The Spiros Voutsinas Memorial Lecture on the Future of the Eurozone and Transatlantic Banking Reforms

Foreign Policy Association

Speech by William R. Rhodes

Good evening, honorable members of the diplomatic corps, ladies and gentlemen. Thank you Joseph for your very warm and stimulating introductory and his remarks. Let me say how very pleased I am to see Spiros's family here this evening, his daughter Jean and son-in-law Peter & his assistant Sofia.

It is truly wonderful that this lecture series is being inaugurated and a great honor for me to be the first speaker in this series. Spiros Voutsinas was a good and stimulating friend and we first met at a Foreign Policy Association function several years ago. He was an outstanding banker, and an outstanding leader of the Greek-American community.

The topic that I have been given this evening, bringing the future of the Eurozone together with Transatlantic banking reforms is both complex and fascinating and covers topics that Spiros and I always talked about at our regular lunches. Permit me to start with some points on the immediate Eurozone situation, then underscore some key lessons of crisis resolution, and then turn to the banking themes.

It was most troubling for Spiros in recent years to see the modern Greek economic tragedy that has brought such pain to the Greek people.

The Eurozone as a whole has become the sick-man of the global economy. It was in the late fall of 2009 – yes almost five years ago now – that then new Prime Minister, George Papandreou, publicly revealed Greece's serious fiscal problems. He announced that the budget deficit was more than four-times larger than the Eurozone Maastricht Treaty limit of 3% - it was 12.7%. The

ratings agencies swiftly downgraded Greece and the Prime Minister introduced a major economic program designed to restore fiscal order. This was the start of the Eurozone crisis – one that as we have seen has lasted for almost five years.

For the people of Greece this period has been a nightmare. They have experienced nearly fiver years of negative growth – indeed they have confronted a depression. Total unemployment is now at 27%, with youth unemployment close to 60% - and we should remember that at the height of the Great Depression of the 1930s in the United States the unemployment rate was less that it is in Greece today at 25%.

The persistence of these extraordinary rates has been a major factor in encouraging political support in the country for radical right-wing and left-wing political parties, as was seen in the recent European Parliament elections. The challenges before the leadership of the country are formidable. We have to wish Prime Minister Antonis Samaras well as he courageously strives to chart a course that can win public support, build investor confidence and ensure the support for Greece from its Eurozone partners.

While a number of leaders of the European Commission have consistently declared that the Eurozone is now on a solid course to growth, the facts tell a different story. The 18-country Eurozone's growth in the first quarter of this year was 0.2%, the same as in the final quarter of 2013.

The German economy grew by 0.8% in the first quarter, which was double the rate seen in the previous quarter and this is on comparative terms is the bright light in the Eurozone's growth scenario. The Germans are the political power in the Eurozone and they have preached austerity time and again and the result has been region-wide stagnation, despair for close to 20 million unemployed

people and the prospect of a totally lost decade for millions of young people under the age of 25.

Moreover, the Eurozone now faces a deflationary threat. Latest data for May shows that the annual rate of inflation is back at the same level seen in March at just at just 0.5%. This is the lowest level seen since November 2009.
I have long argued that the European Central Bank needed to be far more aggressive in stimulating the Eurozone economy. Finally, in early June, it introduced a package of measures that was urgently required – it cut interest rates to record low levels, and it said it would make, as a start, up to €400 billion ($545 billion) in low-interest loans, with 4-year maturities, available through the banking system to assist, in particular, small- and-medium-sized corporations.

Perhaps even more needs to be done by the ECB and I shall return in a few minutes to talk more about banking issues. But as we look at the economic scene in the Eurozone it is clear that the ECB cannot do all the heavy lifting. The European Parliament elections have seen radical parties in a range of countries come to the fore on a scale that none of Europe's establishment political parties anticipated. The message, which I believe the French and the Italian governments have understood very clearly, is that a major economic course change is needed.

Recently, I met French Prime Minister Manuel Valls who has a clear and realistic view of what measures need to be taken. He supports efforts to transform the policy focus of the Eurozone from austerity to growth. Importantly, his perspectives have been publicly supported by Italian Prime Minister Matteo Renzi. They well call for a temporary suspension, for example, of the Eurzone 3% budget deficit limit to allow for greater fiscal stimulus.

