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REFLECTIONS ON "BANKER TO THE WORLD"

William R. Rhodes

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About the Series

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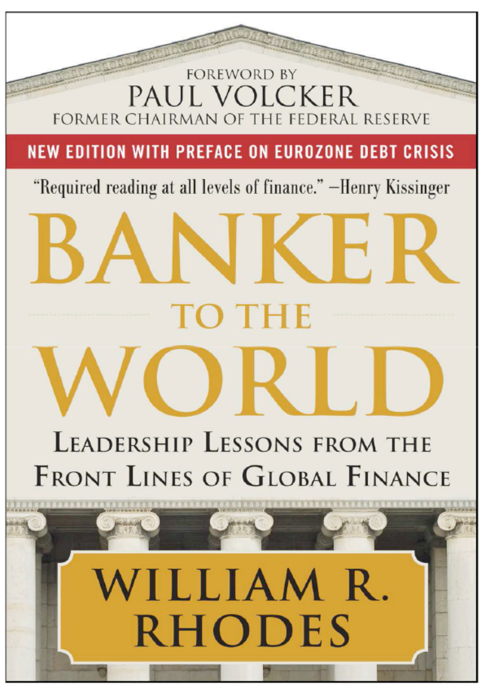
About the Author

President & CEO, William R. Rhodes Global Advisors, LLC. Author: "Banker to the World: Leadership Lessons from the Front Lines of Global Finance." Former Senior Vice Chairman of Citigroup and Citibank, North America, current Senior Advisor to Citigroup.



Thank you ladies and gentlemen for the kind invitation to speak to you today and thanks to Dean Bernard Ferrari, and to my friend Professor Steve Hanke for his gracious invitation and introduction.

We are meeting at a time when the world economy confronts many uncertainties. For example, we are seeing sluggish growth in world trade; increasingly volatile financial markets; persistently high rates of unemployment in much of Europe; concerns about the prospects for our own economy and the major economies of China and Japan; and the prospect of significant divergence in the course of monetary policies by the leading central banks which could give rise to new challenges, particularly for emerging markets.

Indeed, we have much to talk about this afternoon and my remarks will largely concentrate on key aspects of economic and financial policy in the four major economic powers of the world – the United States, Japan, China and the 18-member country euro-zone. It is important to stress that the developments in each of these economies will impact the global economy, and in particular the emerging markets.

As we look at conditions today, it is useful to have a sense of history. I have just come back from Mexico, where I went to launch the Spanish edition of my book, "*Banker to the World: Leadership Lessons from the Front Lines of Global Finance*." As my book draws lessons from past sovereign debt crises, it was natural that conversation would go right back to mid-1982 when Mexico got into debt difficulties that were to launch what came to be known as the Latin debt crisis and that saw a lost decade of growth for the continent as a whole.

We also recalled how Mexico became the first "Brady Plan" sovereign and how in the years thereafter it overcame adversity at times to become a vibrant democracy, an economy where market competition has become a key engine of growth and where a dynamic, well-educated, entrepreneurial middle-class has emerged to secure future progress.

Many of the lessons of past sovereign debt crises are applicable today. We need just consider the unfolding situation in Ukraine as an example. The first priority there is to establish political stability, and clearly Russia will play an important role. Then, a matter of urgency is to find a viable course out of a formidable economic crisis. In the medium- to long-term, the full energies and skills of the international community will be needed to assist this country, including such multilateral institutions as the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development, and the European Investment Bank. I submit that there will benefit for Western governments and financial agencies to draw lessons from past crises as they move ahead to confront Ukraine's challenges.

So this afternoon, I would like to first reflect on some of the lessons from past crises and then, against this backcloth, focus on some of the critical challenges that the world economy confronts.

