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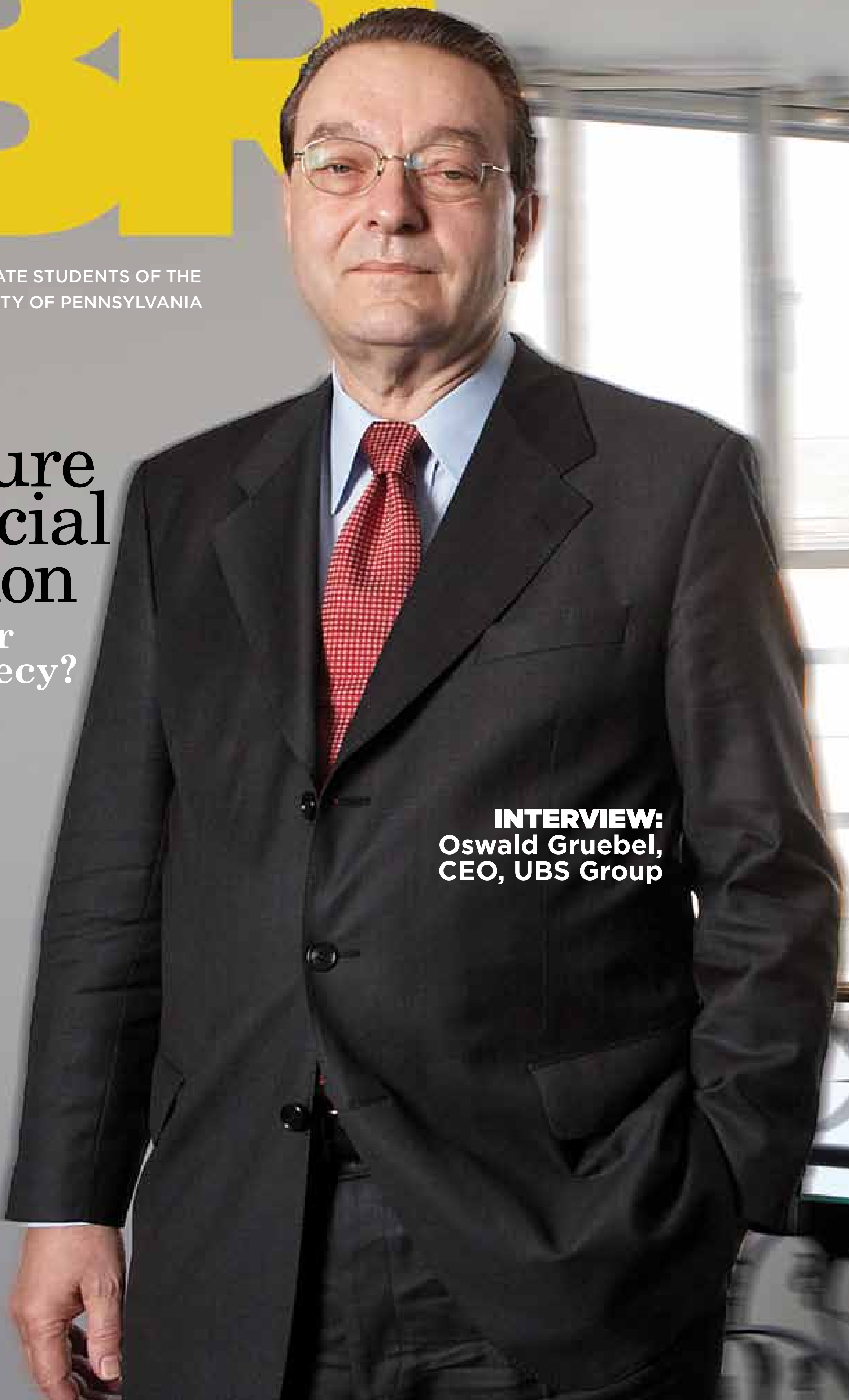

The Future of Financial Regulation

Still Room For Banking Secrecy?

INTERVIEW:
Oswald Gruebel, CEO, UBS Group

INTERVIEW:
Prof. M. Yunus, Nobel Laureate

PAKISTAN'S GAS CRISIS:
Pipe Dreams & Empty Pipes

EUROPE:
The Greek Apocalypse

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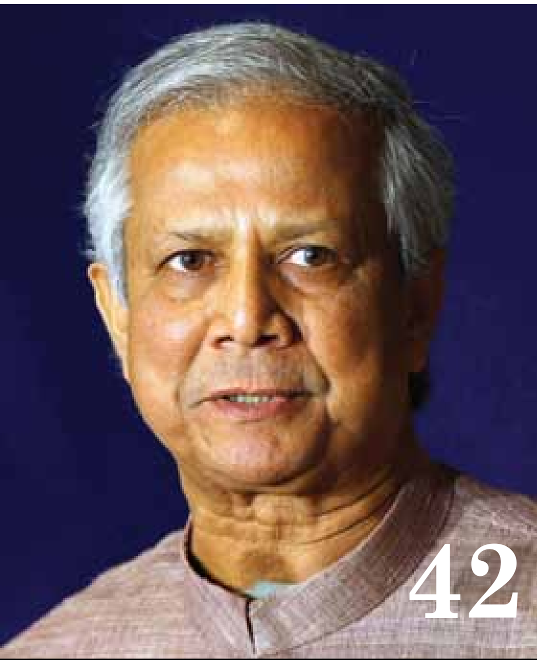

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EDITORS' NOTE

The *International Business Review* is a student-run publication, featuring business-related editorials as well as internationally oriented interviews and articles. We aim to provide a platform to exchange ideas, opinions, and perspectives on economic issues, as well as to enhance communication and spark debate amongst students, faculty, and alumni, alike.

The spring 2010 edition of the International Business Review focuses on the future of financial regulation. As the world emerges from The Great Recession the complexity mounts because the division and extent of power and responsibilities remain unresolved. While the most important financial institutions operate globally, governmental regulators continue to operate locally. As Oswald Gruebel, the CEO of UBS, put it during our interview: "nobody is looking at the interconnection of banks on a global level". In fact, just as Prof. Herring noted, the first bank to fail was not a bank located in the United States, but, indeed, a German bank. However complex the situation may be today, Professor Muhammad Yunus, the Nobel Laureate and Grameen Bank chairman, insisted that "this is a good time to use our understanding of what has gone wrong, apply new ideas, redesign the system, start new, and fresh".

By focusing this issue of the IBR on the status quo of financial regulation, we hope to provide a few additional insights on the matter to all our readers and the community.

This magazine is your magazine, too! We invite all of you to contribute. Read, engage, and enjoy!

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GLOBAL FINANCE names the World's 50 Safest Banks 2009

