Thank you very much, governor, for inviting me to come to Riga. It is actually only my second time in Riga. I am glad to say that the weather is better than on the first occasion (*laughter from the audience*), though the weather yesterday and today is rather reminiscent of London in December.
As a result of hardly having been here I am certainly not an expert on the Latvian economy and with the governor sitting in front I am not going to answer any questions about what might happen in Latvia. Instead... The governor did say in his remarks that the Latvian economy is a small open economy in the middle of a very much wider world and so I want to talk today where the wider world is going.

Though I think I should say before that, that those of us look at events around the world, although we may not know very much about the details of the Latvian economy, have marvelled at your abilities to undertake what is sometimes known as internal devaluation -- a restoration of competitiveness --, of the extent and scope you have been able to do this, while maintaining political and social stability. It is a development which many of us have admired, and which many other countries within the European Union would wish to able to emulate – though so far with much less success than you have had.

Now, having said that let me start about the general background and in particular – some current developments in the United States.
Since the first half of 2010 the speed of recovery in the developed world more generally has slowed quite sharply. There were fears that there might even be a "double dip". I think that that is unlikely, but the speed of growth in the United States and in Europe, the EU more widely, is likely to slow down to levels which, although still positive, will not be positive by very much. And the rate of growth is likely to be under the sustainable rate of growth overall – so that unemployment in most of our countries will certainly not fall and in many cases is likely to rise again, which is in itself likely to make the population in the developed world feel somewhat as if there had been a "double dip". It won't be there statistically, but in terms of psychology people are going to worry about the recovery having somewhat petered out.

Now, why has recovery slowed? (Though admittedly this is still prospective, it is beginning to come into the data, but it has not been fully there yet: we do not have any figures from the third quarter of 2010 in almost any country yet.) And I think there are four reasons for that.

The first one is that the recovery from the major crisis we had in 2008 was largely driven – as it often is – by an inventory stock cycle. And the inventory stock cycle, the benefit the rebound from the destocking in 2008 and early 2009 is beginning to wear off.

The second issue is that deficits and debt have been rising rapidly in almost all our countries and in many of our countries they have been rising to levels that are extremely uncomfortable, so that we are all having – in Europe at any rate – to undertake austerity programmes. As I am sure that you all know, today is the day when the austerity programme will be unveiled in my own country. Apart from the general outline of how large this will be, we don't know exactly where it will fall and we do not know the exact details of it yet, nor – how it will be received by the press, by workers and trade unions and by the economy more widely.

As the governor said very rightly -- when you get these kinds of concerns that there has to be cutbacks in the public sector in order to maintain and reestablish stability -- there is a tendency for that to affect confidence in advance – when nobody quite knows who is going to be hit and by how much. And so there is or has been a weakening in investment programmes, in consumption in the private sector - in advance of details of knowing just exactly what is likely to happen.

Now, the third factor in bringing about some reduction in the rate of growth and recovery in the second half of 2010 in my view can be attributed to the cut-back in the quantitative easing, the QE programme. As I am sure again that you all know – it's actually virtually impossible to work out quite how much effect the QE programme, the credit easing programme in America has actually had. Although it is not an appropriate academic approach I am actually quite struck by the fact that the absolute depth, the worst point of the crisis was really reached towards the end of March 2009, when asset markets were at its lowest point, where there was a concern that despite the stimulatory measures that have been undertaken both fiscally and monetarily – that the economies did not seem to be recovering.

It was at the end of March 2009 that the quantitative easing and credit easing programmes were introduced by the FED, by the Bank of England and there was a yet further expansion of liquidity by the ECB. And it was from that low point that the recovery really started. And it started quite strongly, went on quite strongly in 2009. Strongly enough that most of the central banks decided that they could return towards normalcy and actually cut back or stop any further quantitative easing expansion in around the end of March-April 2010. And it was I think from that point that again the recovery began to run out of steam. Now, I know this is only a coincidence – it is not causation. We don't know how much there was of a causal factor, nevertheless I do think that there are grounds for belief that QE might be more powerful than many of the sceptics indicate.

