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FPA Book Event: Banker to the World
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Featuring:

William Rhodes, Author of Banker to the World: Leadership Lessons from the Front Line of Global Finance

WILLIAM RHODES: Thank you, Tom, for introducing me. I wanted to thank Pricewaterhouse for all it does for the Foreign Policy Association. I wanted to thank Noel Lateef personally. He does such a great job of running the Foreign Policy Association, but I understand he came down with a stomach virus and he didn't want to communicate that to any of us here. I thank him for giving me this opportunity.

I will talk briefly for 20 to 25 minutes and then have questions which is always a fun time for me. I want to talk about the lessons learned in the debt crisis of the 1980s and 1990s in Latin America, Asia in the 1990s, Turkey in 2001, and Uruguay in 2003, where I led the restructurings and worked with governments there. I was asked to write this book by a number of policy makers, fellow bankers and people from the countries themselves to put down on record to help ameliorate whatever the next crisis is going to be because we're always going to have one crisis or another. The question is, "Do we learn the lessons from one so that the next one isn't as bad?"

That's what I want to do. What we see today, specifically in the Eurozone, is that these lessons have not been learned in the sense that they have not really taken into account the lessons from these other crises. You are going to ask me why, and the answer is that the Europeans will tell you that they are mature economies, so what do they have to learn from the emerging markets?

As it turns out, they have an awful lot to learn. We're two years into this crisis, which started with Greece. If you take a look at our own situation, the United States has the reserve currency of the world. I will be happy to give you my thoughts on our economy in the question and answer period. We have a tremendous deficit problem here in the United States and having the reserve currency of the world is not going to cover it up for us.

These things always come home to roost. I think in the case of Europe, we're seeing a crisis that started with the very small economy of Greece, and which has now expanded until it's affecting the economies and the markets worldwide, as you see daily with the volatility in the marketplaces here in the United States and worldwide. You also see it in the growth or lack of growth in this economy and other economies worldwide.

The first lesson learned is that every country is different. There is no cookie cutter approach. This is very important because you can't just say, "There's a plan for one country and it'll work everywhere." You have to adjust any sort of a plan you have. A case in point - Greece got into trouble because of the sovereign. They built up a tremendous deficit that was hidden on the books and this is why I think when you take a look at a sovereign, it is very important to understand what kind of management they have. That then infected the banks.

In the case of Ireland, it was completely different. The Irish had a very good fiscal situation. The government itself was very careful at building up deficits. What happened was the regulation of the banks was not good and the banking system basically put the whole country in the tank when the government guaranteed the banks.

In the case of Portugal, which was next on the list, it has had really no growth for 10 years and the banks were dragged into that by being pushed to buy government bonds by the accounting regulations that the EU had on the banks. What did they do? They basically told banks, "If you hold sovereign bonds, you don't have to put any capital against it." That has come home to hit these countries and the banking and other financial institutions there, but particularly the banks.

In the case of Spain, the Cajas, similar to our savings and loans, way expanded in their housing bubble, similar to our housing bubble and similar to the Irish housing bubble, and were not properly regulated there. Many of them failed and had to be taken over by government, and are being combined as we speak right now. In addition to that, the Zapatero socialist government waited a long time to implement necessary budget and austerity measures.

In Spain, you have an election coming up on 20th November, which will decide whether the socialists stay in power or the Conservatives of Partido Popular comes back in. It'll probably be the Partido Popular based on polls, but at least you have a date certain, unlike the situation in Italy, where you don't know when elections are going to take place. We don't know when elections are going to take place in

Greece either, although there is a new government that has just been announced. That at least is a date certain.

Spain by the way is fourth largest economy in the Eurozone, with Italy the third largest. In the case of Italy, you have a situation where Italy has 120% deficit to GDP, which is very, very high. A book written a few years ago by Rogoff and Reinhart basically states that based on the history of debt crises throughout the centuries, if you have over 90%, it's very difficult to really bring a country back any time soon. The debt to GDP is 150% more or less in Greece. In Italy, it's 120%.