1. KfW (Germany)
2. Caisse des Depots et Consignations (CDC) (France)
3. Bank Nederlands Gemeenten (BNG) (Netherlands)
4. Landwirstchaftliche Rentenbank (Germany)
5. Rabobank (Netherlands)
6. Landeskreditbank Baden-Wuerttemberg-Foerderbank (Germany)
7. NRW. Bank (Germany)
8. BNP Paribas (France)
9. Banco Santander (Spain)
10. Royal Bank of Canada (Canada)
11. National Australia Bank (Australia)
12. Commonwealth Bank of Australia (Australia)
13. Banco Bilbao Vizcaya Argentaria (BBVA) (Spain)
14. Toronto-Dominion Bank (Canada)
15. Australia & New Zealand Banking Group (Australia)
16. Westpac Banking Corporation (Australia)
17. Banco Espanol de Credito S.A.(Banesto) (Spain)
18. ASB Bank Limited (New Zealand)
19. HSBC (United Kingdom)
20. Credit Agricole (France)
21. Wells Fargo (United States)
22. Nordea Bank (Sweden)
23. Scotiabank (Canada)
24. La Caxia (Spain)
25. Svenska Handelsbanken (Sweden)
26. US Bancorp (United States)
27. Banco Popular Espanol (Spain)
28. DBS Bank (Singapore)
29. Pohjola Bank (Finland)
30. Deutsche Bank (Germany)
31. Société Générale (France)
32. Intesa Sanpaolo (Italy)
33. Bank of Montreal (Canada)
34. DnB NOR Bank (Norway)
35. The Bank of New York Mellon (United States)
36. Caxia Geral de Depositos (Portugal)
37. United Overseas Bank (Singapore)
38. OCBC (Singapore)
39. Axa Bank Europe (Belgium)
40. Credit Suisse Group (Switzerland)
41. Landesbank Baden-Wuerttemberg (Germany)
42. Nationwide Building Society (United Kingdom)
43. CIBC (Canada)
44. National Bank of Kuwait (Kuwait)
45. Barclays (United Kingdom)
46. UBS (Switzerland)
47. JPMorgan Chase (United States)
48. Bank of Tokyo-Mitsubishi UFJ (Japan)
49. Banque Federative du Credit Mutuel (BFCM) (France)
50. Credit Industriel et Commercial (CIC) (France)

The only Arab bank in the list of the

World's 50 Safest Banks - 2009

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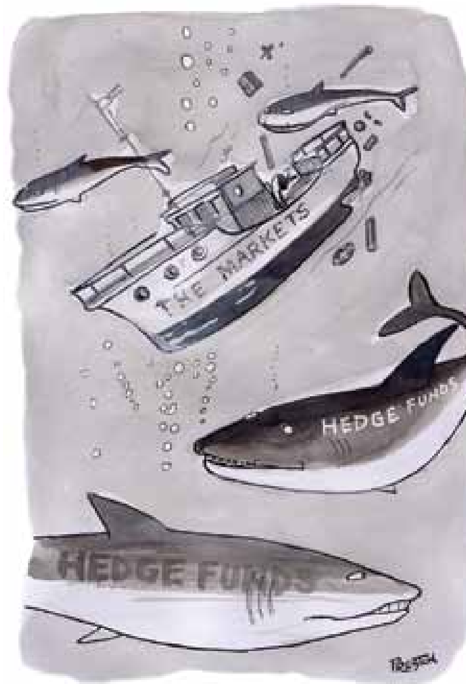
EXTRACTING JEKYLL FROM HYDE: A STATUS UPDATE ON THE EFFORTS TO REORDER WALL STREET

BY SEAN CAVERLY

The clarion call is out. Heretofore investment banks-cum-hedge funds-cum-bank holding companies must ply a new trade, or at least find a new way to ply an old trade. Having legally restyled themselves as 'banks' to gain access to the Fed discount window and avoid the same fate that befell Lehman Brothers, the last remnants of Wall Street's investment banking titans are now in the midst of justifying the regulatory mirage that allows them to maintain the duality of a legal classification as a commercial bank while not engaging in the deposit-taking and other activities that characterize such banks.

The Obama Administration's January 21 proposal of a return to a Glass-Steagal environment would immediately call into question the basic business model and organizational structure of many of Wall Street's leading firms. Instead of the amalgamated institutions that dominated the business from the time of Sandy Weill's orchestrated tie-up of Citicorp and Travelers into a financial supermarket, the future may portend a return to less vertically-integrated firms, if not a complete return to pre-Gramm-Leach-Bliley Act era divisions between broker-dealers and commercial banks.

Bulge-bracket firms are faced with an unsavory dilemma over the Paul Volcker championed proposal to banish major forms of proprietary investment. Should the industry collectively gather its nerve



and press its protestations to hiving off proprietary trading desks, internal hedge funds, and in-house private equity funds, it will raise the ire of an already hostile Congress. Moreover, the very attempt to shield these business lines would serve as an implicit admission that an unhealthy addiction to volatile trading operations had caught hold as the means to prime the corporate earnings pump. However, if Wall Street attempts to argue that scrutiny of principal investing activities is unwarranted given the marginal contribution that they make to revenues, it risks begging the question of why it is expending so much effort fending off the proposed regulation of businesses that could be construed as rounding errors on the corporate income statement.

Upon closer inspection, the trading activities of Old Wall Street are more than the mere footnotes that banking chieftains care to admit. Trading is the wellspring through which many of the other businesses flow. Whether agency-based brokerage, market-making and flow trading, or prop trading, other elements in the portfolio such as M&A advisory, new issues underwriting, and asset management, to name but a few, all benefit from the one thing that a developed trading operation captures most efficiently: market information. Top Wall Street houses are not so much purveyors of brokerage services as they are of information services, capturing, contextualizing, and then disseminating trading ticks into actionable investment information bits for clients and their own account. Hence, Volckers' Rule represents a Wall Street apostasy simply because Markets are, in fact, price discovery mechanisms and liquidity founts.

To the extent that unencumbered proprietary trading is both a symptom and further enabler of a parlor game culture run amok, the Volcker rule is one type of attempt to rebuild economic linkages between traded instruments and the underlying economics of the assets that those instruments represent. Traders may not have underwritten the mortgages that went bad but neither did they put the brakes on the frenetic securitizations that ultimately led to moral hazard and mis-pricing of risk.

IN FINANCIAL REGULATION AS IN LIFE, EVERYBODY SETS OUT TO DO SOMETHING, AND EVERYONE DOES DO SOMETHING, BUT NOBODY REALLY DOES WHAT THEY HAD SET OUT TO DO...

How to curb this culture of excessive risk taking is open to considerable debate. One of the more plausible ways around this dilemma suggested by The Economist is to take a look at a firm's balance sheet and "rejigg" liabilities vis-à-vis "contingent convertible" capital or Coco debts—a layer of debt that converts into equity should the bank's core capital fall below a certain level of risk-adjusted assets. One downside of this approach is that the coupon is priced quite expensively, on par with equity.

Another potential method is to impose risk-based margin requirements on all trades, and not just with counterparties

If you believe that banks

Proprietary trading as % of group revenues, latest

Goldman Sachs	10	Credit Suisse	<2
Credit Suisse	<5	Barclays	1.8
Citigroup	<5	Bank of America	1
Barclays	2.4	JP Morgan Chase	1

Source: The Economist estimates with company guidance

but also with the Federal Reserve that is now serving as the implicit backstop for bulge bracket firms. Such a TALF-like system would encourage firm-level risk rationing and be more efficient than the transaction tax proposal floated by the Obama administration because unlike a tax, the institutions would get their capital back at the conclusion of the trade. An iron-clad definition of what constitutes acceptable quality collateral would be key to upholding the integrity of the system and something that critics have justifiably questioned in the implementation of TALF thus far. This kind of approach might be the best that Wall Street can hope for and all the more unlikely because the heavy hands of government, both at home and abroad, are intent on doing 'something'.

With any approach it pays to heed the law of unintended consequences, as eloquently put by The Economist. Take the initial Basel Rules for instance—sound policies initially intended to ensure banks have enough capital to cope with economic crises. In essence these rules provided an incentive to hold AAA securities—those which require less capital to be held against them. The problem was with the paucity of AAA bonds and a solution took the form of machinations manifested by a coterie of financial whiz kids, or what you now know as the CDO based on sub-prime mortgages. In these cases the top tier was often rated AAA.

In financial regulation as in life, everybody sets out to do something, and everyone does do something, but nobody really does what they had set out to do. There's no reason to expect anything different from the pending debate on financial reform. Additionally, it could be all "sound and fury": a recent LSTA, the regulator for syndicated loans, poll undertaken by industry participants has the chances of the Volker Rule passing at only 15%.