Again, and another factor in this whole process, the final factor that I am going to mention is the imbalances. The imbalances between those countries which overspent relative to their incomes, notably - the Anglo-Saxon countries, and ran very large current account deficits – and those, which saved relative to their investment and ran very large current account surpluses.

Problem is that those imbalances have not been removed from the world and you still are going to have the countries which overspent, both private sector - in housing bubbles and in the public sector and they are going to cut back. It makes it very much easier for them to cut back if they can move from current account deficit quite rapidly to current account surplus. Now, that can only be achieved if the surplus countries move in the opposite direction – increase domestic expenditures relative to their savings and move from current account surplus towards – at the very least – a balanced position.
And that has not been happening. And the three major current account surplus countries around the world – China, Japan and Germany, have not been moving

sufficiently to increase their domestic expenditures in order to bring their surplus positions back into balance -- or even desireably -- into deficit.

And it's against that background to some extent that the Americans have started quantitative easing. Although it is not actually said in as many words, the countries in the emerging Asia see QE as a way the FED is going to force inflation or appreciation – one or the other – onto the emerging nations of Asia. (I was in Thailand very recently and they saw that particular problem for themselves.) And many of the other Asian countries, like Thailand and Korea and Taiwan, are almost going to be in as much trouble if they get forced into inflation or appreciation - if China does not in itself change its policies towards having a more sustainable position.

Now, they in many of these countries they are thinking about the alternative, since they neither want inflation nor do they want to have appreciation as long as China does not appreciate, so many of them are thinking in terms of an alternative strategy, which is the introduction of capital exchange controls over inward capital flows. Again, Thailand made a small step in that direction, Brazil has done and this may occur more generally.

[ATT] Now, one of the points or key points of this is that one of the areas of the world that is likely to be affected by the expansionary American monetary policies is of course Europe and the euro zone. And whereas Asia may try and resist the American monetary expansion – either by capital controls or some other measures, in China and elsewhere, Europe is not going to take those kinds of steps. The ECB is not going to introduce any form of capital controls. The ECB is determined to avoid any form of inflation – and rightly so – and that means that the implication of this is that the American monetary expansion is likely to feed through – and indeed already has fed through into appreciation of the euro vis-a-vis the dollar. So the euro is likely to appreciate in price and the competitiveness of Europe as a whole is likely to go down - with one proviso.

And the proviso of course is whether there are further difficulties that are though possibly in store for the peripherals. That is the members of the euro zone who are facing some difficulties with their competitiveness and with financing their debt (what are generally known as the PIGS – Portugal, Ireland, Greece and Spain).
For the moment things have been looking a little bit better in these countries, particularly in Greece. The austerity programmes, that have been put in place in Greece and in Ireland.. not quite at the same extent, perhaps, as in Latvia, but nevertheless - serious measures have been undertaken. They each of them face difficulties which you did not, I am glad to say. Ireland has the difficulty that its home-grown banks expanded far too far and far too fast and therefore it has its banking system – Anglo-Irish and Allied Irish Banks around its neck. As did Iceland to a far greater extent that you ever had.

You have been relatively fortunate in having a very large proportion of your banking system undertaken through foreign banks, notably – Swedish banks who have been relatively well capitalised and able to continue through the crisis in the Baltic states to a much greater extent that would have been likely had your banking system been dominated by domestic banks. And just compare what you have gone through with what Iceland went through and what Ireland is going through at the moment!

Again, Greece is shackled to a far greater extent by problems of inflexible working practices, cartels in many of the professions, corruption, lack of tax payments because of grey and black economy. I know that Governor mentioned that you have had it to some extent in Latvia, but to nothing like the extent that has occurred in Greece.

And there are doubts whether Portugal and Spain have necessarily done quite enough and indeed again the political position in Spain, Portugal and Ireland is much more fragile than the political position has been in Latvia. So in many respects you have been in a much better position to undertake the kind of measures to restore the economy than many of these countries.

So the outlook for these countries does remain fragile. As I say I think that the market generally believes that the measures undertaken, the austerity measures undertaken – in Greece and Ireland at least and to an extent also in Spain have been serious and will help them to get through. The problem now is much more whether, subject to these measures been undertaken, whether it is possible for these economies to show growth.