Key Lessons from Past Crises

In the Forward to my book, I underscore the importance of seven key lessons:

1. First, each country is unique. There can be no single formula that applies to all countries at the same time. A cookie-cutter approach does not work – the depth and breadth of today's euro-zone crisis and recent emerging market volatility reflect, in part, the fact that the authorities for too long have treated all of the crisis countries in the same way and tried to impose policies of austerity across the board. Some of today's emerging market economies, such as South Korea and Mexico, are in relatively good shape because they have pursued prudent paths, including significant structural reforms, while others, such as Turkey, Argentina, South Africa, Thailand and Venezuela, have faced pressures in part because of unique political developments and in some cases due to lack of structural reforms.

2. My second point relates to one common denominator in a sovereign crisis, and that is contagion. We must not lose sight of the risks and speed of contagion – be it economic or political, or both – and always be mindful that this is especially the case now that technology has sharply accelerated the speed at which markets can move.

   As early as January 2010, weeks after the onset of the Greek crisis, I warned senior European policymakers at the World Economic Forum in Davos that there were very real dangers of contagion. While I was to repeat these warnings, they were rebuffed by officials who asserted that the euro-zone was different because they are developed markets and could not be compared to emerging market countries. Well, I was pleased that finally at the end of 2012 – long after the world recognized a euro-zone crisis and not just a Greek crisis - that German Finance Minister Wolfgang Schäuble publicly admitted that he and his euro-zone colleagues had underestimated the dangers of contagion. It was a costly error.

3. Thirdly, when facing an economic crisis, time is the enemy. Paul Volcker taught me back in 1982, when he was Chairman of the Federal Reserve Board, that the longer one waits to take tough decisions in times of crisis, the more difficult it is to stem the tide and curb the ensuing increase in losses. Politicians are mostly more comfortable putting off very tough decisions and looking for ways to find time. The markets see this and react negatively and the citizens of a country lose confidence in their government, as we have seen time and time again.

4. Fourth – when in crisis, reforms and measures that a government can present to the population as being home grown in origin rather than imposed by an external source have a greater chance of acceptance by its people.

   The Mandarin Chinese word "weiji" is appropriate in this context. It consists of two characters – one represents danger and the other opportunity. The danger is that national leaders appear weak to their own people and that reform programs are seen to be imposed from the outside. We saw such strong leadership in times of crisis in Brazil (1994), in South Korea (1998) and in Turkey (2001) – we have not seen sufficient leadership during the euro-zone crisis.

Leaders must be willing to promote programs that generate domestic support, raise international confidence and demonstrate strong leadership.

5. Fifth – the focus needs to be on growth, deregulation and structural reform. The public at large needs to be convinced that policies are being put in place, including ones that may involve sacrifice, that can and will lead to future sustainable growth. Programs that only strengthen austerity for countries in acute difficulties will always fail because, above all, they will never secure the level of public support and commitment essential to seeing them through. Rather, growth must be at the center of the stage: it must be the product of prudent fiscal policy, sound monetary policy, constructive and comprehensive structural reform, including deregulation; and, importantly, it must provide the environment where the energies of private enterprise can be unleashed to create new investments and new jobs.

6. Sixth – private sector participation must be involved in any country reform program from the beginning – which often means engagement in external debt restructuring. In most cases, the private sector holds the majority of the debt and can ultimately help the country return to the capital markets with access to financing at reasonable rates.

7. Finally – there has to be strong and courageous political leadership to implement unpopular, but necessary reforms. I would suggest, for example, that we have not seen enough of this in the United States in recent times, let alone in the Eurozone.

   The key is to seize the moment with a sense of urgency, announce measures clearly and firmly, explain why they are essential and detail plans, including timelines, for their implementation.

   Leadership in times of crisis requires the patience to see the reform process through and the ability to successfully sell such programs at home.

Global Economic Concerns Today

Now, permit me to turn to some of the most concerning challenges before the global economy today. As a general statement, let me begin by suggesting that overall the prospects are for slow global growth – slow growth of world trade and slow increases of GDP. Moreover, there are rising risks to this less than unsatisfactory outlook.