Of all the permutations of action likely to be taken, from the draconian utility-banking ideas put forth in the spirit of the Volcker rule by Boston University economics professor Larry Kotlikoff, to the proposed imposition of a new resolution regime for large institutions as championed by former Treasury Secretary and Goldman Sachs CEO Hank Paulson, the best that can be hoped for is a compromise that first does no harm. **iBR**

Mr. Henry Gosebruch, M.D. at JP Morgan, and Wharton Alumnus (W'95)

BY DANIEL HELLWIG ('11) + DIEGO ARROYO ('10)

ON CONFIDENCE, COMMUNICATION, AND COMMON SENSE

Mr. Henry Gosebruch is a Managing Director at JP Morgan, he graduated from the Wharton School in 1995. He has transaction experience across a variety of sectors, and has worked on over 100 closed M&A transactions, totalling more than $100 billion in cumulative value. In 2007, the New York Times listed Mr. Gosebruch as one of Wall Street's Future 100 bankers, lawyers and investors under the age of 40. He has also been featured in Bloomberg Magazine, CFO Magazine, Dealmaker Magazine and The Deal. The editorial staff of the iBR had the opportunity to meet Mr. Gosebruch in New York to learn about his experiences over the last decade, as well as his expectations for 2010, as financial markets continue to recover.

Mr. Gosebruch, how did you, personally, make your decision to work in corporate finance, instead of going into academia, for example? The great thing about M&A and investment banking is that a good part of the job consists of problem solving; figuring out the best practical option. You always, very quickly, have a practical situation, which is very exciting to me. You only see how transactions really work when you complete one, and to me, that is the great part of the job. Academically analyzing certain problems is part of it, but you're applying it to real world situations. Some people like to work with actual transactions; others prefer academia. At the end of the day, I am very happy about the direction I went.

And working in M&A, do you sometimes still follow up on new, finance-related theories? Many parts of M&A are not fundamentally different than they were twenty or thirty years ago, we are still advising companies. M&A is based on deal experience and industry knowledge. More important than following new academic publications is transaction experience, and knowing how to negotiate effectively. It's not about the latest academic financial theory; it's about bridging that gap between party A and party B.

You started at JP Morgan in 1995. Means of communication have changed tremendously ever since. What were the most notable effects on the way business is being done? Everything is just a lot more real-time today. This might be hard for you to imagine, but when I started at JP Morgan, we barely even had e-Mail. We did not have the Internet on our computers. There was only one computer at the corner of the floor with the Internet. Everything happened via phone calls and voicemails. Today, a lot happens via Blackberry. In many instances, this can be faster, but in other instances, it might not be. Having a real conversation with somebody can create a very different type of relationship than trading emails back and forth ever could.

Would you recommend that students start to work in Europe or other parts of the world in order to gain international exposure and experience? I am a German citizen and I thought that I would come to the US, work here for a couple of years, and then go back to Europe. But I have had way too much fun here. I was provided with great opportunities by JP Morgan. Investment banking has become more and more similar in Europe and the United States, as clients have become more global and more sophisticated. The specific industry sectors tend to be larger in the US compared to Europe – thus industry specialization tends to be more intense. In Europe, many sectors tend to be broader, so bankers need to cover companies in many different countries. The local element always plays an important role. Given that your level of specialization can be bigger here, you can get a more specialized skill set more easily.

The world has become truly global. What are the most important leadership lessons you learned, working in a globalized marketplace? Clear communication, both internally and externally, which includes giving very direct feedback. There is often a tendency in the United States to put a nice spin on everything, and not to be direct. I believe that it is very important to be encouraging, but people will only trust you if you are very direct and give them real time feedback. Building relationships that way works very effectively. Communication and direct feedback are key. You can lead by example, but you also need to see the right opportunities to allow others on your team to shine. Everybody must have a meaningful role.

Speaking of internal communication: how did you experience the integration of Bear Stearns into JP Morgan? Our senior management is very well organized regarding M&A and has overseen a large number of our own acquisitions. As a firm we are very experienced with integration work. All things considered, the integration went extremely smoothly. Especially in my area, there are fewer complications than in other areas. Within a month or so, everybody knew where they were working, who their boss was, and what they had to do. Having real conversations was crucial, and could not have been replaced by sending emails back in forth.

Looking at the overall market situation today, what do you expect looking forward? We are pretty optimistic. There is an expectation on the M&A side that 2010 will be a nice rebound off of 2009. We have seen an increase in strategic dialog, and regained the necessary underlying economic stability. Ultimately, M&A is driven by CEO confidence. Making important strategic moves is difficult when there is no confidence in either your own business or the business you want to acquire. Many transactions in 2009 were executed by companies with strong balance sheets and no financing issues. Stocks had declined significantly so it would have been hard to reject compelling offers. There will be significant strategically-driven deal activities in 2010 even if stock prices continue to appreciate.

To what extent do you believe that the rise in asset values, namely stocks, is a result of excess liquidity in the markets, rather than an actual economic improvement? Liquidity in the financial markets is obviously a key driver. The debt capital markets are very strong right now. We are looking at a completely different world than we were just a year ago. The high yield market is very strong as well, and we have seen a real surge in activity in the equity markets and equity issuance. We are also beginning to see a larger number of significant IPOs. When companies have more alternatives to raise capital, M&A should increase. Liquidity is only one key factor; economic stability and CEO confidence are just as important.

What lessons are to be learned from the crisis? At the end of the day, you have to go back to transactions that make sense from a strategic perspective. Just because there is cheap financing available does not necessarily make a deal good. We have seen many transactions that were ultimately driven by excess capital. I believe that strategic rationale, not purely financial rationale and cheap financing, should be driving deals. Also, it is easy to criticize how TARP was handled by the government, but I believe it was essential that the government took action to provide some stability and confidence for the capital markets.

What regulatory measures should be changed? I am skeptical that increased regulatory measures could improve things. There will always be people with wrong incentives. For me, it comes back to people ignoring fundamental values and inherent risks. If some people would have said: "I don't understand these returns, I don't get it. It does not make fundamental sense to me, and so I am not going to bet my entire balance sheet on it." If we had had more people thinking along those lines, we could have avoided a lot of what happened.

What do you think about "to big to fail?" In a healthy market environment, everybody should be allowed to fail. Looking forward, I think that it should be clear that every financial institution is on its own. People have to be responsible. There shouldn't be a "too big to fail", everybody should be allowed to fail. We can't have a system where people take excessive risks because of some implicit guarantee. This is why we, at J.P. Morgan, are in favor of establishing resolution authority, which would allow regulators to unwind a systematically important company in an orderly way, similar to a process used by the FDIC when it closes failed banks.

You have seen and interviewed many students fresh out of business schools, just like Wharton. Looking at these students' skills, what would you ideally like business schools to teach more of – or less of? Having graduated from Wharton myself, there is no question that the education is an extremely valuable tool to have. Sometimes I see new students come in who might have a very good general understanding but – at the end of the day – no real business sense. Of course: you need to get the numbers right and pay attention to detail. But sometimes students are too mechanical and really don't get the big picture. Let's take the cost of capital, for example: yes, there is a textbook formula, but there is also the concept of capital markets and how financing actually works in the real world. Common sense is essential. Wharton does a great job by encouraging students to get practical experience.

Many students, both at Wharton and other schools, will read this interview. What single piece of advice could you pass along to these students? You have to figure out what you would really enjoy doing. When I was at Wharton, people, for the most part, wanted to go into banking or consulting, which created an especially competitive environment. Many people get into it without really knowing if it is the right thing for them. You have to find something that you can be passionate about and that you can enjoy - and I believe that you have to work really hard at finding that.

Investment banking is a very hard job, not necessarily because it is scientifically or academically challenging, or because of complicated math, but rather because you have to juggle a lot of projects and a lot of pressure at the same time. You can only do this if you can have fun doing it. People need to be truly critical and ask themselves: am I getting into banking just because everybody else says that that is what I should be doing, or am I really enjoying it? We want to work with people that are creative - that can think about a problem and understand the big picture - but not at the expense of screwing up at their actual tasks. If somebody asks you to run an analysis and you come back and say: why don't we also look at it this way? That's great. But if you come back with it and you have done somewhat of a poor job: that is not so great. Focus on what you have to do, do it really well, and then go beyond that. But, don't go beyond that without actually doing a great job at what you were originally asked to do.