The difficulty here is that if growth does not occur and the key relativity is the relationship between the nominal rate of interest and the nominal rate of growth in the economy. If the nominal rate of growth in the economy remains very low, lower than the rate of interest, then in effect the debt income ratio just spirals upwards. Irrespective of the extent to which the country has undertaken sufficient reduction of government expenditures. So there is a need to get growth going in these countries.

And the next hurdle, which I think will influence very much the degree to which the crisis in the peripherals is going to be avoided, will be when the Q3 and Q4 GDP figures for countries like Ireland and Greece and Portugal and Spain come out. If these figures are negative then I think the feeling of crisis, the feeling that despite the financing measures that have been undertaken by the EC and the IMF in the form of the European Financial Stabilisation Fund, that these have been just short term financial measures and will not necessarily result in the solution to the issue. So besides the austerity measures one has got to try to achieve somehow a return to growth. (And, of course, the American measures, pushing up the exchange rate of the euro as a whole will not in that respect will not be particularly helpful.) And that of course I think is the main danger.

Again, I would say that Latvia is in a considerably better position than most of the Mediterranean countries because the rates of growth in the euro zone as whole and the EU as a whole differ as you go further north. The further north you go, the better the outlook is. Scandinavian countries – Norway, Sweden, Finland and Denmark have recovered quite strongly, Germany is doing well, Poland is one of the countries that hardly affected at all by the crisis and with the continuing strong price of oil Russia is doing well. And therefore the countries which are contiguous to Latvia are doing far better than the Southern or Mediterranean countries within the euro zone. So, a certain concern about whether the euro zone as a whole will do rather well and what will happen to the Mediterranean countries does not translate exactly into a slower rate of growth for yourselves.

So, there are dangers ahead. Dangers much more for other countries: the governor put up figures for CDS spreads and the CDS spread for Latvia is falling relative to the CDS spread for a whole range of other countries, particularly Ireland and the Club Med countries. And that is very much the way that the market sees it: you are no longer in the eye of the storm – you have managed to make your way out of that but the crisis isn't completely past. The crisis is not resolved and there are certainly dangers ahead for dealing with the problem and the Club Med countries, the PIGS. And where that goes nobody can really tell. One just has to see and trying to forecast in these kinds of circumstances is not an easy job and I would not try to make many forecasts myself.

And if I may turn towards the end of my talk towards the slightly longer term, there are I think major problems for the world as a whole, particularly in the United States. I am struck by the fact that ideological differences in the Unites States are now a great deal sharper than they are in Europe. In Europe in most of our economies – with the possible exception of Belgium and France – the ideological differences are not really all that great. And policies of what is slightly centre-right coalition are fairly common throughout EU and the differences between the centre-left and the centre-right are not great: we don't scream at each other. In America they really do scream at each other. And the difference between a Tea Party Republican and a, shall we say, a Salt Water Democrat, are huge: they really have massive differences. And these differences are going to make it very difficult for the US to solve its deficit and debt problem in the longer period. And the reason for that is that both the Republicans and the Democrats may agree that the deficit is too large and there needs to be an agreed programme to bring down both the deficit and the debt, but they will see it in very different ways of how to do it. The Democrats will not want to cut basic public social expenditures, the Republicans will not want to raise any form of taxes – for anyone, however rich. With the result that you are likely to get deadlock. And indeed there is even a concern whether there may be a deadlock over the arrangement for dealing with the Bush tax reductions. As you know the Democrats want to extend the reductions for everyone, except for the very rich and the Republicans want to extend the reductions for everyone, including the very rich. And it may well be that there will be sufficient deadlock in Congress that there is no agreement at all and so nobody gets the reduction extended and if that should be so, then even with QE the Americans might move towards a double dip at the beginning of 2011.

