better. Let me let Abby say something. Thank you very much.