

U.S. DEPARTMENT OF THE TREASURY

Press Center

Acting Assistant Secretary Baukol's Speech at the 2009 Globes Israel Business Conference Monday, December 14, 2009

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Thank you, Asaf, for your kind introduction. And, thank you to Globes for hosting this conference. It is an honor to be speaking to such an impressive gathering of political, economic, and business leaders. Today I will discuss four main issues: the international response and cooperation following the global financial crisis, the U.S. economic outlook and challenges, the outlook for this region, and some comments on the Israeli economy.

The global economy is experiencing one of the most challenging periods of economic stress in decades, with every corner of the world affected in terms of unemployment, business failure, and loss of wealth. Global challenges remain – unemployment is unacceptably high, financial stresses abound, and individuals and businesses must still restore the health of their balance sheets. Yet only a year after the events of last autumn, financial markets have mostly stabilized and a modest recovery is underway in many countries.

The economic policies put in place here in Israel, in the United States, and around the world have helped to slow the pace of decline in economic growth, pull the global financial system back from the edge of failure, and establish the basis for recovery. Much of this has been due to countries choosing the path of multilateralism, avoiding the temptations of protectionism, and working together to undertake enormous and cooperative efforts towards macroeconomic stimulus and financial repair.

In the United States, we took aggressive action to confront our challenges. Treasury Secretary Geithner has described that our ongoing strategy to recover from the crisis has four critical elements:

- **First, we have been working to stabilize and repair the U.S. financial system.** As we have learned from past crises, repairing the institutions and markets necessary for the supply of credit is essential. To help restore confidence in the banking system, we worked quickly to increase transparency and disclosure, which helped bring billions of dollars of private capital into banks so they could safeguard against a deeper recession. We put in place a powerful set of innovative financing mechanisms to help restart credit markets, and we launched a comprehensive program to mitigate the U.S. housing crisis.
- **Second, we have been working to help offset the dramatic contraction in aggregate demand.** Earlier this year, the United States put in place the most sweeping economic recovery package in our nation's history – including immediate tax incentives for businesses and households, support for state and local governments, and investments in priorities ranging from infrastructure to energy to health care to education.
- **Third, we have worked with the major economies of the world on a coordinated program of macroeconomic stimulus and financial stabilization.** IMF data show that in late 2008 and early 2009, when global GDP fell at an annual rate of over 6 percent, the G-20 undertook a massive discretionary fiscal stimulus to support demand, equal to about 2 percent of GDP. Monetary policy became increasingly and highly accommodative, while countries recapitalized financial institutions, and provided liquidity support to unclog markets and guarantee inter-bank financial flows. In the G-20, we agreed together to keep our markets open to trade and investment. And together we worked with the IMF and multilateral development banks to develop an unprecedented program of financial support for emerging and developing economies.
- **Finally, even as we have been confronting the immediate crisis, we have been looking forward** – to take steps to help ensure that we do not allow a similar crisis to occur in the future, and to build a better foundation once recovery has firmly taken hold. As we have been discussing in the G-20, the IMF and other multilateral fora, countries will need to design **exit strategies**. Secretary Geithner has observed that "as growth strengthens and financial headwinds diminish, we will be able to begin the essential process of restoring balance to public finances and fully removing the broad backstop still in place for credit markets. This will require a delicate balance. If we put the brakes on too quickly, we will weaken the economy and the financial system, unemployment will rise, more businesses will fail, budget deficits will rise, and the ultimate cost of the crisis will be greater... [but] confidence in our ability to reduce future deficits and to exit from the extraordinary monetary policy and financial emergency measures is [also] very important..."

At the same time, **stronger standards across our financial systems** will be an important legacy of this crisis. In hindsight, neither market participants nor regulators adequately appreciated the risks inherent in complex financial products, let alone the aggregation of these risks across the system. Responsibility for sound financial regulation begins at home – but it also should be more consistent across the globe to avoid regulatory arbitrage, gaps, and spillovers. National regulators, working through standard-setting bodies, have strengthened their collaboration. We are working with the G-20 to subject non-bank financial institutions, credit rating agencies, and hedge funds to greater oversight. At the G-20 Leaders Summit in Pittsburgh, the group agreed to focus further on improving the quantity and quality of bank capital; overhauling the oversight regime for over-the-counter derivatives markets; making progress on strengthened resolution regimes, including international cooperation; and ensuring that compensation practices are better aligned with long-term value and risk management.

