

Fire fighter

Two years ago, Citigroup's William Rhodes already raised the alarm about the impending sub-prime crisis. But he was considered a party-pooper, and few heeded his warning.

By Wong Wei Kong

In a bullish world, his was among the few voices urging caution. William Rhodes warned of a sub-prime crisis two years ago, but few then heeded the banker who made his name fighting economic fires around the world over three long decades. And it's something the senior vice-chairman of Citigroup recalls with some irony.

'The first time I talked publicly about the difficult economic situation we're in was here in Singapore two years ago at the IMF-World Bank meetings,' says Mr Rhodes, who is also chairman, CEO and president of Citibank, in an interview with BT here. 'At a press conference by the Institute of International Finance where I am first vice-chairman, I mentioned that I was very concerned that we were in the midst of a liquidity bubble and a major housing problem, in particular, sub-prime.'

'Now you will remember that this meeting of the IMF and the World Bank was full of euphoric feelings over where the world economy was going and I didn't have much company in my concerns. The only two people I could remember who had similar concerns were Paul Volcker, former chairman of the Federal Reserve, and Larry Summers, former US treasury secretary.'

'One newspaper wrote that there were only three pessimists at the conference and mentioned the three of us. It's interesting that the other two are now economic advisers to Senator (now President Elect) Obama.'

The crisis fighter has seen it all happen before, having joined Citigroup in 1957. In the 1970s, he had helped Jamaica restructure its debts. He went on to build his reputation for the leading role he played in the 1980s in helping to manage the external-debt crisis that involved developing nations and their creditors worldwide. Through the 1990s, he headed the advisory committees of international banks that negotiated debt restructuring agreements for Argentina, Brazil, Jamaica, Mexico, Peru and Uruguay.

In 1998, when South Korea experienced liquidity problems, he chaired the international bank group that negotiated the extension of the short-term debt of the Korean banking system. In early 1999, at the request of the government of Brazil, he acted as worldwide coordinator to help implement the maintenance of trade and interbank lines by foreign commercial banks to Brazil.

'I have been through so many crises, and you get a feel for these warning signs that are there.'

'My concern was that it was going to lead directly to a recession and that, unfortunately, is where we are today. There was a tremendous over-leveraging of the system based on cheap credit and a drop by some in standards in lending and investing,' he says of his early warning of a bubble in late 2006.

Frustrated, Mr Rhodes penned an editorial for the Financial Times in March 2007 - the first of several as the sub-prime crisis developed. The article carried a 'Market Warning' tag in bold red. In it, he wrote: 'What is clear to me is that in the next year a material correction in the markets will occur.'

The problem, he says, was that most people were lulled into a false sense of comfort. 'People saw the bubble building up but they felt that there was more time before it burst. One of the things Paul Volcker taught me was that when you are approaching a problem or a crisis, the clock is always running against you and so you have to try to get out in front of the problem. What happened here was that people thought they had more time and they felt that this was something that was not going to hit for another year or two. So in a sense, they saw the warning signs, understood that we were in a bubble, but thought that there was time to handle it. I think that view was shared not just among those in the private sector but also by many in the public sector.'

It was something all too familiar to Mr Rhodes. Back in the 1990s, he had also sounded warnings of a financial crisis in Asia, only to be told his experience was in Latin America, and that the high savings rate in Asia and Asian values would prevent a crisis in the region.

Lack of urgency

'How do you know when to take steps when there is a bubble? When people start having too much to drink from the punch bowl at a party, you just take the punch bowl away. On the whole, that was what didn't happen this time. People thought they had more time.'

But time finally ran out in August 2007, when sub-prime problems started to hit banks and markets badly worldwide, which led the US Fed, the European Central Bank and other central banks to pump liquidity into the system to stabilise the situation.

Again, Mr Rhodes warned at the time that worse was to come.

'I think one of the problems in this process was that most financial institutions did not see the need to raise capital, and one of the things we did correctly (at Citigroup) was that we started raising capital in November 2007. We raised US\$50 billion in the first half of this year, including funds from GIC and from the Middle East. We saw that this was going to be a major problem and that we needed to raise capital early.'

And true to Mr Rhodes' prediction of more trouble, Bear Stearns collapsed in March 2008.

'The period after Bear Stearns is what I refer to as a false dawn. There was a bailout arrangement between the Fed and JPMorgan and after that, the Fed gave investment banks and brokerage houses access to the Fed window, so the perception was that the financial problem was basically over. I remember sitting in a meeting in the beginning of May with a number of CEOs and one of them mentioned that the financial problems were largely controlled. I had to disagree with that.'

In an FT piece in May 2008, Mr Rhodes argued that the US economy was still in need of urgent action. 'I said you need public funds to put a floor under housing which wasn't very popular with the administration at that time.'



WILLIAM RHODES

**Citigroup senior vice-chairman
Citibank chairman, president and CEO**

1957: Joined Citibank after graduating from Brown University

1977: Appointed head of Latin American corporate business

1980s-1990s: Headed the advisory committees of international banks that negotiated debt-restructuring agreements for Argentina, Brazil, Mexico, Peru and Uruguay

1991: Named director and vice-chairman

1998: Chaired the international bank group that negotiated the extension of short-term debt of the Korean banking system

1999: Worldwide coordinator implementing the maintenance of trade and interbank lines by foreign commercial banks to Brazil

2007: Donated US\$10m to Brown University for the establishment of the Rhodes Center for International Economics at the Watson Institute

There was a perception that things were getting back to normal but they really weren't. All you had to do was to see that the interbank lending had not returned to normal, the counterparty risks were very high and that Libor was actually rising.'