When you start out in the business you will be working very long hours. You see people up all night and putting presentations together, without actually spending five minutes thinking about what they are actually going to say. Always take some time to prepare how to present your ideas effectively. **iBR**

> "I AM A GERMAN CITIZEN AND I THOUGHT THAT I WOULD COME TO THE US, WORK HERE FOR A COUPLE OF YEARS, AND THEN GO BACK TO EUROPE. BUT I HAVE HAD WAY TOO MUCH FUN HERE… "

NOT YET, BUT THEY MIGHT BE SOON: CANADIAN BANKS IN TROUBLE

BY ALEXANDER MASSA ('10)

Alexander is a senior at the Wharton School at the University of Pennsylvania. concentrating in Finance. He is originally from Montreal, Canada.

For the second consecutive year, the World Economic Forum has ranked Canada as the country with the soundest banking system in the world. The big 5 Canadian banks also enjoyed near-record profits in 2009. Scotiabank, for example, saw its fourth quarter earnings nearly triple from the same period a year ago. While many countries are struggling to rebuild their troubled banking systems, Canada and its profitable banks appear to be a shining light in an otherwise dark and murky financial world.

But appearances can be deceptive. Some troubling signs point to dangerous similarities between Canada's current policies and those that almost brought down the entire world economic edifice a few years ago. Dangerously low interest rates, a faltering real economy and aggressive banking activities are all threatening to drag Canada and its banks down a dangerous, yet all too familiar path.

The Canadian Narrative

Canadian banks weathered the financial crisis relatively un-scathed; not only did they not directly receive any federal bailouts, but all, except CIBC, recorded profits in 2008. Lower risk appetite and structural differences protected them from the oncoming storm. Toronto-Dominion (TD), for instance, exited the structured products business in 2005, while RBC imposed several years ago a limit of 30% on the share of earnings its capital-markets business could contribute. The Canadian system is also an oligopoly of five too-big-to-fail banks. To mitigate the risk of a systemic collapse, regulators were forced to impose more stringent regulations, including maximum leverage ratios and higher tier 1 capital requirements. This tougher supervision did prevent balance sheets from expanding out of control in the last decade and, compared to the casino-institutions south of the border, Canadian banks certainly have been better prepared to withstand the economic downturn. Unfortunately, Canada is now suffering from many of the same ills that have plagued western economies in the last decade. But unlike in other parts of the world, the distortionary effects of artificially low interest rates and excessive credit have yet to severely impact the banking system – in fact, it's the complete opposite: free money has spurred lending activity and boosted banking profits. However, if history is any guide, Canada and its banks might be setting the stage for trouble ahead.

Too Much Credit

Wholesale bank funding costs in Canada are currently at all time lows. Like in the United States, the overnight target rate has been at 0.25% since April of last year. But the Canadian banking system is not in gridlock and this free money is flowing rapidly into the economy, causing asset inflation and ample malinvestment.

Housing prices, for example, are at exorbitant levels and have barely fallen from their peak. A Bank of Canada official recently commented that the housing market required "vigilance, but not alarm". Meanwhile, 35 year fixed-rate mortgages below 6% continue to push housing prices up.

The housing market is also supported by a fully nationalized version of Freddie Mac and Fannie Mae called the Canada Mortgage and Housing Corporation (CMHC). It guarantees all mortgages with loan-to-values above 80% and purchases mortgage backed securities directly from issuers. As a result of low interest rates and explicit government guarantees, the fluid mortgage market has helped keep house prices well above their long-run averages. Rapid credit expansion has also made Canadians some of the most indebted people in the world.

As Canadians have taken on more debt to purchase homes, cars and electronics, the debt-to-income ratio has swelled to an all time high of 145%. That means that for every $100 of personal disposable income, Canadians carry $145 in debt. In 1990 that number was $88.60. While predatory lending certainly is not as prevalent as it was in the United States during the subprime debacle, it nevertheless remains a problem. For instance, home hardware store/gas station Canadian Tire (TSE: CTC.A) has been aggressively expanding its financial services business in the last few years by issuing credit cards to customers waiting in line to fill up on gas priced at below-market rates. Similar to what happened in the United States, cheap money is creating an illusion of growth by burdening consumers with an ever increasing amount of debt. Canada is on a credit binge that will eventually need to end.

Faltering Real Economy

Canada's commodity based economy has done relatively well in the last few years. Unemployment has remained stable at 8.5% and the IMF forecasts Canada's growth to be 2.6% in 2010. However, growth figures are slightly misleading given that domestic spending on housing and consumer goods has largely replaced investment and foreign demand for Canadian exports. Massive fiscal stimulus has also created Canada's first deficit since the mid-1990s. In other words, growth in Canada is no longer primarily fueled by its productive export-driven industries but rather by cheap credit from the Bank of Canada and enormous amounts of spending by the federal government. Manufacturing also continues to slow as demand remains weak from abroad and the strong Canadian dollar cripples exports. Mark Carney, governor of the Bank of Canada, has warned that the recovery will be "more protracted and more reliant on domestic demand than usual". The faltering economy coupled with growing private and public debts might quickly overburden Canada's 31 million inhabitants who are already strained by notoriously high taxes. Unfortunately, while Canada's productive economy continues to slow, banks are diverting an increasingly large amount of household earnings away from savings towards debt service. This will undoubtedly hurt the real economy in the long run. Meanwhile, Canadian banks continue to seek profitable opportunities abroad – and risk dangerously overextending themselves - to expand beyond Canada's relatively small domestic market.

Aggressive Expansion

The big 5 Canadian banks have an average tier 1 capital ratio of over 10%, well above the 7% requirement, but regulatory uncertainty and a general lack of clarity about asset values have forced them to focus on capital preservation over acquisitions. But that is likely to change. In fact, TD's $8.5 billion purchase of New Jersey based Commerce Bancorp in late 2007 might be a better indication of things to come. Bank of Montreal (BMO), the country's fourth largest lender, is currently expanding into China and India. Scotiabank last month raised its stake in China's Xi'an City Commercial Bank to 14.8%. This comes after Scotiabank paid $270 million last year to increase its stake to 49% in Thailand's Thanachart Bank. Canadian banks are also actively looking to make acquisitions in Vietnam, the Philippines and Malaysia. Meanwhile, the turmoil on Wall Street has allowed banks like RBC to aggressively expand their capital

markets operations. Not only did RBC become a Primary Dealer in 2009, but its investment banking activity has helped make it the largest company by market capitalization in Canada. With their rivals hobbled by bad debts and enormous losses, Canadian banks are understandably taking advantage of their privileged position to expand. But this enormous international footprint also exposes them to much greater financial risks. The global economic crisis is far from over and many financial experts believe that the drastic increase in the global monetary base will eventually have destructive effects on the world economy. A crisis in virtually any part of the world, especially in Asia, could potentially be devastating for Canada and its banks.