In March 2007, I warned in a *Financial Times* article that the global "Goldilocks" economy and markets would face a material correction within the next 12 months and there was a need to exercise greater prudence in lending and investing. This warning was ignored by most people in the private and public sectors. One year later, in March 2008 and six months before Lehman Brothers imploded, I underscored my continuing concerns in another *FT* article. Once again we saw investors overly interested in the search for yield, while authorities for the most part continued to underestimate the gravity of the rapidly evolving crisis.

As I reflect on those articles in 2007 and 2008, I am surprised by the fact, as revealed just last week in the publication of the 2008 minutes of meetings of the Federal Reserve Board's Open Market Policy Committee, at just how complacent were most members of the Fed's Board. They did not appreciate the potential severity of the nation's financial problems, not even after Bear Stearns collapsed. They failed to sense that the nation was heading towards the worst economic crisis since the 1930s.

And, what should be key concerns right now?

Three weeks ago, on February 3, I wrote in *The Financial Times*: "Now, new storms are likely. Recent financial market developments triggered by emergency central bank actions in Argentina, Turkey, India, South Africa and Venezuela, but reflecting broader concerns about interest rate trends, may prove to be just a foretaste of things to come. The risks are rising of a prolonged period of exceptionally volatile and disruptive cross-border financial flows that could create financial market turmoil and undermine the fragile revival of growth now seen in many economies."

And, I added, "In 2013, key central banks were moving in parallel. They were pumping out liquidity, holding interest rates down and shouldering the lion's share of responsibility for stimulating growth. But now divergence, rather than cohesion, is emerging. Traders may win, while everyone else may lose."

The risks to growth are all the greater because the 18-member country euro-zone continues to show a lack of political leadership that experience tells us is essential to overcome crises; because Japan's efforts to stimulate growth may fall short; and, because China is facing complicated economic management problems of its own that are bound to have an international impact.

The United States

The United States remains the most powerful economy in the world and the logical place to start our discussion on the outlook for growth. Despite a great deal of political posturing on all sides, some of the most fundamental challenges to the sustained growth of our economy have not been seriously addressed in Washington.

I refer of course to the medium- to long-term financing of the combination of major entitlement programs – Social Security, Medicare, Medicaid and the consequences of the Affordable Care Act (Obamacare). Without changes in the these programs and without meaningful tax reform, our children face the rising prospect of seeing their nation live increasingly beyond its means. This danger already dampens long-term investment prospects and will increasingly do so.

Moreover, it is only appropriate given that we are meeting at one of our country's leading universities that I stress that critical to our U.S. business competitiveness in years to come, as well as to employment prospects, is that every effort be made to strengthen our educational system. The economic risks of failure here could be significant.

In the shorter-term, with Congress unable to do much, all eyes are turned on the Federal Reserve Board. The outlook for the U.S. economy is far from certain, although I think it likely that it could grow by 2.5% to 3% this year. The Fed will be watching a series of indicators, from the jobless numbers to inflation to growth, in determining its policies. It is likely to move ahead with the policy of exiting from quantitative easing that was announced just before Ben Bernanke handed the Chairmanship of the Fed over to Janet Yellen and that involves a gradual reduction – a "tapering" – of its government bond purchases. The pace of "tapering" is uncertain but I have no doubt that the Fed will gradually reduce the volume of its bond purchases. Financial prudence demands this: after all, we have seen the Fed's balance sheet balloon from around $800 billion to close to $4 trillion since the onset of "quantitative easing."

Managing this process will test the Fed and its new Chair. Central bank coordination and clear communication across the world will be vital to avoid excessive financial market volatility.

This is especially the case as just as the Fed starts to move towards tightening monetary policy and perhaps the Bank of England will as well, so the European Central Bank (the ECB) is under pressure to ease further and I will say more about this and the policies of Japan and China shortly. The key point is that divergent paths of monetary policy will open opportunities for arbitrage, for highly volatile short- term capital flows across national borders as investors search for yield and so the outcome could be turbulence in financial markets. This would dampen confidence and the prospects for economic growth.