Italy has also had problems with their political situation because Berlusconi, who is still the prime minister until the new government is formed, unless that's happened while we've been standing around here, had a real problem with his own cabinet and his own party. He had real arguments and had a difficult time getting along with Tremonti, his finance minister. This made it very difficult to put through the proper deficit reducing austerity measures and really get a budget through. They just managed to get through the 2010 budget, much less the 2011 budget over the last week. This just shows you what the situation was there.

The banking system actually in Italy is still in pretty good shape, but all these things have created these difficulties and the markets respond when they see that action isn't being taken. The worst thing that you can do for a politician or a policy maker is to give a date when something's going to be done and not do it, or make an announcement that something will be done, don't give a date, and don't do it anyway. I think this is what we've been seeing in Europe.

I gave you some of these examples of how each one of these countries got into trouble for different reasons. There is, however, one common denominator here, and that is contagion. That is something that the European policy makers thought was a word that was only utilized for emerging market countries. As so-called mature economies, members of the Eurozone and the European Union, it didn't apply to them.

I saw Prime Minister Papandreou at the World Economic Forum in Davos in January of 2010, and we were talking about that. I talked to the Head of the European Central Bank and a number of other senior policy makers from Europe. I mentioned contagion to them and they basically said, "Look, this is an isolated problem of Greece. There is no way you're going to have contagion like we had in Latin America and like we had in Asia in the 1980s and 1990s. This is something that is not for Europe, not for mature economies."

Unfortunately, all you hear and see about in the print and media today is contagion because that's what we've had - Greece, Ireland, Portugal, Spain and now very much Italy. This is another one. It's basically both economic and political. In a number of the countries I've mentioned to you, it's not just economic, but it's also political because where you have economic contagion, it spreads to politics and you have political contagion. I think that again, this was something that we faced all throughout Latin America in the 1980s and the early 1990s, and in Asia in the

Asian financial crisis in 1997 and 1998. I have mentioned also Turkey and Uruguay at the turn of the century.

Another point that is key here is timing. I went down to see Paul Volcker in the fall of 1982 at the beginning of the Latin American debt crisis. Paul was then Chairman of the Federal Reserve System and was kind enough to give me an introduction to the book. The first lesson that Paul taught me was when he said, "You know, Rhodes, you don't have all the time in the world to get some of these things done." This was in the midst of the beginning of the Mexican debt crisis, which everyone thought could have turned into the Great Depression. They were talking about it. The IMF and World Bank meetings in Canada in Toronto were rearranging the deckchairs on the Titanic.

He said, "Timing is key. You've got to get out there and you've got to reassure the market that the countries can in one way or another restructure their debt and get back to service their debt." He said, "Never forget timing." Again, as you've seen over and over again in Europe, there's a feeling that there's all the time in the world. Look at the announcements just taking place this year. July 21st, the whole crisis was supposed to be resolved in Europe. The Heads of State got together. They had a meeting. They made announcements of what was going to be done, and that was supposed to be it. The problem is that no timetable was mentioned and in fact, most of what they said was going to be done was not done.

Now we have again a meeting on October 26th and 27th in Europe. The same thing was said. They didn't talk much about 21st July. The feeling was that they had all the time in the world to resolve these problems. The truth of it is you don't have all the time in the world to resolve them, particularly when markets almost move in nanoseconds today. When we did Latin America in the early 1980s, the markets didn't move that rapidly, or even in Asia in the late 1990s, but today, they move extremely rapidly.

I would say that we are seeing that in a very strong manner in what's occurred in Italy because the perception was this summer among the leaders of Europe that Italy was not going to be a problem, that Italy was going to be a very competitive economy and they would work their way out. You see what's happened and you see where the markets have gone, and so I think timing is critical.

I also think it's very important, and this is my fourth point, that when a government announces its reform and austerity measures, they should be able to say that these measures are really self-grown, that the government itself in the country has been willing to put together a package and implement it with the support of major international financial institutions, or in the case of Europe, the Troika, which is the European Union, the European Central Bank and the International Monetary Fund.

