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Q&A-Businesses to bounce back rapidly from looming mild recession: Andy Baldwin, EY

The global economy is likely heading towards a technical recession, but it's not going to be as severe as previous ones, **Andy Baldwin, Global Managing Partner of Client Service at Ernst & Young**, told the Reuters Global Markets Forum in Davos, Switzerland on Tuesday, January 17.

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Following are edited excerpts from the conversation:

Q: Your opinion on the Inflation Reduction Act, where energy security is concerned? Do you see it as protectionist?

A: When you look at the energy challenge it's really around three elements. It is around security, affordability - that's a huge issue in a number of countries that's driving inflation - and the energy transition. So the successful energy policies have to manage those three dynamics and obviously with a short-term pressure. Specifically on the Inflation Reduction Act - the legislation was clearly well-intentioned, but it is having some unforeseen consequences on a number of U.S. allies and the risk we all face is inadvertently you see a rise of effectively economic nationalism or protectionism. And so the challenge from a global growth perspective is that if you have that act and the European Union does a similar act, it's likely to see some of the Asia Pacific countries do a similar thing and ultimately this becomes a zero-sum game. You need a level of free movement, flexibility. We probably won't see a return to the economic liberalism we had before the pandemic.

Q: Do you see the situation escalating from here?

A: I think there is a very real risk that we will see that. And if you look at what's emerging now in the global economy, we're really seeing the emergence of a series of trade blocs. We have the U.S., Mexico and Canada, the Indo-Pacific trade area, the European Union and the risk is that you see increasing barriers being set up and created between those which ultimately will impact economic growth in the longer term.

Q: Investments into climate - where is the money going to come from?

A: Most people acknowledge that to make the necessary investments will require collaboration between both governments and the private sector, particularly the financial services industry. To be able to do that, you have to look at the standards, and we ideally would have a single global standard. It's probably unlikely we're going to get it - EY believe we should move to a single global standard - we will likely have two or three standards, the European standard, with the U.S. we got the International Board that's recently been established, and what we hopefully will see is a level of interoperability between those standards where there's some common definitions of some metrics and data. Because if we don't have that, it's hard for investors to look at performance of a company against the standards and have a level of comfort and confidence that the information is accurate and it's telling a true picture of that organisation's evolution. So I think on the positive side, we've done some recent research which shows that the investments in some of the sustainability technology and some of the sustainability areas are actually delivering better returns than people expected, but from an investor perspective, it is really being able to have a level of confidence in the information and the data that companies are reporting, so the investors can say, ‘OK, this is a business, it's making progress on its ESG goals, therefore, I'm prepared to invest in them.’

Q: Are you then confident that the private sector will step up and the money is going to come?

A: It has hit some headwinds, both political headwinds in certain parts of the world and the energy crisis is creating challenges because back to security of supply is more important at the moment than potentially the journey towards decarbonisation. We have to acknowledge that in some parts of the world we are dealing with that tradeoff between people being able to heat their homes, which is more important right now, than whether that's coming from clean energy or from fossil fuels. But I believe that we will navigate and get through the energy crisis and I do think there are funds available. Certainly the conversations I have, there's a level of consensus, both politically and societally, that this is the right thing to do and people want to be seen to be investing in the right things. I’m less pessimistic, I do think we have an immediate short-term issue that we're wrestling with, but fundamentally I think that’s the direction of travel. On ESG, it’s inexorable. It is going happen. It may not happen at the pace we would like it to in the next one to two years because of the unprecedented situation we're dealing with, there's a fallout of the Russia Ukraine war, but there is obviously collective consciousness that's developed everywhere on climate change.

Q: What is your view on inflation and central bank policy?

A: The initial view of inflation was, it was temporary. People now feel it's become more structural. The catalyst for the inflation was partially linked to supply chain challenges post the pandemic plus the energy crisis. If you look at some of the critical drivers, it was around energy, food and some of the supply chain areas that now inevitably has transitioned into wage-based inflation, which is more challenging. So you see a level of industrial unrest in many economies - in my own country, the UK, we've seen levels not seen since the 1970s, which is a cost of living driven crisis. So I think this has become more of a structural challenge. Essentially we've got central banks using monetary policy and tightening of monetary policy after a 10-year period of unprecedented loosening of monetary policy. I would say on the positive side, in a number of parts of the world we appear to be passing through what we call peak inflation. So if you look at a number of countries in Europe, for example, Spain, in the last two months, there is a 1-1/2% drop in their inflation rate. The view is inflation peaked in the UK. I think it dropped in the in the US. So I think we will see a steady decline now hopefully in inflation. This presupposes there's no further escalation obviously of the military conflict at the moment and some of the related factors. But I think we will see inflation starts to fall. We should be mindful though it's unlikely we're going to go back to the period post the financial crisis where we had effectively level of no inflation. We're probably more into the period of the last 40 years where we've had the level of inflation at 2%, 3%, 4% was not unusual. With the dollar, for example, that had been strengthening significantly against all the other major currencies with the Fed signalling that they were coming towards the top of the interest rate moves because obviously inflation was softening. You saw the dollar start to fall. The sense is in a number of the economies we’re probably heading towards the point where there may be one or two more increases in interest rates to come. But we're probably heading towards the top of that interest rate curve. Then the question would be how quickly does it come down because clearly from an investment point of view that's having an impact on businesses. It is very asymmetric. Not all parts of the world are experiencing the same economic environment. India, parts of Asia, the Asian Middle East are all enjoying very strong growth at the moment and the recession we don't think will be as severe in the U.S., the predictions of the recession in Europe are certainly moderating from where they were probably three or four months ago. So we will probably inevitably see a technical recession, but I don't think it's going to be as severe. Our view is we'll see businesses bounce back probably more rapidly from that recession, we don't think it's going to be a deep recession, touch wood.