Looking Ahead

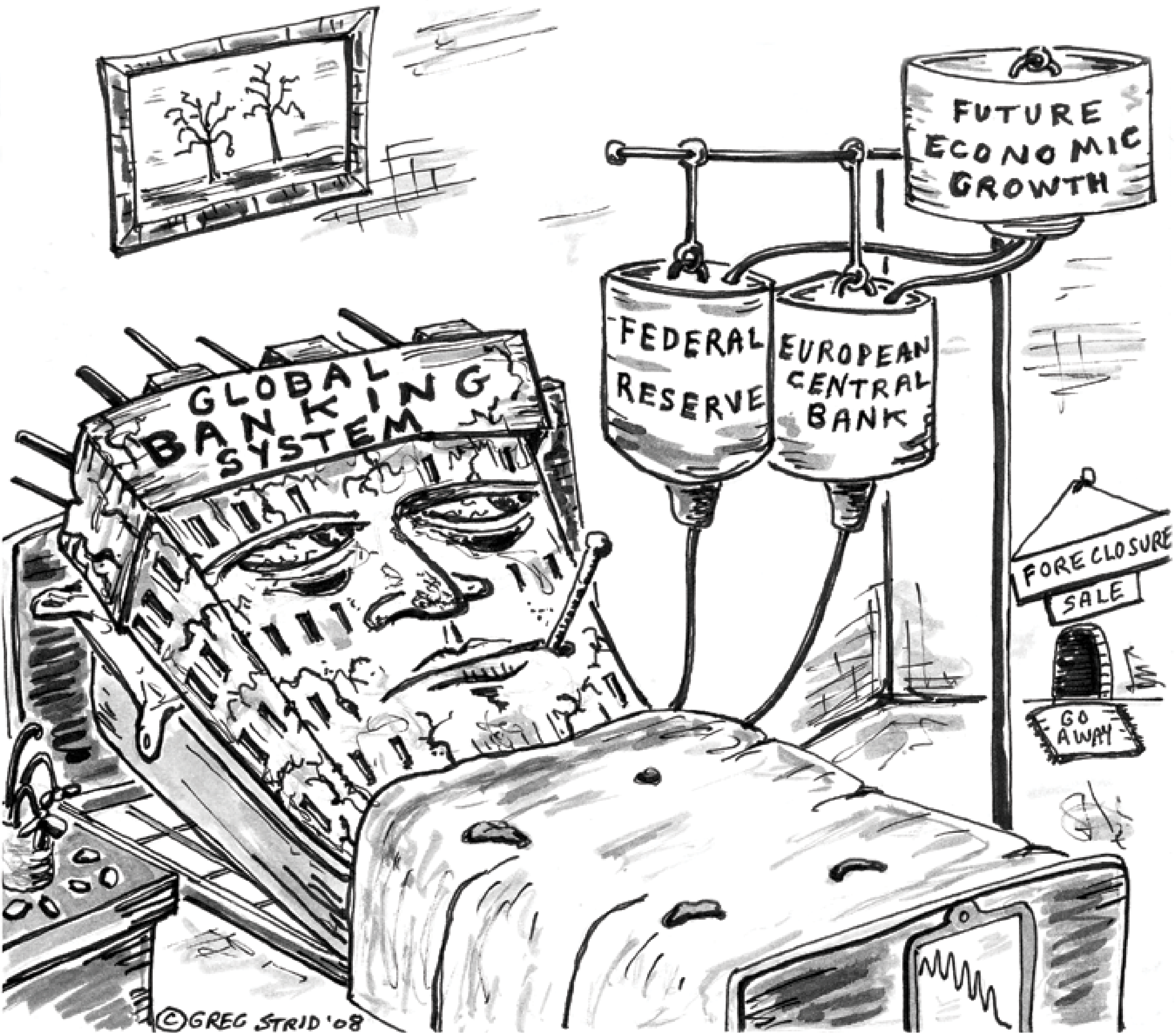
The dominant Canadian banks have remained rather vigilant in protecting themselves against future shocks. In the last year, their average reserves for impaired loans to gross loans ratio, a measure of the size of reserves as a proportion of gross loans, has increased by over 31%. Yet their average reserves for impaired loans to impaired loans ratio, a measure of their average reserves as a proportion of impaired loans, has diminished by almost 26% for the same period. This means that reserves are not increasing fast enough to compensate for the increase in losses. In other words, the reserve cushion is growing in size but is shrinking relative to growing losses. This might be an early sign of a turning point for Canada's banks.

If it has not started already, the destructive effects of massive credit expansion will begin to overwhelm the banking system as the country's debt burden increases and delinquency rates continue to edge higher. Substituting the faltering real economy with massive public and private debt has helped make Canadian banks highly profitable and will likely give the illusion of growth for a period of time, but ultimately it will hurt Canada's long term prospects. Massive expansion abroad has exposed Canadian banks to incredible international risk that could lead to unforeseen losses if the global economy fails to recover. Since Canada does not have the political will or the resources to bail out its banks if they get into trouble, the country and the banks are destined to share the same fate.

Looking ahead, it will be critical for Canada's banks to avoid overextending themselves or the consequences could be disastrous. Unfortunately, free money has caused a dangerous shift in Canada's once highly conservative banking sector. That is why Canadian banks require "vigilance, but not alarm" – yet. **iBR**

THE FUTURE OF FINANCIAL REGULATION

BY CHARLES HENDREN ('10)



Over two years after the beginning of The Great Recession, we have finally begun to crawl back from the edge of the abyss. Much has been done, from an unprecedented stimulus package to near-zero interest rates; however, the job of rebuilding the financial architecture and getting the real economy back on track is just beginning. Unemployment still hovers at around ten percent, and consumer confidence is at its lowest level in nearly a year. Foreclosures are expected to continue rising throughout 2010, and bank lending has remained tight despite massive liquidity support. Clearly, there is much left to be done.

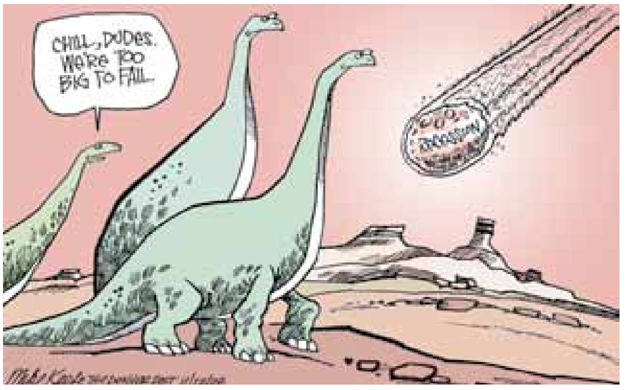
How We Got Here

As Federal Reserve Governor Daniel K. Tarullo argues: "In many respects, this crisis was the culmination of changes in both the organization and regulation of financial markets that began in the 1970s." Thus, it is important to understand those fundamental changes before a coherent and thoughtful vision for financial reform can emerge.

First, widening global imbalances and easy money policies pursued by the Federal Reserve at the beginning of the decade laid the foundation for the eventual housing bubble that formed. Making matters worse was a shift from the relatively transparent and standardized securitizations facilitated by the Government Sponsored Enterprises (GSEs) to a new system of private-label securitization, in which private entities transferred otherwise illiquid assets, such as residential mortgages, to special purpose vehicles (SPVs), which then packaged and sold securities backed by these assets. The resulting "originate-to-distribute" model reduced accountability throughout the system and led to a rapid deterioration of underwriting standards as originators competed for market share.

At the same time, the trend toward consolidation in the financial services industry accelerated at the turn of the millennium, facilitated by the passage of the Gramm-Leach-Bliley Act of 1999, which officially allowed for the combination of commercial banking, investment banking, and insurance services within a single institution. Continued consolidation led to the creation of a growing number of exceedingly large and complex financial institutions. This resulted in the so-called "too big to fail" problem, where the failure of even a single institution could threaten the stability of the entire financial system, as occurred with the failure of Lehman Brothers. "Too big to fail" institutions, due to their implicit government backing, enjoyed unfair funding advantages and faced diminished incentives to properly manage risk.