If you give the impression or let the populace of a country believe that the program is imposed on the country and imposed on the government, then you're not going to get them to support it. We’ve seen this in Greece, which is why in desperation at the end of almost two years, Papandreou decided to call a referendum and then pulled it off the table. He was very much aware that his own people didn't support these programs. I've had experience in Latin America, Asia and elsewhere. At the end of the day, if the population isn't convinced or the majority of the population isn't convinced that the program is going to lead to growth and is something that their government really had a hand in putting together, they're not going to support it.

That's what happened very much in the case of Greece. Now you have a new technocratic government in Greece headed by Lucas Papademos, who I know and who is former Vice-President of the European Central Bank and a very respected individual. I think he may have a shot at implementing this program, which they haven't implemented to date. He's respected throughout Greece by all the political parties and respected by the Troika, so we'll have to see if he can do what Papandreou and Venizelos were unable to do over almost the last two years.

I look at this very much as the Mandarin Chinese weiji or crisis opportunity because a lot of these things come around and it's an opportunity for a government to implement proper programs that maybe they couldn't have implemented before when they weren't in the depths of a crisis. So far, we have not really seen much of that. The closest we've seen to that of the countries I've mentioned is Ireland. At this point in time, if you asked me which country was going to come out first of this, I would say probably Ireland.

The reason, and you don't hear much about Ireland, is because they're trying to implement their own program there, backed by the Troika, but it's basically an Irish program. I think that as an example of countries that did this and heads of state, leadership is key here, and that's what we haven't seen in Europe. It's true in our own country and any country - if you don't have firm political leadership, you can't get tough economic programs through, particularly ones where you're talking about austerity.

I'll give you three examples of those, where I think the leaders of Europe should look. First of all, I would say Brazil under Fernando Henrique Cardoso, who was then Finance Minister. Brazil had gone into a moratorium in the late 1980s and they were being shut off on their credit lines worldwide. The country was going through a very difficult period economically and politically. He was named as finance minister and the first thing he did was to put through a debt restructuring. We did a version of the Brady Plan, which I'll mention afterwards, which allowed the country to settle their debt problem, which had been open for a number of years.

Immediately thereafter, he and his own Brazilian team, not imposed by the IMF or anybody else, put together what's known now as the Real Plan to basically stabilize the economy, get the country out of hyperinflation and start servicing its debt and getting growth. What's key in all these programs is convincing a population that you can get a plan on the table that'll lead to sustainable growth. No population is going to put up with austerity forever. For example, Greece is at the end of its third year of negative growth and the austerity program has pushed it even further. It'll probably have 6% negative growth this year, and next year it looks like negative growth also.

The steps Fernando Henrique took got him elected President for two terms. I think it's fair to say that Lula da Silva more or less continued that program and Dilma Rousseff is continuing it today. This was done in the early 1990s, so when you do the right things and you can sell it to your population, then you can take the most difficult situation in the world and turn it into an opportunity.

Another example I would mention is Korea in 1997/98. Korea was one of the countries most hit by the Asia financial crisis. You had Korean women going around block on block in front of the Central Bank of Korea, melting down their gold jewelry because they didn't want Korea to go into default. Koreans have tremendous patriotism, but that alone was not going to get them out of the problem. They had just elected a new President, Kim Dae-jung, who was the first really leftist president of the country since World War II when they got their independence from the Japanese.

Everyone was greatly concerned that he wouldn't take the necessary steps to turn the economy around, which had taken, as I said, the brunt of the Asian financial crisis. I was given the job of restructuring the short-term debt. Some of you in the room know this. The first thing I did was get on airplane to meet him when he was president-elect. I said, "I need your support, Mr. President. You're going to be president in two weeks and if I don't have your support, I'm not going to get the banks." I had stopped the banks from pulling worldwide. The reserves were less than $1 billion. Today they're $330 billion.

He said, "Rhodes, if you will restructure that debt, you're helping Korea and my job is to take Korea out of this mess. I think the IMF program may be too rigorous, but I know it's necessary to get my country out. I will see that it's implemented and I will see you have our full backing." He did it, so even though he had qualms, and he showed the leadership to get Korea out. Now, Korea has had a problem here and there, but the Korean economy is one of the fastest growing, not only in Asia, but in the world because he took the necessary leadership.