Taken together with other countries' responses to the crisis, this has represented the most aggressive international response to a crisis in the last 50 years, implemented with unprecedented speed and breadth. This response would not have been achievable without the concerted coordination and cooperation across many countries.

We are already seeing signs of recovery as we look at recent U.S. economic performance. Real GDP rose 2.8% at an annual rate in the third quarter – the first increase in over a year – and most private forecasters expect growth of almost 3% in 2010. Government spending continued to lend support to the economy but private spending increased for the first time since the second quarter of 2008. Consumer spending rose solidly in the third quarter.

Business investment in equipment and software has ticked up, the first increase since the recession began. Residential investment has risen for the first time in four years. There are signs of recovery in the job market, with smaller-than-expected job losses in November and a downtick in the unemployment rate from 10.2% to 10%.

Also encouraging, financial market volatility has decreased notably, and equity markets have rebounded. Measures of financial risk have declined substantially, with some measures returning to pre-crisis levels, and credit flows have picked up considerably.

Nonetheless, we recognize that we have significant challenges ahead as we continue to unwind the effects of the crisis and our crisis response. The U.S. budget deficit remains high as a share of GDP; this is necessary to overcome the downward economic spiral set off by the financial market disruptions. As the economy recovers, receipts will rise, outlays on programs like unemployment insurance fall, and temporary spending programs will phase out. We therefore expect future year deficits to decline to about four percent of GDP.

Deficits of this size are still too high. Getting these deficits under control and putting the nation back on a fiscally sustainable path is a top priority of this Administration, and this will be a key goal of the policy process surrounding the 2011 budget. The President is committed to cutting the U.S. budget deficit he inherited in half by the end of his first term.

Another key challenge will be to maintain the cooperation we have seen so far across countries to help ensure balanced growth moving forward. Countries will need to continue to cooperate to achieve a durable recovery, avoiding past excesses. As U.S. consumers save more and as our government embarks on a path of fiscal consolidation, economies with large and sustained surpluses must shift growth towards domestic demand and reduce reliance on exports. The global economy can no longer rely on the U.S. consumer as the engine of import demand. One of the key outcomes from the G-20 Leaders Summit in Pittsburgh was the commitment to a Framework for Strong, Sustainable, and Balanced Growth. In the follow-on G-20 meeting of finance ministers and central bank governors in Scotland, the G-20 set out a detailed process and timeframe for achieving the Framework's goals, and launched a new consultative mutual assessment process to evaluate whether individual country policies will collectively deliver our agreed objectives.

Turning to the outlook for this region, the Middle East has been less affected by the global financial crisis than many other regions. There are three broad types of economies in the Middle East to highlight.

First, oil exporters have fared reasonably well, given the recovery of oil prices this year. Oil exporters appear to be emerging from the global financial crisis in a relatively strong position. Many oil exporters enacted aggressive fiscal and monetary loosening to speed economic recovery. The region's finance ministries and central banks, in addition, took swift action to maintain financial stability. Higher oil prices and a return to sustained growth in 2010 would likely enable oil exporters to again serve as leading global capital exporters.

Let me reference one oil exporter which is a bit unique: **Iraq.** The post-crisis fall in oil prices has put heavy strain on Iraq's fiscal situation. Iraq's outlook is heavily tied to oil prices, as 90% of its economy depends on the petroleum sector. Iraq's fiscal balance will likely swing from a large surplus in 2008 to large deficit this year, forcing Iraq to make difficult choices. Iraq is working closely with the IMF, World Bank, and international donors to meet the challenge, and has already registered several achievements over the past several years, such as lower inflation, increased budget execution, and a moving forward with bid rounds its oil sector. Iraq's security situation also continues to stabilize.

Second, some other economies in the region are more insulated from the global economy, with relatively low exposure to European financial flows and trade. These include Egypt, Lebanon, and West Bank and Gaza – economies that have been relatively unscathed by the global economic crisis and face a more mixed outlook due mostly to other, non-crisis factors.

Although the financial sector's low penetration and foreign exposure shielded **Egypt** from the global crisis, the IMF predicts that a slow recovery in exports, a reduction in inflows from the Gulf, and slowing domestic demand will contribute to a modest decline in medium-term growth.

Lebanon's economic resilience has surprised most observers, with the IMF projecting 7% growth this year. Unlike many other developing economies, Lebanon saw considerable banking sector inflows during the financial crisis, as sound financial regulation limited banks' exposure to subprime-related assets. But the new government faces considerable challenges, including fiscal pressures from servicing Lebanon's high debt burden.