Finally, government regulators and supervisors were, for the most part, asleep at the wheel as the seeds of the crisis were sown. In fact, many government policies played an important role in fueling and exacerbating the subprime crisis. In particular, Basel II and various regulations imposed on pension and mutual funds helped feed demand for AAA-rated securities in excess of their existing supply. Furthermore, the risk weighting system underpinning Basel



II greatly incentivized the securitization of subprime mortgages and other risky assets, which, if kept unsecuritized on banks' balance sheets, would have commanded full risk weightings. Finally, measures such as the Community Reinvestment Act placed increasing pressure on the GSEs to issue financing to low-income households throughout the country. Initially the source of safe financing, the GSEs eventually held over half of the AAA-rated tranches of subprime securitizations. These are just a few of the myriad failures of government regulation that precipitated the recent crisis.

Confronted with these failures, there is understandably a desire to find someone or something in particular to blame—whether it is private-sector greed or government incompetence. Still, if the last two years have taught us anything, it is that the subprime crisis really was a systemic breakdown of epic proportions. In short, it took all of us working together to mess things up this badly. With that in mind, it is important to take a broad approach to banking regulation going forward, addressing the wide array of threats to systemic stability. This necessitates truly fundamental structural and policy changes.

Structural Changes

While the economy of the United States has long been the envy of the world, the same cannot be said about our regulatory structure. The sharing of regulatory authority across the Federal Reserve, Treasury Department, and an "alphabet soup" of regulatory agencies has led to substantial overlap, as well as gaping holes, in regulation. As the pace of financial innovation continues to quicken, there is an overriding need for flexibility and accountability on the part of regulators, a need that has been completely unmet by our fragmented regulatory structure. Currently, large financial institutions face multiple regulators, which encourages regulatory arbitrage. They are also regulated on the basis of their sometimes arbitrary legal forms instead of their true business function. This structure clearly needs to change, with an emphasis on increased consolidation and accountability.

Regardless of the actual agencies involved, any regulatory regime should focus on three core objectives: micro-prudential regulation of individual institutions; macro-prudential regulation, which helps guard against systemic risk; and consumer protection. While the government certainly failed in all three areas, macro-prudential regulation is arguably most important going forward. Recent experience has shown that monitoring the safety and soundness of individual banks is not sufficient to guard against systemic risk, especially given the global and interconnected nature of the modern financial system. Instead, regulators must protect against growing risks in the system as a whole, focusing on increases in overall leverage and the deterioration of lending standards. This will necessitate more regular and stringent scenario analyses and stress tests, which can account for correlations between institutions and asset classes, while at the same time explicitly evaluating the impact of worst-case scenarios.

Finally, the regulatory framework must be expanded—and loopholes closed—to account for the rising "shadow banking" system, including investment banks, hedge funds, SIVs, monoline insurers, and others. In theory, the shadow banking system has the benefit of getting certain risks off of banks' balance sheets and transferring those risks to the institutions and individuals most able to bear them. However, the entities within the shadow banking system are highly leveraged and are largely funded through short-term capital markets, while their assets are typically long-term and illiquid. Furthermore, because they are not depository institutions, these entities lack federally insured customer deposits and are unable to access the support of the central bank in its role as lender of last resort. This combination of factors makes these institutions particularly susceptible to even minor disruptions in credit markets; however, these entities operate almost entirely outside of the existing regulatory umbrella. Thus, regulators must find some way to establish appropriate capital and liquidity requirements, while at the same time providing mechanisms to support and potentially shut down these firms in times of crisis. Still, regulators must

"These new regulations will fundamentally change the way we get around them."

remain vigilant. The current shadow banking system was largely a product of regulatory arbitrage, and it is possible that a new set of firms will emerge in response to upcoming regulations. This, along with international competition, should put an upper bound on possible regulations going forward.

Policy Changes

In addition to the aforementioned structural reforms, there is also an overriding need for a renewed policy response to the problem of systemic risk, including measures to address the core problems of too big to fail and the originate-to-distribute model.

Arguably the biggest challenge facing regulators is establishing adequate capital standards for financial institutions. Capital standards, at the most basic level, serve as a buffer against losses during a crisis. There are also some discussions about using capital standards to lessen the procyclicality of the financial system and to discourage the formation of large, complex financial institutions. Regardless, it is clear that reforms to Basel II must take place, as both Bear Stearns and Lehman Brothers were well above the threshold for a "well-capitalized" bank in the days before they fell.

To start, regulators will need to precisely define what is to be counted as capital when evaluating capital requirements. This could include core Tier 1 capital, Tier 1 capital, Tier 2 capital, or potentially new forms yet to be defined. Then, it is clear that capital standards will be raised across the board, as existing standards are simply not sufficient to absorb losses during true financial crises. Finally, regulators will have to decide whether and how to increase capital standards over the cycle and for larger, systemically important banks. The devil is always in the details, but it seems clear that some adjustments to capital standards for larger institutions and during boom times would help to mitigate the too-big-to-fail problem and shore up systemic stability.

Finally, it is important for regulators to establish a regulatory framework that controls the negative effects inherent to the originate-to-distribute model of securitization. Originate-to-distribute presents a slew of incentive issues by allowing originators to book fees up front and then transfer the risks of their loans to third parties. This is made worse by CDOs and CDO2s, which push credit risk further down the line. Because the original issuers do not have to retain the credit risk of the loans they sell, they have little incentive to monitor this risk in the first place. In the incredibly competitive financial services industry, with myriad firms fighting for market share by increasing volume, lending standards will inevitably deteriorate over time, thus increasing systemic risk. Thus, it seems necessary—but likely not sufficient—to implement some form of risk retention policy, under which originators are required to have some "skin in the game." Such a policy, in addition to potential reforms to compensation policy and accounting standards, could help to mitigate the perverse incentives created by the originate-to-distribute model.

How Congress Has Responded

Senator Dodd's recent proposal at least begins address many of the principles outlined above. Of course, the bill was weakened considerably as it moved through the congressional sausage mill, but it still helps to fill certain gaps in the regulatory structure. The bill calls for the establishment of a Consumer Financial Protection Bureau, to be housed in the Federal Reserve, which will write much needed consumer protection laws for mortgage originators, credit card companies, and other lenders. It also establishes a new Financial Stability Oversight Council and extends federal regulation to cover credit rating agencies. The most promising proposal, however, is an enhanced resolution authority, which could liquidate banks as they near insolvency, thereby avoiding the messy consequences of a Lehman-esque collapse. These measures, while unlikely to solve the enormous problems facing the financial industry, nevertheless represent a worthwhile first step in reforming America's regulatory framework.

"Cutting back to a single securities regulator is a good idea. After that, one more reduction and our troubles are over."

As previously discussed, the recent financial crisis was in many ways the result of profound changes in financial markets over the past forty years, and thus our regulatory structure must also respond to those same changes. Still, no one can possibly predict what financial innovations and legislative proposals will occur over the next decade—much less the next forty years. As a result, the actual nature of financial regulation in the future really is unknown at this point. What is known, however, is that the current structure cannot and will not remain. The 21st Century demands a more flexible, streamlined, and accountable system, and we owe it to ourselves to at least begin to meet that demand. **iBR**

INTERIVEW: OSWALD GRUEBEL, CEO, UBS

"...but even though we have created global banks, we did not create a global regulator."

BY DANIEL HELLWIG ('11) + HAMAD ALMUDHAF ('11)

THE FUTURE OF BANKING SECRECY

Oswald Gruebel has been CEO of UBS since February 2009. The bank returned to profitability for the fourth quarter of 2009, with even its investment banking division reporting profits, and no longer being encumbered by large fair value adjustments. The editorial staff of the IBR had the rare opportunity to meet with Oswald Gruebel in Zurich, and learn about the future of banking secrecy, the current financial position of UBS, as well as some of Mr. Gruebel's personal experiences.

Mr. Gruebel, you started your career as an apprentice at a German bank. As of today, how important is a business education, as offered by institutions like Wharton?

Today, you could not do it the same way I did it. When I started my career, you certainly did not have business schools in Europe, and in my own case there were special circumstances, anyway.

I started my career very early and believe that at I have had success in banking because I worked all my life and I learned in the process while today students can learn how things should be done at university.