The last example is Turkey, which had gone through a number of financial and economic crises in the 1990s. The Ecevit government came into power and there was another run on the banks. The International Monetary Fund wanted to help. We had a new government, the second Bush administration, and they had real doubts about bailing out countries because of the experience of Argentina. I was asked by the IMF and the Turks to convince our own treasury to let the IMF support the plan.

Kemal Dervis, who had been a Vice-President of the World Bank, had a plan. It was a Turkish plan. All he needed was some time to implement it. We were able to convince the US and the other authorities to give him time to implement it. He was able to go to the Turkish people and say, "You've got to accept these austerity measures because they will lead to growth. It's our plan. It's not being imposed on us by the Europeans, the US or the International Monetary Fund. They will back it, but it's our program. We designed it." It worked and look where Turkey is. At the meetings here at Pricewaterhouse, as Tom knows, you have the Deputy Prime Minister and the Prime Minister to speak about where the economy of Turkey is going.

Leadership is key and the ability to say that you can carry it out and it's homegrown. I think this is what's going to have to happen in Greece because just the Troika and everybody else imposing something on the Greek people will not work. They need to see firm leadership of their own to carry it out. We're going to need to see that in the case of Italy. All of these programs have to lead to growth because if you don't have growth, you can't do it. This whole question of strong political courageous leadership is tied in together with all of these.

One of the final points here is the private sector. Probably a number of you remember in the 1980s and 1990s having all these programs with Latin America and Asia. There was an old song about bailing out the banks within the chief holders of the debt. No one says that much now, but the European Central Bank is in there buying bonds of all these countries and where are the bonds coming from? They're coming from the private sector because it was not called in at the beginning of this crisis to sit down at the table, as they were in so many of the emerging markets to say, "We have to work out a plan together, and if necessary, that may have to be a hit. However, it'll be better to do it now than to do it later."

In the case of Greece, they never even bothered to call the private sector in until the summer. Then they went through all these various discussions, which ended up nowhere. We're now at an agreement in principal, but there's really no timetable or even details of how it's going to work out a 50% haircut on the private sector side of the holders of Greek debt. If the private sector had been called in along with all of these other things, the problems in Greece would be something we wouldn't even be discussing here because it wouldn't have gone onto these other countries.

Obviously, I've mentioned five countries, but this is having an impact on France and even on Germany. Although the UK is not a member of the Eurozone, it's a member of the EU, and it's impacting them and the other members of the Eurozone in East and Central Europe, not to speak of what it's doing to our economy. Bernanke just said it today again. The Chinese, President Hu Jintao, mentioned it at the Group of 20 meetings. India and China just signed a press release yesterday criticizing Europe and the so-called mature economies for impacting their economies. The markets today are so interlinked that you can't segregate emerging from mature markets. I think that getting the private sector involved is really, really key.

I will take kudos for our own regulators here who have been beaten up really badly for what happened in 2007 to 2009 here in the United States. Two years ago, they decided to have a series of tough stress tests on the banks. All the banks involved had to substantially increase capital, and it worked. In the case of Europe, they're now into their third stress test. The first one cleared the Irish banks. Within months, the Irish banks were in the tank and had to be intervened by the government. A good number of the savings and loans that were all passed in Spain were also in the tank and had to be intervened by the government or merged. A number of the regional banks or Landesbanks in Germany had to be helped out by the states.

Then they said, "Okay, we screwed up the first time around. We're going to have a second set of stress tests." That was in 2009. After giving various dates for it, the results finally came out at the beginning of July this year. One of the banks that was top on that list of passing grades was Dexia. I think those of you who follow the market know what happened to Dexia. They had to be intervened, part of it nationalized and so on. Among other things, they were heavy holders of sovereign debt and the regulators in Europe said, "You don't have to maintain capital against sovereign debt because sovereigns don't default."

At the time of the Mexican crisis, Walter Wriston used to say, "Countries don't go bankrupt because they eventually work it out and they have assets." I used to kid him about it and say, "That's right, Walt. It's just the banks and institutions that lent to them." This was very similar. Now we have a new set of stress tests that were announced in the communique of the Eurozone on October 26th and 27th. They're saying that they have to move forward their capital requirements to minimum June this year to get to 9% Basel III capital requirements. As part of that, they had to write down a lot of the sovereign bond debt of countries in trouble.