In calling for greater coordination among central banks so that markets are better prepared and confidence is raised, I am talking about concrete measures:

1. First, the leaders of the major central banks meet regularly at the Bank of International Settlements in Basel. They need to use these meetings to discuss the impending divergence in policies and the impact these risks for markets and economies.

2. Second, they could signal as a result of their deliberations that they – notably the major central banks – are willing to provide swap lines to some of the key central banks of emerging markets, especially those whose policies are sound and who could be subjected to damaging capital outflows.

3. Third, the International Monetary Fund has credit facilities that can be drawn upon by countries without additional conditionalities that may need them and that are pursuing sound economic policies. Countries that announce that they are using these IMF lines of credit signal to the markets that they are acting to strengthen their reserves.

4. Fourth and very importantly, the leading central banks and here the Fed again is crucial, need to find better ways to communicate clearly and in a timely manner to the public and to the financial markets.

The Fed's record has not been encouraging. Perhaps, Janet Yellen and her Fed Board colleagues will accept the view noted on September 26 of last year in a speech in Frankfurt given by Fed Governor Jeremy Stein, who stressed that what is particularly important for the central bank now is – and I quote – "Doing everything we can to ensure that this difficult transition is implemented in as transparent and predictable a manner as possible. On this front, I think it is safe to say that there may be room for improvement."

On the positive side, the U.S. is going through an oil and gas revolution thanks to the use of hydraulic fracturing also known as "fracking." This will be, going forward, a major stimulus to the manufacturing sector and will make the country more competitive with Europe and even China. It is expected that by 2015, the US will be the world's leading producer of oil and gas, surpassing Saudi Arabia and Russia.

If the challenges of fiscal and monetary policies can be met by strong leadership in our country, then the new energy reality that is emerging could enable the U.S. to enter a new era of prosperity.

China's Important Changes

Permit me now to turn to China, the world's second largest economy. I have been to China five times in the last 18 months, and about 70 times over the last two decades. On each visit, I gain deeper insights into many aspects of this fascinating nation.

We are seeing the most far-reaching change in Chinese economic policies since former leader Deng Xiaoping made his famous 1992 Shenzhen speech. Then, he took his "modernization" program further by stressing the urgent need for the economy to strengthen investment and become far more export-oriented. Now, China's leaders are striving to put in place a new economic model that places domestic consumption at center stage and sees a substantial opening up of the economic system.

The years of double-digit economic growth in China are over. The challenge before China's leaders is to move to the new model and attain at least 7% annual growth.

The recently held Third Plenary Session of the 18th Communist Party Central Committee will probably go down in history as being as important as similar sessions held in 1978, which was the start of opening the Chinese economy, and in 1993, which set the course toward China joining the World Trade Organization.

You have no doubt read about the decisions to amend the one-child policy, to establish a special council that will provide full power of national security and military matters in the hands of President Xi Jinping, and you may well have also read about the far-reaching plans announced to strengthen migration from rural to urban areas for millions of Chinese and to strengthen the social safety net. These are all important decisions.

Permit me to briefly focus on the economic reforms. The Chinese government has released extensive documentation on the decisions taken in the course of the recent Congress. When you read the 60-paragraph abridged version of the government' s "Decision on Major Issues Concerning Comprehensively Deepening Reforms," it is striking how absolutely key are the economic reforms within the total framework of reforms that are embraced – social, cultural, governance and political reforms. The many economic reform proposals are far more detailed than the media has reported.

The plans that have been set may well serve for the next decade. They will see a major strengthening of market forces in China; the gradual transformation of state owned enterprises into far more market-based and better managed institutions; and the encouragement of all manner of programs to see that Chinese save less and spend more, so that domestic consumption becomes a key driver of growth.

We will see far more opportunities for foreign investors in China and for the Chinese to invest abroad.

We will also see far-reaching financial reforms: I would not be surprised if there will be full RMB convertibility in five to 10 years. The government has announced that it plans to establish a free trade zone in Shanghai, which will serve as an important laboratory for testing financial sector reforms.