Above all I believe in a practical approach to learning. For example, I like case studies because they are based on real situations. Sometimes students coming straight out of university only have theoretical knowledge and are then confronted with reality. For them, the real world might seem inefficient and difficult because there are people everywhere who want to claim their piece, and these people aren't necessarily operating according to what you learned in university. But then the good news is that this is what makes it interesting. It is a continuous process of trying to improve how a company functions.

Overall, my advice is to avoid becoming too specialized in your career or your studies.

In the near future, and as a result of the financial crisis, is there any chance to actually get a global regulator for international financial markets?

Unfortunately, where things currently stand it doesn't seem so. The key point is that any global regulator would have to be sponsored by several governments. Those countries would have to give away some of their local control, and that's why it is so problematic. You're talking about the sovereignty of each of these countries. What is likely to happen is that each country, in consultation with the Basel Committee, will come up with its own rules – how the banks should be capitalized, what an acceptable leverage ratio is, what kind of risk banks are supposed to take, and how much these banks are allowed to pay their employees. We will have to see how it will work out but let us imagine, for example, that the Basel Committee comes up with certain standards that banks should have on capital leverage and liquidity. One of the problems will be when, for example, America says: "No, we cannot accept that, we have a special situation." And then the United Kingdom comes and says: "We have an even more special situation." Everybody in these matters tends to thin they have a special situation.

UBS was clearly not the only bank in trouble over the past few years. At the World Economic Forum in Davos, you mentioned that banks need a level playing field…

What we created in the last ten to fifteen years are truly global banks, maybe thirty to fifty global banks that operate in forty foreign countries, including emerging markets. Take UBS, for example. We have branches and operations in fifty countries around the world. But even though we have created global banks, we did not create a global regulator. We did not create global central banks, for example, or an organization that is sponsored by the world's central banks to provide an overview about what all these banks are doing in all these countries. Regulation has not changed: it is still local, in each country. The central banks have not changed either, and they feel responsible only for their own market. There is no common view on how these global banks should organize themselves or how they should be regulated, what their responsibilities are, or who does what if anyone gets in trouble. From a regulatory standpoint, nobody agrees as to what extent these global banks are intertwined with one another. With open transactions and derivative transactions, we are talking about hundreds of trillions of dollars and this can lead to what we now know as systemic risk, because not one of them could fail without creating problems for the financial system as a whole. This is exactly what we saw in the last 2 years. Yet, we are still trying to solve this problem without a global regulator or global banking rules for banks.

If the central banks could agree on which institutions should be regarded as the 'global' firms posing the biggest risks then these banks could then have the same rules, like capital requirements, liquidity requirements, leverage, and so on. Only then would we have a level playing field. And we would all be able to react more quickly.

Would a global regulator be an alternative to the "global fee" concept?

Again, the chances of getting a global regulator or global rules on how global banks should operate are very low. Every country argues that is has its own problems and that they are special, which is why we cannot agree on a global standard. Now, all over the place there is the "too-big-to-fail" discussion. But the discussions about the banks themselves – how they should be run, what kind of exposures they can take, what kind of risk they can take – are separate within each country, and then each country decides what kind of risk each bank poses. This is not good because some of these banks are, in fact, global. Nobody is looking at the interconnection of these banks on a global level – the discussion has only been about the importance of these banks in their respective countries.

You have been CEO of UBS for almost one year. What were your biggest accomplishments?

There was one big task for the management and myself: to turn the bank back to profitability. We have brought it back to an operating profit in the last two quarters, but in reality, we've had to change the entire structure of the bank. What has happened to UBS should not have happened in the first place, from a risk management point of view. We have changed the organizational structure of UBS, so that these "mistakes" – there is no other way you can describe them – cannot and will not happen again. That no one could have done something to prevent what happened is simply not the case. It was not the failure of the bank as such. You can clearly pin most things down to individual employees who knew what they were doing and did things wrong.

In this continuous process of creating the "new UBS," do you focus on improving risk management?

No, not just risk management. We are looking at the structure of the entire bank. We said, "Look, we have a problem here. How can this be resolved?" If we had not empowered risk management to do something about it, nothing would have changed. However, we have also empowered credit risk management, and compliance, and so on, so that they would have the final word in their respective areas of competence. That is generally what you do in a well run company – you make people responsible for the task they are supposed to be responsible for. Then you get a different result. On the other hand, if management continuously overrides any decision by the people responsible for the matter, the company will simply not work.

You recently released a new code of conduct in light of the tax evasion matter. Can you talk about your vision for this code of conduct?

It was not in light of that. When I started here, we looked at the code of conduct. I wanted to know why certain things could happen the way they did. Did our employees know what they were supposed to do? Did they know what the consequences would be if they did not stick to the business rules of the company? We looked at the code of conduct that the bank had before, and decided that certain points were not clear enough. Therefore, we revised the code of conduct and made it absolutely clear what people are supposed to do. We, as a bank, do not want to help any of our clients, or anybody else who is coming to us to evade taxes. You have to define the proper ethical behavior. We then also had to make sure that everybody would actually read the new code. You can have a wonderful code of conduct, but if nobody reads it, it is not much help. So we had everybody sign it and send back a copy to the company. We are also testing all of our people through an intranet training. Each employee has to answer questions periodically, so that we can see that they have read and understood it. Why does a company need a code of conduct? To make sure people use common sense. Most people use it anyway; you know what's right and wrong. But these days, if you do not have something in writing, you might run into problems. UBS is a big corporation – we have more than 65,000 people in fifty countries around the world. You have to protect the institution from the wrongdoing of employees who think they must do certain things. This could be out of misunderstood loyalty, or simply because people are too ambitious. That is not what the company wants. And this protection is the main purpose of the new code of conduct.

To what extent can Switzerland be considered a tax haven?

There is no denying – let us put it that way – that Switzerland, over the decades, has become not only a tax haven but a haven for safeguarding money. With the explosion of transparency since the end of the 90s, it was clear that anything so-called "secret" would have to become less secret. And this does not only concern bank accounts, but really anything else as well. Yes, Swiss banks are guarding the data, but there is a limit to how strongly they can do that. One thing is clear: with the continuous expansion of transparency and development of technology, it will be very difficult to keep anything secret, unfortunately. I think that we should be very concerned about that.

But wasn't secrecy the trademark of Swiss banking?

It was a trademark, and still partially is. Unfortunately, it is mostly seen as connected to tax evasion. Actually, the majority of clients are not here to evade taxes, but for other reasons. One reason is client confidentiality. Also, if you look at Switzerland as compared to other countries, it really looks like a nice place to live. We have a very high standard of living, and this is probably going to become more and more important. If you can afford to do so, you can move to Switzerland. Unfortunately, Switzerland is not very big…

Speaking of confidentiality: How do you feel about the fact that Germany recently decided to buy a CD with the data of tax evading clients?

There are two points of view on this matter. I think that the majority of the German population clearly believes that people should not avoid taxes. Therefore, some think that if they can get the data, they should use it. Other people say you cannot simply buy data, regardless of what the data is, because it was stolen. Otherwise, you would give an example to everybody else to steal data as well. What is really problematic with the whole thing, even without paying anything for the data, is that the data was stolen. If a government, says: "Yes, we will take that," then it condones anyone who starts stealing data. If the state is doing it, what is wrong with it then? Consider how dependent we are on data these days: medical files, public records, etc. There might be a few people that say, "Look, if you have nothing to hide, why do you care?" This, however, has nothing to do with hiding; it is more a question of privacy in its most basic form. I would say that this is a very worrying development. If stolen data is bought by governments – that is a worrying thing.

The IRS has recently stated that it might resume legal proceedings with regards to Swiss bank accounts of American citizens. What are the direct consequences and implications for UBS?