And that is merely an indication of a much larger concern about how you are ever going to get agreement on the details. I was in Washington at the beginning of last week and I met Alice Rivlind there, who is actually a co-chair of a group of Republicans and Democrats who are meeting together to try and work out a common method of trying to reduce the deficit.
And it may be that if you get a small group of sensible, intelligent Republicans and sensible, intelligent Democrats together in a room and tell them they have to reach some kind of agreement -- they will do it, but whether that can be translated in the larger political cockpit of Congress, with the changing structure of Congress that is likely to take place after the November elections? And we are going to get into a world in which the American political condition runs into gridlock. And it may run into gridlock in terms of the fiscal position. And if it runs into gridlock in terms of the fiscal position - whether one can get out from the deficit-debt problem is very

uncertain. And if you cannot get out of the deficit-debt problem in the US, what then happens?

Without political cohesion any country, and particularly the largest country in the world, the US, runs into difficulties. And that I think is a medium term concern that I very much have: will the Americans ever going to get their political house in order? Will they be able to get an agreement on the difficult terms that are necessary for them? You did. And many other countries in Europe are also doing it. But the Americans may have difficulty. And if they have difficulty, the world will be in difficulties.

And finally, of course, in the very much longer term, the dangers arise from the demographic slowdown of which again you are all aware in the Eastern Europe. As a generality in Eastern Europe your population is going down and the age profile of your populations are also worsening. And that is going to mean that the number of workers per retired is going to go down and that means almost by definition that the tax rates have got to go up and/or the age of retirement is going to rise. And the availability and generosity of pensions has got go down.

It is not a matter of actually trying to respond to this current crisis. It is actually just a matter of arithmetic: if you have a declining, aging population that simply has got to happen in order to adjust the availability of resources that the smaller working population can provide to both the retired and the workers.

And that shift in population is going to include China. The Chinese "one child policy" means that within a relatively short space of time the Chinese population is going to shift dramatically from growth to sharp decline. Each grandchild is now going to have four grandparents to support. Clearly, that is impossible. So, that is not surprising, that the personal sector are going to have to be saving as much as they can, because they know that the extended family system is not going to able to support them when they themselves get retired. But the situation in China is going to turn around in a flash. And when the demography in China turns around the rates of growth in China and the conditions in the world will change dramatically.

You may recall that in 1998-1999 Japan was expected to become the biggest and most successful country of the next century. It didn't. And in some large part because of its demographic turnaround which was quicker than in most other countries. China is going to follow the same kind of path - just wait a few years. India is actually going to be the country – and possibly Indonesia – that is going to have a much better demographic profile.

And of course there is global warming affecting the food production. The effects of this last year were – as you are only too well aware, there was the heat wave and draught in Russia and Ukraine adversely affecting grain production and a flood in Pakistan adversely affecting cotton production -- very much along the lines that those worried about the global worming have been warning. If that kind of pattern of extraordinary global weather patterns occurs – and particularly – if any such effect should impact on the Middle West of the United States, which is the source of the world's tradable food exports. If that should occur, the likely effect on food prices could be dramatic.

What I think you should worry about – what at any rate I worry about – is essentially much more about food and agriculture than it is about energy. The world is actually awash in energy, the only problem is actually pricing it correctly in order to deal with the global warming and carbon. Worry about food and food prices and make sure that your agriculture is doing well much more so than worry about energy.

So, can we get out of all of these problems? Yes, but I think that the key of getting out these problems and the key to the likelihood or the possibility that we may not get out of them – and now again I am talking about the world issues – lies in politics rather than in economics. My subject used to be called "political economy". I wish it was still called "political economy", because politics is ultimately much more important than, if you like, pure economics: if you have a stable political system and a decent education system then you will get out of all your messes and grow quite rapidly. If we have political difficulties and we have conflicts between countries and within countries on the political front, then we won't. And the greatest concerns about the present that I have relate to political conflicts, notably within the US, and between the surplus countries and the deficit countries, which we are not near to resolving.

And I think that I would end by saying that you've had in Latvia some of the greatest difficulties to surmount, but you have shown a degree of political cohesion in facing these which are actually enabling you to surmount them. Whether the rest of the world will be able to show an equivalent extent of political cohesion to deal with the problems that remain is very uncertain. And that means that there will continue to be a great deal many dangers ahead. Thank you.