What's happening with this? You're seeing a lot of shedding of assets by the European banks. They're also announcing cuts in bonuses, eliminating bonuses, cutting some dividends and at the same time, in addition, they may have to try to raise capital. They may have to go to their own governments for help or the stability fund that was approved a short while ago as part of all of this reform effort in the Eurozone.

What will that do? That's going to curtail in some way probably some banks for doing the lending they probably should to various entities and clients in the Eurozone. A number of Eurozone countries, but not Germany, are facing stagnation or recession, so this is just going to make it even worse. Again, it's the whole idea of putting off this stuff and not taking action at the proper time.

As Tom said, I try to be an optimist because the only way you can work your way through these situations is to believe that you can work your way through. To put us to where we are today, you've got to be an optimist. That's why I'm a great believer in the Mandarin Chinese expression I mentioned earlier, which is crisis opportunity. I think that this may be an opportunity for the Europeans to finally do what they should have done a long time ago.

When they put the European Central Bank together and they formed the Eurozone, they had the Maastricht Treaty and they also passed a Stability and Growth Pact.

That said that countries that were members of the Eurozone could not have a deficit of more than 3% of gross domestic product. Germany and France were the first ones to violate it, the two largest members of the Eurozone. What example did that set for other countries, like Greece, Ireland, although Ireland was pretty good in that respect, Portugal, Spain and so on?

At the end of the day, you had a monetary union, the European Central Bank, which functions well, but you had no fiscal discipline, much less any penalties for those countries that didn't live up to what they had agreed to at Maastricht and the Stability and Growth Pact. In this country, we have the structure. The question is whether we have the will on the deficit side, but we have a structure. If you want a comparable period in US history, go back to the Confederation of States, the 13 states. That's basically what it looks like with the fiscal side of the Eurozone.

One of the opportunities here is to really do something on the fiscal side, either fiscal union, set up a tsar on the fiscal side with the ability to put penalties on those countries that don't adhere to it in the Eurozone, including throwing them out. This has been advocated by people like the former Head of the European Central Bank, Jean-Claude Trichet, and a number of others. The Dutch government has made a point of this.

I am hopeful that out of all of this, they will get their act together. That's why I'm hopeful that the Eurozone will not collapse because I think what I've learned is there are three things that eventually get you moving in these situations. One is arrogance and ignorance, which basically get you into the situation where you think you don't have anything to learn from anybody and you know how to do it. Once you get in there, fear takes you and you mess it up. Fear drives you oftentimes to do what you should have done in the first place. I think that's an opportunity I see.

The other one is the International Monetary Fund. All during the 1980s and 1990s, the anchor to the financial system when countries got into trouble was the International Monetary Fund. Because of the changeover with four managing directors in 10 years, that has really weakened the cloud of the institution. Plus today we have the enormous needs of southern Europe. Countries of the Arab Spring, Tunisia and Egypt will all need help and other countries and other parts of the world also.

I think you need new funds for the IMF, but because of the voting rights, it's all tied up. What you could have is what my friend Jacques de Larosière did in the financial crisis in Latin America. He got on a plane and went to Saudi Arabia, which was then the country with the big surplus and said, "I need this money because otherwise we won't have enough funds and you're a stakeholder in the system." He got the money.

Today, you have China, Saudi Arabia and the Gulf countries. I just got back from Kuwait. You have India, perhaps Brazil and Korea that might be willing to put together a special trust fund if it's administered by the IMF to help the IMF become an anchor again. What they don't want to do is just to pile it in to buy European bonds. The Chinese have been very explicit on that.

This may be an opportunity for both of these things to occur, and then I think we can say that maybe this crisis produced something. I am also optimistic, as I said, on Greece, on Lucas Papademos. We will have to see. What happens in the case of Italy is very much up in the air because we don't know what the government is going to be, who's going to be part of it and we certainly don't know when elections will take place.

With that, Mr. Chairman, Tom, I'm happy to answer questions.