On the **Palestinian economy,** growth is fairly strong this year due the confluence of Prime Minister Fayyad's prudent use of international donor assistance, PA improvements in internal security, and encouraging steps by Israel to ease movement restrictions in the West Bank. But this is not enough to ensure sustainable growth going forward. Access to markets outside the West Bank is still severely limited, and Palestinians still lack access to key resources such as Area C. These obstacles remain major impediments to sustainable growth and economic viability. We urge donors, Israel, and the Palestinian Authority to work together to remove the significant remaining barriers to a

vibrant Palestinian private sector and viable economy. This is an essential component – alongside negotiations, and security improvements – of our efforts to support the creation of a viable Palestinian state, living in peace alongside a secure Israel.

Third, several economies in the region stand out because they are well-integrated in the global economy and have faced more significant challenges. Turkey, the Emirate of Dubai, and Israel stand out.

The global crisis severely constrained **Turkey's** access to external finance – a major driver of past growth –weakened external demand. While market analysts project that GDP will contract by 5-7% this year, recent data suggest that the worst is behind Turkey, with a return to positive growth in 2010. Several downside risks jeopardize a full recovery, however, including an expansion in the fiscal deficit that could crowd out lending to the private sector.

Recent headlines on the region's economy have been dominated by events in **Dubai**. Dubai World's announcement on November 25th that it was seeking a standstill from its creditors caught investors by surprise. Although most markets have since recovered, investors are seeking clarity as to how the restructuring will proceed and whether other government related-entities will be affected. I note reports this morning that Abu Dhabi is supporting Dubai financially. The impact on the UAE's real economy – through higher borrowing costs and a retrenchment in lending – could be significant.

Here in Israel, sound economic fundamentals – such as low inflation, a high savings rate, and Israel's high-tech export economy – coupled with decisive government and central bank action, have helped Israel to be one of the first countries to emerge strongly from the global crisis in the middle of the year. Instead of experiencing a significant contraction – as was the consensus forecast earlier this year – the Bank of Israel now projects zero growth for 2009 and 2.5% growth in 2010. We welcome the Bank of Israel's speedy action to boost liquidity and encourage lending soon after the onset of the global crisis, and its clear signaling that foreign exchange interventions have been only a temporary response to dampen volatility in the exchange rate.

However, despite the somewhat encouraging near-term outlook, the Israeli economy is facing several medium- and long-term challenges to continue on a strong growth path:

- As East Asian economies become even more sophisticated and move up the value-added chain, and as other emerging markets become even larger players in the global economy, Israel must continue to promote competitiveness, and sell its exports outside its traditional U.S. and European markets. To do so, Israel must continue investing and creating a policy environment that promotes entrepreneurship, education, and research, as well as seeking greater access to emerging markets in China, India, and Southeast Asia. I was encouraged by the discussion this morning of improvements in Israel's education sector, which is an important component in Israel's global competitiveness.
- Much like the United States, Israel also faces long-term fiscal challenges. Bank of Israel research suggests that Israel's already-high debt level is likely to rise through 2020 unless Israel begins to take action to control medium-term spending. Part of this challenge is demographic. As part of the most recent U.S.-Israel loan guarantee agreement in June 2009, Israel agreed to undertake an assessment of the budgetary costs of changing demographic patterns – an essential first step towards dealing with the issue.

Another part of this challenge is institutional – various Israeli sources have observed that Israel could improve its medium- and long-term budget planning. That is why we are working with the Israeli government on a fiscal rule that is specially adapted to better guide medium-term spending. As Prime Minister Netanyahu emphasized this morning, restraining spending is key to economic growth.

I would also like to express U.S. support for Israel's ongoing efforts to forge stronger trade ties between itself and its neighbors – we encourage you to do even more. The Egypt-Israel natural gas pipeline, cooperation between Israel and Egypt on qualified industrial zones, and trade with Turkey, Jordan, the Palestinian Authority, and Egypt are all examples that help illustrate to the rest of the world the economic policies and possibilities that arise for economies with strong, productive relationships with Israel.

There are many reasons to be optimistic about the way forward – for the Israeli economy, the region, and the global economy– particularly given the vast international cooperative effort we have seen during this global crisis. We are eager to continue working with you and our other partners towards our shared goals.

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