Rising from the Ashes
The Birth of a New Economic and Financial Model
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Ladies and Gentlemen, first of all I would like to thank the organizers as well as the Government of Qatar for inviting me to speak before this distinguished audience and at such a critical moment in the history of modern finance and economics.

We have two idioms in English that – although intuitively contradictory – neatly summarize the origin of the current crisis. The first expression is: "Change is constant." And the second expression goes: "The more things change, the more they stay the same."

Over the last twenty years, we have indeed observed political, economic, financial, and technological transformations the confluence of which over such a short period of time is probably unprecedented in the history of humankind. As we reached some of these markers, we bravely declared the emergence of new paradigms from the "End of History" in 1989 to the "End of the Business Cycle" in 1997. Yet each time, we were quickly reminded of the flaws in our hasty declarations.

After the debunking of the latter paradigm, we rapidly emerged from the fairly shallow recession of 2000/2001, and a process of accelerating innovation in financial markets left us breathless. While euphorically watching the undeniable benefits of new financial structures and instruments, we failed to recognize the harmful effects of aggregation and correlation of and among independently beneficial transactions. Our failure was the result of dogmatic myopia, greed, willful ignorance or blissful indifference. And we must confront today not just the toxicity of our financial assets, but more importantly the toxicity of our behavior and thought processes as economic agents. It is in line with our human nature that we pronounced yet another paradigm shift even as we were entering the current crisis, the new paradigm of "decoupling". This too was quickly exposed as a myth when the epicenter of the crisis resulted in a tsunami, the waves of which are eroding the shores of many emerging markets today. This is one of the major reasons why we are gathered here today.

And yet, as we are staring at the abyss of economic collapse and as we are understandably pre-occupied with stop-gap measures to contain the decline in depth and breadth, we must recognize the tremendous opportunity that lies before us. We are given the chance to reflect on the basic assumptions of our economic model and provided with the chance to make global structural adjustments at a scale rarely afforded to a generation. We must be bold, creative and open-minded. In so doing, we might wish to follow three guiding principles:

- To create globally balanced, ecologically sustainable economic growth.
- To be proactive about equitable distribution of wealth.

- And to balance the common good with the benefits derived from individual ingenuity, for example by providing for a stable financial system that meets its function as a financial intermediary, is prudently managed while being empowered to optimize its impact on the real economy through innovation.

Now those are laudable principles, but they must be filled with actionable proposals in order to be translated into reality. Allow me, therefore, to share some specific ideas with you. These ideas address only a subset of the issues that we are facing and highlight only some of the opportunities for structural adjustment but they should provide a starting point. They are all based on my belief that globalization is fundamentally a win-win proposition. Hence our adjustments ought to be global. It is indeed my view that the world is inextricably and irreversibly interlinked. The peril of climate change cannot be confronted in a meaningful way by one country alone. A global pandemic cannot be stopped at the border of one nation and the threat of terrorism will not be contained without global coordination. So here are some thoughts.

1) Let us contain *private communism*. By that I am referring to the last twenty years of unparalleled magnitude and number of mergers and acquisitions in the real economy. It is true that there are natural monopolies in our economic space. There is also no doubt that some of these M&A activities have created companies with the necessary economies-of-scale. By and large, however, they have produced unmanageable and often inefficient conglomerates. The defeat of Big Steel by so-called mini-mills should lead us to question even some of our most basic assumptions about "natural monopolies" or "economies-of-scale".

   Notably, the Chairman of General Motors admitted as much when he stated: "In practically all of our activities we seem to suffer from the inertia resulting from our size." To be sure, the Chairman I just quoted was Alfred Sloan and he made this statement at a Congressional Hearing on the Concentration of Economic Power in 1941. In his usual wit, Ross Perot who served as a Director on the Board of GM put it this way in 1988: "At GM, if you see a snake, the first thing you do is hire a consultant on snakes. Then you get a committee on snakes, and then you discuss it for a couple of years. The most likely course of action – nothing. You figure the snake hasn't bitten anybody yet, so you let him crawl around in the factory floor." This is a scathing condemnation of concentration of economic power and the inefficiencies of conglomerates.