However, China's authorities must confront three serious problems in the financial sector: excessive borrowing by municipal and provincial governments and state-owned enterprises; the risks of rapid growth of the shadow banking sector; and, rising levels of non-performing loans at the major commercial banks.

The government must act to ensure that the banks do not get back into the crisis situation seen a little over a decade ago, when a host of costly and complex special measures had to be taken, such as having the Peoples' Bank of China (its Central Bank) recapitalize the state owned banks and establish asset management companies to take over the problem loans.

China's authorities need to find ways to communicate clear timetables for the implementation of their economic and financial reform policies. At the same time, the authorities need to find constructive approaches to dealing with over-arching problems of great concern to the people of China, notably addressing the intense pollution and environmental degradation that has become widespread; and, importantly, building public trust in government by curbing corruption. Some of these issues may be decided upon at the National People's Congress that starts next week.

Japan Surges

Now, turning to Japan. After nearly two decades of stagnation, Japan's leaders have set out on a new course. The strategy that Prime Minister Abe is pursuing – Abenomics -

consists of "three arrows:" aggressive monetary easing, fiscal stimulus, and structural reform. They have moved on the first two, but action on structural reform and deregulation has been slow and it will be absolutely vital to the success of the program as a whole. Prime Minister Abe recognizes that monetary expansion and a weaker currency alone will not turn around the Japanese economy.

This has been underscored by most recent data. Japan's record January trade deficit – heavily impacted by rising oil and gas imports as the country has closed its nuclear plants - saw a rise of 71% to about 2.8 trillion yen – followed by an unprecedented 2013 deficit of around 11.5 trillion yen. That in turn curbed the fourth quarter's economic growth rate to an annualized level of about one percent – for 2013, as a whole, GDP grew by 1.6%.

It should be noted that as Japan stimulates and its currency weakens, the result is likely to be negative for the exports of its neighbors, notably South Korea and China. It could also cause problems with the very important trade agreement, the Trans-Pacific Partnership (TPP), which the United States is promoting.

A sustainable revival of growth will demand far-reaching structural reforms. The government needs, for example, to assist Japanese business to become more competitive and this calls for long overdue deregulation. Then, a national energy strategy is required, especially given the public concerns about nuclear power. Importantly, fundamental structural and social policies need to be addressed – sooner rather than later – as the budget consequences of an aging Japanese population are considered.

A difficult issue at the center of budget management in Japan is debt. The current debt to GDP ratio is the highest of any developed country in the world and it is approaching 240%. Although Japanese institutions and individuals hold an exceptionally high level of government debt, at approximately 90% - the highest among developed industrial economies – the debt overhang needs to be addressed. This is important in order to place banking and the economy on a sounder long-term footing. In this context, I believe the government is right to press ahead with a consumption tax rise from 5% to 8%, which is scheduled to be implemented this April.

Euro-zone Challenges

Now, let me turn to the 18-member country euro-zone: here the problems are complicated, solutions remain elusive, and the lessons from my book have largely been ignored at great cost.

The European authorities and many economists have been suggesting in recent months – and too much of the media has been echoing their views – that the euro-zone is on a solid economic recovery path. The facts tell a different story. It is important that you resist the Brussels folly of exuberance in the face of some new data showing an uptick in economic activity.

The facts are that, while the trendline of growth for the euro-zone over the last couple of quarters has been upwards, the pace of advance has been extremely modest. Real GDP grew in the final quarter of 2013 in the euro-zone by 0.3% compared to the previous quarter. For 2013, as a whole, real GDP fell by 0.4%.

Germany, the power-house of the euro-zone, saw its fourth quarter GDP rise by just 0.4% compared to the previous quarter; for France, the second largest euro-zone economy, the advance was 0.3%. The truth is that most of the euro-zone has, at best, moved from recession to stagnation.

At the same time, we are seeing the inflation level in the euro-zone run at below 1% and deflation is a risk.

