Banker to the World: Leadership Lessons
from the Front Lines of Global Finance
The Heritage Foundation
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Thank you John for your kind introduction.

Good afternoon. I would like to thank John Hilboldt and Elaine Chao (who I understand will join us later) for inviting me to speak to you today about some of the lessons learned which effect the Eurozone, which I believe are very pertinent today given its sovereign and banking debt crisis, lessons which are included in my book, Banker to the World. Thanks to my daughter Liz, Producer at Fox and Louise Tilzer my partner and designer of my book cover.

Through my years as a banker, helping to resolve the debt crises in Latin America in the '80s and '90s, in Asia in the '90s, in Central and Eastern Europe in the '90s, in Turkey in 2001, in Uruguay in 2003, and in Iraq in 2005. I have learned that there are themes that are common in these situations, and should be implemented by policymakers, on the economic and political side in the eurozone and, for that matter, in the US with its own enormous fiscal deficit, and I think each one of these will resonate with you when we look at the crisis in Europe, which has been weighing down economies and markets worldwide.

These themes are highlighted in the postscript of my book:

1. First, each country is unique and a cookie-cutter approach does not work when dealing with a nation in crisis. Looking at the current eurozone financial problems: Greece's crisis was due, above all, to years of fiscal mismanagement. Portugal's major problem, as you know, was basically a lack of growth for almost a decade.

   Spain's difficulties were largely due to a housing bubble funded by mostly imprudent savings institutions and the previous government's slowness in implementing necessary reforms and austerity measures. And the country is not in a good spot right now. The Eurozone leaders agreed to provide Spain with up to 100 billion Euros, putting a floor under the banking sector, and the Spanish government hired Oliver Wyman and Roland Berger to audit the banks to give credibility to the process, which was a good move as the Bank of Spain (has received a lot of criticism for not having been as active as they should have been) and the results of which were released on June 21 and revealed a 62 billion Euros capital shortfall under a stress scenario. For the last couple of months I have been saying that it was going to cost the Spanish banks at least 100 billion Euros. The Spanish and Italian banks have been using the funds received through the European Central

Bank's LTROs – 3 year loans with 1% interest rate to fund the country's bond issuances and keeping the interest rates at a manageable level, albeit it's a rather high one, as foreign investors have left. This does not seem to me to be a sustainable program for Spain and the question is whether the country will need a greater overall bailout.

The country's fiscal deficit ended in 2011 at a revised 8.9% of GDP, and the EU wants Spain to reduce it to 5.3% of GDP in 2012. Given the present circumstances this won't happen. Unemployment is now reported at over 24% and projected to increase to 25% in 2012. And unemployment for youth under 25 years of age is almost 50%.

In the case of Italy, the major problem has been the size of its debt in relation to GDP, which is 120%, and an indecisive leadership in taking the necessary reform measures by the previous government. Having said that, Mario Monti, the prime minister, quickly took charge of the government, picked his own technocratic cabinet, and in an emergency decree shortly after he stepped in, unveiled an ambitious package of spending cuts and tax increases in order for the budget deficit to be eliminated by 2013. But the contagion from Spain has been driving up the costs of bond issuances and Monti has to call elections latest early 2013.

At the most recent G20 meeting in Los Cabos, Mexico, Monti pushed for the European Stabilization Fund to step in and buy Italian and Spanish bonds to keep the pricing down but it is not clear whether Merkel and the Germans will finally back the proposal. She refused last Friday to do so at the Rome meeting with Monti, Rajoy and Hollande. We will now see what Merkel will do at the EU Head of State Summit taking place today and tomorrow.

Ireland’s crisis owes a great deal to acute problems with its banks, which dragged the sovereign down, The referendum on the EU fiscal reform that was held on May 31 was positive and Ireland is keeping to its agreement with the Troika, which as you know, consists of the European Union, the European Central Bank and the International Monetary Fund (“IMF”).

It is interesting to note that all these five countries have had changes in their governments within the last year, either by electoral process (Ireland, Portugal, Spain and Greece) or by technocratic governments taking over (Italy (no political mandate)).

In addition, we've had a major change with the elections in France with Hollande. He was elected on a pro-growth platform and his party now holds majority in both houses of Parliament.