Q: What has been the feedback so far on splitting EY into separate accounting and consultancy businesses?

A: It is an incredibly complex transaction. It's probably one of the most complex transactions in corporate history. The previous sales by the Professional services businesses in comparison was relatively straightforward, there were trade sales, so we're effectively doing a demerger. We're on track to put this sort of partner vote probably in March or April and the partners are shareholders. We’ll put that to a shareholder vote. Hopefully we'll get a positive reaction to that vote which will take place in 77 countries over that period. And if we get the support for the separation we’ll then move ahead. The timing of the separation really depends two things. There is a level of work we need to do to be able to demerge the business. We're actually pretty well advanced on a lot of that, but clearly we've held back on some of it until the vote and then obviously we need to see what the market conditions are. Our plan at the moment is that it will involve a debt raise, and a form of capital transaction - both of those are influenced by market conditions. If you look at the market today, it's unlikely we would do the transaction today, but obviously the vote is in couple of months’ time, and we've got that level of work to do to get ready. So we think by the end of the year or early in 2024 the market conditions will hopefully be more favorable. We've not fully decided both where we'll be listed on which exchanges. But I think it's fair to say this business will be unique. It'll be a $25 billion plus start up from the get go, the world's largest transactions advisor, the world's fourth largest strategy business, the world's third largest tax business and in the top 10 technology and business consulting business. So we're going to look at both where we list and the exchanges we list on to maximize access to investors, that's what's guiding our thinking.

Q: Has EY withdrawn from more audits than usual especially in high-risk businesses such as cryptos?

A: In terms of the broader point around client acceptance, we're always reviewing our approach and philosophy on client acceptance because a way to think of client acceptance, it's about risk appetite, and we're always looking at our risk appetite in certain sectors. We also have a very large blockchain practice. We have a business of over $200,000,000 of blockchain revenue. That's probably the largest of any of the Big Four and that's because we build our own products as well as auditing. Cients on the crypto side, that's been an area that we've been very thoughtful around, in terms of which crypto organisations we are involved in and which ones we audit. If you look at some of the recent developments around the reserves, that's not an area we were in. We didn't provide services in and around that specific area, but to be very clear, we remain very committed to blockchain and the application of blockchain technologies. We think it is an incredibly powerful technology, which is why we've made the investments we have. We've got some incredible use case examples with many of our clients, Microsoft is one. People should not confuse what's happened in the crypto space with the future strength of the blockchain technology platform.

Q: ChatGPT has taken the world by storm. Do you see any role for that in auditing and consulting?

A: We have a dedicated AI (artificial intelligence) business or practice. We have a very large practice which advises clients, but we also have an AI practice, which is looking at our own technology tools and integrating AI more and more into our own technology tools. We've just announced an investment part of a billion dollars building a new platform called Neil, which will take a significant upgrade of our Canvas audit platform. It's two things. One is around more sophisticated workflow software, but actually it's the integration of AI. We use AI already, but we'll be using much more widespread across our order platform and the idea of it is really to provide more support to our audit teams around the world. AI will be effectively giving them prompts. It'll allow them to run predictive analytics much more on the data, but a critical part of the AI investments is really around many clients. Investing with this is really around the quality of data and you have to have the data sets to train the technology, particularly the machine learning part of the AI side which we use a lot. And so it's becoming an increasing integral part of all of our technology platforms that that we've invested and built, but we've realised it. Part of it is around this data, which is why we invested probably $2.5 billion with Microsoft actually as our main platform provider and what we call EY Fabric which essentially is a data and AI layer across the whole organisation. So 85% of all of the UI now is on the cloud. So all of that data we're able to clean it and it's anonymise it and then be able to utilise that in our UI fabric and that really gives us the ability to integrate that into a lot more of our tools. But we think in the audit area in particular around things like fraud, there's some fantastic use cases to use AI and we've developed some of our own technology around document recognition - some of the biggest documents you can possibly imagine that people have to wade through page by page. We've actually developed a AI tool that will scan everything for us.