Then, according to Eurostat, the euro-zone unemployment rate in December 2013 was 12% - up from 11.9% in December 2012. We are seeing exceptionally high rates of unemployment in a number of countries, such as Greece at over 27%, Spain at over 25%, Portugal at more than 15%, Italy at over 12.5% and France approaching 11%, show no meaningful signs of decline. The euro-zone as a whole has about 19 million people out of work and many others have just dropped out of their national labor market.

For young people in many countries, the situation is of extreme concern. For the euro-zone as a whole, the youth unemployment rate has now reached 23.8%, so there are about 3.5 million young persons under 25 without jobs. Consider, for a number of countries the youth jobless rates are close to 60% in Greece and 55% in Spain, then over 40% in Italy and more than 25% in France and the rates are also particularly high in many of the euro-zone countries in eastern and southern Europe. For many young people the prospects are for a lost decade of economic activity.

The high jobless rates in the euro-zone do not only have economic and social consequences, but political ones as well. They undermine the ability of these countries to restore public respect for established political parties and provide leaders with the mandates needed to introduce vital structural reforms.

Now, permit me to turn to finance. I believe it is essential that the euro-zone's banking system needs to be strengthened. The banks play a far larger role in Europe as the suppliers of finance than they do in the United States given the relative weakness of Europe's capital markets and the strength of ours. The banks need to play full, robust roles in providing the finance needed to support productive investment. This is particularly important for small- and medium-sized enterprises, ("SMEs"), who are key job creators.

But, endless debates and disagreements at the political level in Brussels have failed to establish a pragmatic roadmap for a banking union that provides overall power to the European Central Bank (the "ECB") and that accepts a common resolution approach. They are already one year behind schedule on launching supervision under the ECB. A common resolution system, if it does get concluded, is now not seen as starting before 2018.

As you look across the landscape of euro-zone policy discussion, you see one bright light and it is shining from the European Central Bank. Despite opposition, Mario Draghi did force through an interest rate cut recently - I have been saying for more than a year now that the ECB needed to take this action. Further, an additional rate cut will probably be necessary as well as other actions.

Mario Draghi has also announced that the central bank is prepared, if needed, to undertake a further LTRO program or some other form of asset purchases – these Long-Term Refinancing Operations have been encouraged by the IMF. These operations provide banks with more long-term loans to keep money market interest rates low.

ECB efforts to reduce interest rates and to pursue some other policy actions have faced opposition at times from the strongest power in the region, Germany. Constructive leadership by Germany is going to be essential to restore confidence in the prospects for the euro-zone economy.

The euro may also be too strong in terms of the dollar and other currencies to enable European business to boost its competitiveness in world markets. Export growth will be a vital component for reviving growth in the euro-zone beyond Germany.

Conclusion

Ladies and gentlemen, the sovereign debt crises of the last 30 years teach us that strong political leadership is crucial; that the power of contagion is greater than most official policymakers realize; that each nation's difficulties must be understood carefully, each country has unique economic challenges, and there are no cookie-cutter simple solutions; that delaying tough actions always results in even more challenging difficulties; that the focus for policy has to be on growth and on measures that can clearly lead to sustained growth, including structural reform and deregulation; and, that official policy-makers need to fully appreciate that the private sector is crucial for the restoration of economic stability and growth.

Right now, as we look at the evolving political situation in Ukraine, we have to hope that its leaders, together with foreign governments with which it can find constructive ways to cooperate, alongside international official financial institutions, will heed the lessons from past crises. It will take great energy and wisdom to bring Ukraine from its current volatile and unstable condition onto the road towards revived economic prosperity.

More generally, as we look at many of the situations that now abound in the global economy, we find that the key lessons from the past are still not being fully recognized and applied by those who hold political and central banking power. These situations risk persistent stagnation and high unemployment, which could undermine the positive forces of globalization and generate political pressures for more protectionist policies. For an erosion of free trade agreements, a perpetual cycle of competitive currency devaluations and a dependence on beggar-my-neighbor policies will create major new challenges.

Thank you.