2. However, there is 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, which was not the case in 1982, at the time of the Latin American debt crisis or even in Asia in 1997-98 at the time of the Asian Financial crisis.

Policymakers almost always underestimate the scale and speed of contagion, and unlike in the 1980's and early 90's, the holders of sovereign debt are no longer just banks but a vast array of market participants from hedge funds, pension funds, insurance companies to individual investors. The EU authorities paid insufficient attention to warnings by some in January 2010, including my own, of the serious risk of contagion from Greece to other eurozone countries. We can now add Cyprus to this list which has also now asked for a bailout.

3. When facing an economic crisis, time is the enemy. Paul Volcker taught me this, back in 1982 when he was Chairman of the Federal Reserve. The longer one waits, the more difficult it is to stem the tide and the ensuing increase in losses. Politicians are mostly more comfortable putting off very tough decisions and looking for ways to buy time. The markets see this and react negatively and the citizens of a country lose confidence in their government. In the case of Greece, the former government used more than its allotment of time and did not solve the problems.

   And speaking about time, the eurozone's and EU multiple announcements (18th Summit) the next one is on Thursday and Friday this week since the crisis began, have tended not to mention a definitive timeline by when measures will be achieved on the public sector side. It is of the utmost importance that there always be a timeline on implementation and one that is always met, to increase market confidence and ensure success.

4. 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 has a greater chance of acceptance by its people. The Chinese word "weiji" is appropriate in this context. It consists of two characters in Chinese – 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 outside, in the case of Europe by the Troika, rather than being presented as one of local origin backed by entities like the IMF.

Greece, Spain, Portugal, Italy, and Ireland's leaders should study the actions of previous leaders caught in the hurricanes of sovereign debt crisis: from then Minister of Finance and later President Fernando Henrique Cardoso's Real Plan in Brazil in 1994, to South Korea with President Kim Dae-jung in 1998, and Turkey with Finance Minister Kemal Dervis in 2001. These examples are instructive as we look at the sovereign debt difficulties that have gripped the eurozone, and indeed at the debates over the budget and the debt ceiling in Washington. Leaders need to be willing, as Cardoso, Dervis - backed by Prime Minister Ecevit - and Kim, to promote programs that generate domestic support, raise international confidence and demonstrate strong leadership.

5. These reforms, very importantly, must provide a country and its people a sense that any austerity or fiscal reform program will provide a road to sustainable growth in the future. A case in point is Greece, in its fifth year of negative growth, probably negative 6% this year, with no growth in sight. The Brady Plan gave a pathway to sustained economic growth for Latin America and other countries around the world, which is why it was successful.

   Austerity and reform efforts must lead to growth because that's the only way to get countries back to the markets.

6. Strong and courageous political leadership to implement these reforms is essential and this is what has often been lacking in Europe up to date. The key is to seize the moment and demonstrate the kind of resolve that ensures the execution of structural reforms such as privatizations, tax reforms and necessary budget cuts, labor mobility and the need to be competitive both internally and externally.

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

7. Finally, and very importantly, private sector participation must be involved in any country reform program from the beginning. In most cases, it holds the majority of the debt and can ultimately help the country return to the capital markets with access to financing at reasonable rates. In this context, it is useful to draw lessons from the way that Uruguay overcame its debt difficulties a decade ago in 2003.

The Troika and in particular the Greek authorities all failed to learn these lessons from past crises. The costs have been substantial and the scale of the problems significantly greater than over two years ago when I first spoke with then Prime Minister George Papandreou at the World Economic Forum in Davos, Switzerland in January 2010.

Only last summer did Greece and the Troika initiate discussions with the private sector which led to a final agreement announced on February 21st with a net present value discount of 74%.

There remains however, a lot to be done in terms of upfront actions by the new Greek government in the coming months. The real question is whether Greece will be able to carry forth the reforms agreed to. The economy is now in a depression. A willingness to implement is key and will be difficult.

There is uncertainty surrounding the new government, and given my experience in debt restructurings, they will insist on reopening provisions, particularly those related to interest rates and maturities with the official sector portion, i.e., EU and IMF. (Rogoff/Reinhart)

8. Regarding the European banking and financial sector, we need to remember that banks in Europe are much more important to the total economy there, than in the U.S., as our economy relies more on the capital markets which are more developed than theirs, and what we saw in December of last year was a withdrawal of interbank lines and lending by money market funds and other financial institutions worldwide to Europe.