He saw another blow-up coming and that was exactly what happened next, with the rescue of Fannie Mae and Freddie Mac, as well as the collapse of Lehman Brothers. 'In September, I was giving a speech in Vienna at the opening of the Swift (Society for Worldwide Interbank Financial Telecommunication) conference, with 2,000-3,000 people in the audience. I told them that rather than the storm calming down, I thought that we were entering the eye of the storm... People thought I was being too pessimistic. And then several days later, Lehman Brothers went into bankruptcy.'

'The concern in the market place worsened because Lehman Brothers was so interlinked with the markets worldwide.'

Convinced that more had to be done, Mr Rhodes called for an RTC-type solution (the Resolution Trust Corporation, set up to take over failing US savings institutions in 1989) in another article in the FT. Two weeks later, the US announced the Troubled Assets Relief Program (TARP), a US\$700 billion financial lifeline to take over distressed assets from banks.

He also urged the International Monetary Fund (IMF) to intervene to help emerging countries fend off the financial crisis, and for the US Fed to enter into swap agreements with key countries to provide liquidity to corporates. Arguing that too much of the emphasis was on the developed countries while emerging market nations were being ignored, he predicted that the crisis was going to spread very quickly to the emerging markets, and debunked the notion - popular in some circles - that developing markets have decoupled from the advanced economies.

Subsequently, the IMF announced some US\$35 billion in emergency loans to three countries - Iceland, Ukraine and Hungary - and said it would extend up to US\$100 billion more in short-term loans to developing countries that have been hit hard by the financial crisis but are sound economically, with no conditions attached. The Fed also set up a series of swap agreements, including with Singapore and one with South Korea, which Mr Rhodes helped to put together.

More pain ahead

Mr Rhodes warns that there will be more pain before the world gets out of the crisis, and problems in the US will have a significant impact on the economies of Europe, Japan, Asia and South-east Asia.

'The real economy is going to be hit in the US. We had negative growth this last quarter and I think we are going to have substantial negative growth this quarter, and there's a good chance we are going to have negative growth in the first quarter of next year. This will make for three consecutive quarters of negative growth which might make it the worst recession in the US since 1982.'

'Although we're probably in the worst global recession we've faced since World War Two, I think the markets are starting to stabilise, and governments are beginning to put major stimulus packages in place. We could still see a second stimulus package in the US in a lame-duck session of the Congress after the elections or at the beginning of the new administration. I think you will see additional measures to work on the foreclosure problems in the US. Once you have a firm floor to housing then you will start to see a recovery.'

'I think the consumer in the US is key and since the US started this I think it's very important to stimulate the consumer to come back, and this means finishing the job in housing and getting another stimulus package going.'

He says Singapore is positioned well to get through the recession and may be able to recover early on in the cycle. 'Singapore is in a very strong position going forward because you have very strong political leadership, you have a strong economic team, you have made tremendous advances in technology, in pharmaceuticals. You have excellent infrastructure here and very high education levels. You have so many of the positives here. In addition, you have strong savings, probably the strongest savings situation in Asia.'

'It is necessary to bring the consumer back in the countries Singapore exports to. If you ask me how long it'll take, I would say that the US economy should start turning around by the end of next year. I advise governments that when you face a problem like this, you just put in all the stimulus you need, and you can solve the inflationary issues afterwards.'

'What you need to do is to create positives and you must restore consumer confidence so that consumers start buying. So confidence is key. That restores interbank lending, and that restores the purchasing power of consumers. It's all confidence at the end of the day.'

Coordinated action among countries and central banks will also be important so that no one will be able to arbitrage one market against another. 'All of this requires leadership, courage and a sense of timing.'

But it's not all gloom and doom, and Mr Rhodes says the crisis also presents opportunities. 'I'm a believer in the Chinese saying weiji, or crisis and opportunity. For Singapore, these difficult times present opportunities and that's the way Singapore needs to look at this.'

For one, a wave of banking merger and acquisitions in Asia and around the world is likely, as the adverse economic conditions force institutions to consolidate and seek economies of scale.

Putting things right

The crisis also offers a good opportunity to learn lessons and to put things right. 'One of the unfortunate things is that after each crisis, people say 'we've learned the lessons and won't allow this to happen again' but the problem is that a couple of years go by and people forget the lessons.'

That's why changes must be made immediately, he says. And a crisis allows you to take tough steps that might not be possible in normal times.

'One of the things we need to do is to have international accounting standards. Right now, you have an International Accounting Standards Board in the UK which much of the world follows. But others have their own standards, including the US. So we must make sure we have similar accounting standards because otherwise, it's going to be very difficult to understand balance sheets and have the transparency you need,' he says.

'Second, I think regulators worldwide have to agree on a set of regulatory norms so again you won't have individual countries arbitraging against each other on regulatory norms. We are in a globalised world and we now see there isn't any decoupling because markets are so tied in one with the other.'

'One thing that needs to come out of this is to make sure that, as much as possible, there is some sort of an early warning system.'

He also sees a move towards more centralised regulatory regimes. The likely model could be that in the UK, where there is one regulator for all financial institutions, to fulfil the need for a more centralised regulatory process.

'One of the things we have to be very careful about is that we don't have over-regulation. You need what I like to call smart regulation. So there's a happy median here and what you need is smart regulation, not over-regulation.'

For banks and bankers, this will be a sobering time of self-reflection. Banks and financial institutions will have to review their risk management mechanisms, and it is also important for them to seek views from outside the institution.

'You need to go back to basics, and good risk management is one of them. And if you see problems arise, do something about it in a timely fashion and learn from your mistakes.'