   We knew all of this. In fact, our capitalist model is based and dependent on a competitive and transparent market. The proliferation of national and sometimes global monopolies/oligopolies has introduced unreasonable risks and inefficiencies to the proper functioning of the global market. It should be recalled that anti-trust legislation, which exists in many countries, was designed to protect consumers, to create efficient markets and to avoid systemic risk. I would add that the proper enforcement of such anti-trust legislation also ensures the effectiveness of our fiscal and monetary policy tools. The more we digress from the ideal market model the less potent these tools become. Our current policy conundrum is living proof.

2) While we must undo the monopolistic structure of our real economy, the diffusion of power in the financial sector is of even greater importance, because the latter functions as the circulatory system of the real economy. Yet, during this time of crisis our regulators and treasury departments are doing the opposite by advocating the merger of one systemically important, bad bank with another. By so doing, they are building banks that are no longer "too big to fail" but instead "too big to save". This is a recipe for disaster. Let us remember that exactly two months ago, near-defunct Wachovia Bank and Citigroup apparently got the official blessing for their shot-gun wedding, a deal which fell apart days later when Wells Fargo made a counter offer. It was not before long that Citigroup itself had to be bailed out by the U.S. government. Large financial conglomerates which have mushroomed over the last ten years are creating an unacceptable systemic risk. It has become increasingly apparent that even the best-intentioned management simply does not have an informed view of the risk exposure of their one-stop shops. Concentration of power in the financial sector also further enhances homogenization of risk management techniques, which leads to instant systemic failure when event risk materializes.

3) We must rethink the major policy objectives of our central bank model. Price stability is the key goal for many central banks. This is interpreted to mean a fight against consumer price inflation. In the United States, this dogmatic self-restraint induced a double bubble in housing and consumption that is at the heart of the current crisis. Central banks should develop methodologies to measure asset price inflation and to counter such inflation, if observed, with monetary policy.

4) Liquidity event risk must be effectively addressed. There is probably little value in considering a redefinition of liquidity ratios. Such ratios will continue to serve a useful purpose in times of normal business cycles. For that reason, I also believe that it would be ill-advised to introduce countercyclical liquidity and capital adequacy ratios, because such ratios would put at risk the soundness of individual institutions during such normal cycles. This call for countercyclical liquidity and capital adequacy ratios is really a desperate attempt to address the structural crisis that we are presently facing. It is doubtful that implementation of such countercyclical ratios today would accelerate our recovery, as nobody would be fooled by the fact that we have moved the goal posts.

   By the same token, the recent efforts by central banks to inject huge amounts of liquidity into the banking system have largely failed to revive the interbank market. And such injections also carry a huge price tag.

   The question, therefore, arises how we deal with the seizing up of liquidity that is an infrequent occurrence mostly accompanied by a structural crisis. It might be instructive in that context, to review the creative approach that has been taken by the Central Bank of the Republic of Turkey ("CBRT") in this regard. Over the last couple of months, the CBRT has acted as a Central Counter Party ("CCP") to its domestic financial system. Rather than injecting liquidity, it has organized blind auctions between and among Turkish banks and has acted as a CCP to the transactions resulting from these auctions, hence removing counterparty risk from consideration in the Turkish interbank market. As a result, the Turkish interbank market has continued to function normally. Such model should be considered by other national central banks, but it might also be worthwhile adopting on a coordinated basis at the global level.

5) Self-collateralizing settlement risk elimination systems such as CLS Bank should be considered for all markets that lend themselves to such system. CLS Bank is the world's largest payment system. It went live in September 2002 and it currently settles the foreign exchange transactions of 57 global financial institutions in 17 currencies. During the most tumultuous days of the global credit crunch, CLS Bank worked without a hitch and set daily records of over 1.5 million Instructions/day as well as more than $10 trillion in value/day. Without CLS Bank, foreign exchange markets would simply have seized up as interbank markets did. Global trade as we know it would have come to a standstill during the last few months. Planes would have been grounded, ships would not have docked and all kinds of goods would have stopped flowing, creating unimaginable shortages of critical products across the globe.

6) Distributed Capital Group ("DCG"), based in New York, is another company with a creative business model that will be a major tool for true risk reduction and that will enhance capital flows especially to emerging markets. The company has designed a new risk-transfer product that conforms and capitalizes on central clearing. With idiosyncrasies of transaction risk eliminated, there is room for more diverse features within the transaction. So what this means is that competition for moneycenter limelight is no longer to be pursued as a zero-sum cutthroat exercise, to rise at the expense of New York or London, but rather, one directed at expanding scope.