This could have caused a serious liquidity problem among the banks in Europe which is the reason why the ECB announced more generous facilities for its banks, the LTRO - three year loans with 1%

interest rate and broadened the range of collateral it would accept. It also eased its requirement for reserves that banks must maintain. Last December it lent 489 billion euros to 523 banks. A second wave of refinancing on February 29 provided 529.5 billion euros to 800 banks.

This action from the ECB to boost liquidity in Europe was a step in the right direction and prevented what could have been a run on some banks and another LEHMAN type situation, but the fact is that all it did was buy time for governments and financial institutions to get their act together.

And finally after two years of failed stress tests, the European Banking Authority ("EBA"), announced in the end of October, 2011 (last year), that it had developed a third set of stress tests which requires banks to strengthen their capital positions by building a temporary capital buffer against sovereign debt exposures to reflect current market prices and for all banks to reach a Basel III Core Tier 1 capital ratio of 9% after sovereign debt writedowns, no later than the end of June 2012.

The result of all of this has been major writedowns of sovereign debt for Greece and other problem countries by eurozone banks and other financial institutions, as well as the shedding of assets and staff reductions. Some banks announced withholding bonuses and dividends and a number of them are going to the capital markets to cover any shortfall. This could have a negative effect on bank lending in Europe, which is already seeing recession or stagnation in most of its countries, with the exception of a few up to now, like Germany and Poland. The ECB will drop interest rates again soon. They need to push growth in the Eurozone.

As I mentioned before, sometimes a country's problems start with the banking sector, other times with the sovereign but at the end of the day one impacts the other so it is important to ensure that banks are properly capitalized and willing to lend. The two are inextricably linked.

Although the US banks have their own problems, I think it is fair to say that banks' stress tests in the US, which started in 2009, and which resulted in substantial capital raising by banks was done better. It stands in contrast with the first two stress tests in Europe. The results of the latest stress tests of the major 19 US Banks in 2012 was also well done. The criteria used by the regulators was very tough. (13% unemployment, 50% drop in equity prices, 21% decline in housing prices). Moody's downgrade.

The Eurozone has a monetary union but not a fiscal union. They need to move more rapidly to finalize the fiscal pact approved at the March 1 and 2 meeting of the Heads of State (although they did not mention a date when it will be finally implemented). In order to provide better governance to the members of the EU, they are proposing, among others things, automatic penalties for countries that exceed European deficit limits. Since Maastricht and the Treaty for Stability and Growth that required deficits no larger than 3% of GDP were violated by Germany and France some years ago, there has been a lack of fiscal discipline and no penalties for countries that stray in this area, which helped bring on the situation that the eurozone faces today.

There is increasing talk of a single regulatory body for the Eurozone, whether the EBA or the ECB with a deposit insurance similar to the U.S.'s FDIC. And it is also important for the ECB to continue to ease liquidity in the European banking system and give time for the banks to increase their capital. It also needs to drop interest rates now. In short, a package of well thought out measures are needed to reassure the markets.

In closing, it is important to note that the markets are tied together more closely now than ever. We are seeing this even in a country like China where the fear over Europe, its largest export market, has impacted the country and caused the world's fastest growing large economy to start reversing its anti-inflationary stance by reducing the reserve requirements on its banking system (3 times since November), opening up the financial sector and the People's Bank has been forced to drop interest rates. China's Premier Wen Jiabao at his opening address to the National People's Congress on March 5 stated that China's economic growth goal for 2012 would be 7.5% and not 8% as had been projected. Any level of GDP growth below 7% would be construed as hard landing and it would not be good for the world economy.

- Leadership transition and the naming of seven of the nine members of the standing committee of the communist party.

- Bo Shi Li scandal/corruption/princlings

- Economy/harder soft landing

- Domestic consumption

- Opening up the financial center. Social safety net

- China banks not bailing the world out like 2008 and 2009

- Middle class fed up pollution of food water and air

- I would be pleased to answer questions on these or any other country situations.

Thank you.