However, such approaches may be countered by the German government, which has staunchly promoted the austerity course. It is difficult to predict what will transpire. The Dutch were long the allies of the Germans in supporting austerity, but in the first quarter of this year we saw the Dutch economy decline by an annual rate of 1.4%, after a 1% advance in the final quarter of last year. So, the Dutch too may be coming around to the view that austerity is not the appropriate course.

What is evident is that minimal real growth, rising deflationary risks and sustained very high unemployment is not acceptable.

Spiros was always interested in discussing at our lunches the core lessons that need to be drawn from past experiences of financial and economic crises. He always used to quote back to me the lessons that I wrote about in my book, *"Banker to the World."*

Unfortunately, the European Commission's leaders for too long believed that lessons from past crises in emerging markets had no relevance to their own situation in the Eurozone, because they argued their problems were in sophisticated industrial countries. They were wrong.

Spiros considered these lessons important and so allow me to highlight 7 key points made in my book, "*Banker to the World*":

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 is due in part to an attempt to impose the same "austerity" policy on all member countries.

2. Second, we should never lose sight of the risks and speed of contagion – be it economic or political, or both – and 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 policy-makers 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. Third, when facing an economic crisis, time is the enemy. 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 votes in the recent European Parliamentary elections demonstrate how the established political parties in much of Europe have failed in this regard.

5. Fifth – the focus needs to be on growth, deregulation and structural reforms. Structural reforms and deregulation are always difficult, and they are impossible unless there is a wide public conviction that a workable growth policy is being pursued. This has not been the case in most of the Eurozone.

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. 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.

Against this background permit me now to move to the topic of Transtlantic banking. The topic is especially pertinent here this evening as the challenges of banking regulation are ones that Spiros was always very keen to discuss.

He and I certainly agreed that it was essential following the 2008/2009 financial crises that every possible measure be taken to restore the soundness of the international financial system. Major efforts have been made by financial authorities to ensure that banks deleverage and recapitalize. Overall, there has

been significantly more progress on this front in the United States than in most of Europe.

The relatively slow pace of actions in much of Europe to strengthen the banking system has explicitly contributed to the failure to secure growth across much of the Eurozone. Simply stated, the banks have not been playing the full roles that they should be playing to provide finance for investment and consumption that are essential to restore growth. The banks have been pulled in many directions by overly complicated regulatory mandates and by the slowness that the political authorities have shown in building a banking union.

Now, at last, the ECB has been given the supervisory authority to introduce meaningful stress tests and to work towards a strengthening of the banking system across the Eurozone. This is a crucial component of measures needed to revive the Eurozone's economy.

The challenge after the financial crisis not only called for reviving the financial system, but also for introducing measures to ensure financial system soundness. The quest for far-reaching answers here has fallen on the shoulders of the Financial Stability Board, which has endorsed Basel III actions, and under the leadership of Bank of England Governor Mark Carney tried to pursue sound reforms.

But, the Basel III agreements have been taken by many national and regional authorities as the minimum standard and we have seen, from the Dodd-Frank Act here in the US, to the Vickers Commission in the UK, to the banking directives in the Eurozone, how a globally fragmented system is evolving. Instead of a level playing field, we have a system that offers increasing opportunities for regulatory arbitrage.

We have seen that the leading national financial authorities have found it exceedingly difficult to agree upon core sets of international system-wide rules and regulations for our increasingly globalized markets. Long before the financial crisis I argued for agreements to harmonize accounting standards. This has not been achieved. For me it is a symbol of the continuing problems to put in place a uniform global bank regulatory regime that all understand, that enhances fair and open competition and that creates a genuine level playing field for banking. And, we have a global system that has not adequately found the road to guard against too big to fail. In practice I think the major US banks have pursued, and are pursuing, restructuring to fundamentally change their business models, which offers significant confidence. The Eurozone debates about this issue, by contrast, have consistently been based on weak compromises and current arrangements do not inspire confidence.