   Addressing Currency Risk is a powerful route to ensuring a more complete and more stable globalization. DCG has devised a very elegant approach to relieving currency risk for any currency pair in the world, provided: (i) central clearing; (ii) cultural engagement with globalization (i.e. a desire to be a part of globalization and its standards); and (iii) balance sheet capital willing to support the products.

   DCG works with the Chicago Mercantile Exchange among other derivative platforms, to connect the next economies to globalization, to facilitate bi-directional capital flows, and to deliver risk transfer through the transaction. So any aspiring moneycenter in the world can invite itself to a seat at the expanded table of global financial centers, by subscribing to the three new fundamentals of global transaction finance.

7) A global financial market must be regulated and supervised by a global regulatory and supervisory body, but first each jurisdiction must streamline its own regulatory and supervisory framework. From a regulatory perspective we might wish to consider three anathemas: *No more off-balance sheet accounting, no more offshore banking, and no more non-bank banks.* We should also resist the calls for abandoning fair value accounting. It his hardly prudent to change the rules of the game in order to create a more favorable appearance of the balance sheets of our financial institutions.

   As supervision is concerned, it should be brought under one umbrella covering banks, investment banks, hedge funds, insurance companies and other non-bank banks. This means that we look at the financial system in a holistic way.

   Once national streamlining has been concluded, such national oversight should be integrated into a global oversight regime. This requires international standardization of regulation which will be politically difficult but will have the benefit of reducing regulatory arbitrage between industries and between countries. It will also require the establishment of an effective global supervisory body, at least for systemically important institutions.

8) We must strengthen Risk Management at the institutional level, especially in an effort to identify and contain systemic risk. For this purpose, I propose a Public-Private Partnership of overseers, chief risk officers and representatives from academia as well as from the IMF and the BIS, who should meet regularly with one mission only, i.e. to identify the five key systemic risks affecting the financial system. Their brief reports should be submitted to the Boards of every major financial institution and it should be compulsory that Boards review such reports, assess the exposure of their own institutions against these risks and take remedial action if necessary.

9) The rating agency business should be made competitive. Currently, the Securities and Exchange Commission ("SEC") of the United States designates rating agencies as nationally recognized statistical rating organizations ("NRSROs"). Only with such status are rating agencies truly able to compete in the ratings process. There are currently only seven such registered agencies (A.M. Best Company, Inc.; DBRS Ltd.; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; Moody's Investors Service, Inc.; Rating and Investment Information, Inc.; Standard & Poor's Ratings Services). A more competitive landscape in this field would help to avoid the shortfalls of homogenization of risk management in the financial services industry. I prefer such approach to the Basel II option for banks to develop their own internal rating based approaches ("IRB"). At present, it appears that most banks that are considering the implementation of such IRB approach expect a strengthening of their capital adequacy ratios under such approach. This should give us pause as to the aspect of self-control. While supervisors have to approve the IRB approach of each institution, this would appear to put far too much onus on such supervisors.

10) Many suggest that the fact that issuers of plain vanilla bonds pay the rating agencies for their ratings creates conflicts of interest. Even if it were a feasible economic alternative to fully replace such issuer fees with fees from investors, I venture to submit that this would only change the nature of conflicts of interest, if we assume that rating agencies are indeed susceptible to them in the first place.

    By the same token, rating agencies should not be allowed "consultancy" services to help originators structure complex financial instruments, such as collateralized debt obligations. Just as was required of auditing firms some years ago, such consulting should be spun off as separate businesses by the rating agencies, because, in this case, we are indeed encountering conflicts of interest. Rating analysts who advise originators and investors on how to structure complex instruments so that they are assigned specific ratings become a captive of their own advice. If circumstances change or if rating analysts recognize flaws in their original assumptions after such structured instruments have been issued, it is difficult for them to publicly so concede by downgrading the ratings for instruments that they helped to structure.

    Also, rating agencies should use models only as a tool in their qualitative assessment of structured instruments and they should focus on the default probability of these instruments. This will help to maintain the integrity of the rating system, which allows investors to compose their portfolios of bonds across sectors, industries and instruments according to their own risk appetite by simply comparing alphanumerical ratings of default risk.

These are just some proposals that we might wish to consider when making use of this unique opportunity to redesign our economic and financial model. Some are provocative, some controversial, some have a proven record, others are innovative and new. All of these are intended to stimulate a discussion aimed at creating a stable economic and financial equilibrium. Thank you.