It is important to note that the post-financial crisis search for financial safety and soundness has also included significant reviews of the approaches to risk management and risk governance in each major bank. I think considerable progress has been made in a range of areas, such as credit risk and operational risk. But an area of equal importance is reputational risk and here I believe we are challenged.

I have been engaged for some time in efforts, notably through the Group of 30, to increase attention by bank regulatory authorities and by bankers alike on issues of reputational risk, which explicitly involves issues of banking culture. Just a few months ago Spiros and Joseph Ficolora and I attended a meeting at the New York Federal Reserve Bank where this was the central issue. The fact is that on both sides of the Atlantic the level of public trust in banks remains low.

This is at least in partly due to the seemingly endless stories of banking problems and multi-billion dollar settlements with the U.S. Department of Justice. Last

October the G30 published an important report: *A New Paradigm: Financial Institutions Boards and Supervisors.* The report underscored how a deficiency or failure of culture including reputational risk can be as destabilizing to an institution as problems of capital or liquidity.

To be sure, issues of culture and risk are "soft" and correspondingly hard to deal with. We concluded in our G30 report that greater attention needs to be paid to reforming culture in many institutions. Every bank has its own culture. Boards and supervisors must better understand cultural factors in effective governance. A good culture underpins and is reflected by the actions of a company's employees, a problematic culture will also be reflected in how a firm and its employees perform.

The cultural tone of a firm is set by the ways in which those at the top of the organization act – both the CEO and his or her most senior colleagues, but must also include middle management and down to the teller level and also include the members of the Board of Directors. This process also has to be consistently monitored.

A lot more work needs to be done on reputational risk, corporate culture and bank codes of conduct. The Financial Stability Board is encouraging the G30 to pursue such work and I expect that the G30 will indeed do so. The crucial issue is that on both sides of the Atlantic no effort should be spared by the leaders of banks to regain public trust – it is essential to enable banks to play their full roles and contribute to growth as well.

I am sure that were Spiros with us this evening, then he would agree that as we scan Eurozone and Transatlantic banking conditions there is much to concern us. Our worries are compounded by geo-political uncertainties, from Russia-Ukraine to the Middle East, by the significant challenges that China has to deal

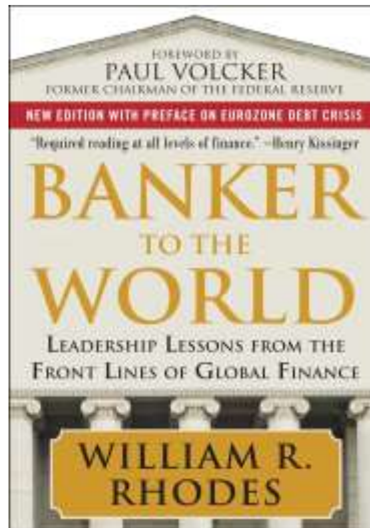
with given its housing and shadow banking problems, and by how Japan finds a path out of stagnation to real growth.

Moreover, we dare not be complacent about the U.S. growth rate itself. The Department of Commerce announced today that the U.S. economy contracted at a seasonally adjusted annual rate of 2.9% in the first three months of the year. While we can look for growth above 2% for 2014 as a whole, this is a weak level at this point in the economic cycle.
More broadly, the World Trade Organization reported earlier this week that global trade in the first quarter of this year rose at an annual rate of just 2.2%, which is in line with the sluggish pace seen in 2013 and which is less than half the rate that the WTO was predicting for 2014. Indeed, it is worth recalling as an indication of just how weak trade expansion is today that as the global economy emerged from the Great Recession, world trade growth was fully 13.8% in 2010.

Today, however, given the formidable pressures on so many economies and the poor performance of trade, we need to be mindful of the potential risks of greater protectionism and of beggar-thy-neighbor policies.

Indeed, as we look at all the issues I have raised tonight, I think we can all agree that this is a time when international leadership on the global economy is absolutely vital and we have not seen enough of that. Unfortunately, major leaders are preoccupied with other issues and the next G20 summit is not until November in Australia and I fear it will not be what is now most desired – a meeting where meaningful global economic cooperation and coordination is revived.

Thank you.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