The situation, as we see it, is pretty clear. An agreement was made between the United States and Switzerland. For us, it included delivering data on specific accounts to the Swiss authorities. The Swiss authorities then had to decide whether they will deliver it to the IRS. That was the agreement. When the agreement between the United States and Switzerland was made, it was very clear that the courts here could simply say no. That was discussed, and that was very clear. As far as we are concerned, we have fulfilled and are still fulfilling our obligation under the agreement between the two states to deliver the data to the courts here. I cannot see any further obligations for UBS. We did what was asked from us. This is something that has to be resolved between the governments of the United States and Switzerland.

Mr. Oswald Gruebel has been CEO of the UBS since February of 2009.

With regards to this trend, how important do you consider the U.S. market for UBS, also in comparison to the emerging markets in Asia as well as the Middle East?
The U.S. market is important to us. We have roughly 23,000 employees in the United States; it is still the biggest fee-paying market in the world by far because it is the biggest economy in the world. We have a huge wealth management operation there. Right now, we are in the process of getting back to industry-standard profitability. The U.S. is clearly the biggest market in the world for investment banking, so it is very important to be there. There are other regions, let us call them "growth regions," where we will clearly invest going forward, but everybody else is doing that as well. I would not call the countries in Asia emerging markets – We should probably find a new term for them. They will probably have the biggest growth rates and there are huge opportunities on the banking side.

With the current restructuring process, where do you see the core competencies of UBS five years from today?
Our core competency is very clear. It's wealth management. In the future, it will remain at the core of the bank. We also have investment banking and asset management. Because of all the continuously changing regulations and all these new laws, banking is really going back to a client-serving industry, with less proprietary trading than we have seen up until recently. If the trend we have seen so far continues, it would only be a question of time until some things become problematic again. That is clearly what governments and politicians want to avoid.

Do you expect major changes in the way people in the banking industry are compensated?
Yes, clearly. Compensation was reduced because the industry is enormously sensitive to earnings. But, there are people who do understand how markets can be profitable in volatile times, and their "prices" remain unchanged. The same is true for managers who can manage through these periods – their "prices" are actually going up. Recently, we've had a lot of people going into trading and hedge funds. We have a shortage of good managers in the industry – of people who understand the whole business, not just one aspect of it, and who, at the same time, are capable of managing a big organization. This is something you cannot learn at university. It will take you a few years in the real world to understand how all the operations work. You have to learn about all the intricacies of an organization as well as the problems that an organization can create for itself.

As of today, most of the students graduating from business schools would like to start a career in investment banking or private equity. Is this the best approach to start a career?
That would be the right approach if you want to be a specialist. But, as a specialist, you are very vulnerable. If you only learn to operate in one area, you are totally dependent on how this area develops. Currently, private equity is not necessarily a booming market – quite the contrary. If you really want to go into banking, then I would suggest that you work in all sections of a bank and that you try to understand each of these sections and what is done there, individually – from retail banking to corporate banking, to asset management, investment banking as well as private banking. Banking really gives you a picture of what people are doing. As long as we have money, you will see everything going through a bank – how we behave, what we think, how we react in stressful situations. That is what makes banking so interesting; it's the most fascinating job because in a way, it's our daily life.

> "AS LONG AS WE HAVE MONEY, YOU WILL SEE EVERYTHING GOING THROUGH A BANK – HOW WE BEHAVE, WHAT WE THINK, AND HOW WE REACT IN STRESSFUL SITUATIONS".

If you could pass on one piece of advice to all the students reading this magazine, what advice would that be?
Obviously I have a specific perspective – I have been in banking since I was nineteen and from where I sit the most interesting jobs are in banking, and as an industry we are also pretty lucky that over the long term it pays well! **iBR**

EXECUTIVE COMPENSATION: FAIRNESS AND EQUALITY?

BY SINDHURA CHITTURI ('13)

Sindhura is a freshman at the Wharton School, and a member of the College Republicans Club at the University of Pennsylvania.

The debate over executive compensation rages on, although nearly a year and a half has passed since President Bush signed into law the Troubled Asset Relief Program (TARP), which effectively rescued Wall Street banks from the consequences of their own risk taking. Many of the banks that received government assistance paid their executives millions of dollars in bonuses, angering Americans as well as Washington. The clash over executive compensation is much more complex than disputes over everyday economic issues given the unprecedented nature of the TARP bill. Typically, economics does not involve concepts such as fairness and equality, but because the government funded the bailout with taxpayer money, these concepts are more important than ever before. Therefore, Congress is justified in restricting executive compensation on Wall Street.

Those who argue against government restrictions on executive compensation believe the matter should be determined by the free market. Yet, their argument means little today, since the whole reason the debate is taking place is because the government had to rescue banks from the forces of the free market. Left alone, these banks would have indisputably failed. For years, Wall Street reaped the benefits of excessive risk taking and over-leveraging, but when the bubble burst, did not have to pay the costs because the government intervened. In order to make banks accept responsibility for their actions and recover some of the cost of the TARP bill, Congress should impose a tax on bank bonuses. Great Britain recently imposed a 50% payroll tax on banks that pay workers bonuses more than £25,000 ($40,750). The United States should move in a similar direction.

Wall Street argues that taxing bonuses will make it harder for banks to retain the so called "best and brightest" executives. This statement could not be more inaccurate. It is doubtful that these executives really are the "best and brightest" since they propelled the country into the financial crisis. And even if they are, elementary economics teaches us that people alter their behavior more significantly when they foresee a future change in their income. If Congress imposes a one-time tax on bonuses, executives will not leave the financial sector.

If arguments about egalitarianism and economics are not enough, it is actually in the banks' self-interest to restrict executive compensation. Multi-million dollar bonuses that occurred while thousands of Americans lost jobs have evoked feelings of populism. Wall Street should remember that the last time populism was this strong, things did not bode well. In September of 2008, the TARP bill initially failed because populist feelings were rampant. At the time, members of Congress voted against the TARP bill because their constituents voiced outrage over the legislation. Banks are jeopardizing their chances of receiving government money in a future financial crisis by not limiting executive compensation.

Even if Congress places restrictions on executive compensation, the financial crisis has shown us that executive compensation must be reformed. Today, many firms determine executive compensation based on individual short-term performance. We know only too well that this can lead to executives making decisions that are clever and beneficial in the short-term, yet imprudent and harmful in the long-term. In the future, firms should instead base executive compensation on individual long-term performance. The firm's overall performance should also play a role in determining bonuses because it would give executives an incentive to make the firm succeed. Moreover, basing bonuses on long -term firm performance would prevent firms from paying record bonuses in years that they suffer record losses. As Congress moves to restrict executive compensation, now is the time for firms to reform. **iBR**

INTERIVEW: PROF. HERRING, THE WHARTON SCHOOL, UPENN

"In virtually every country, regulators are paid on a bureaucratic scale..."

BY CHARLES HENDREN ('10) + DANIEL HELLWIG ('11)

ABOUT REASON, RATIONALE & REGULATION

Richard J. Herring, Jacob Safra Professor of International Banking at the Wharton School, sheds some light on the current progress of banking regulation reforms, as we emerge from the most recent financial crisis. Prof. Herring offers insights into the underlying complexities of our financial system that hinder the progress of reforms, and stresses the importance of international cooperation for successful regulation.

In what ways have your ideas regarding financial regulation changed as a result of the recession? They have changed in a major and in a minor way. The former is that systemic risk is no longer just a phenomenon of commercial banks. I think the entire profession, and particularly the Federal Reserve board, has always assumed that this was true. Our favorable experience with the bankruptcy of Drexel-Burnham in which the stock market actually rose when it failed reinforced this belief. However, investment banks have changed in ways that have made them clearly systemic. The boundary may even go beyond investment banks. We simply do not have the tools to deal with such institutions and it is not yet clear that we will get them from the legislation. Moreover, we have found that our tools for dealing with systemically important commercial banks are also inadequate because of the incredible corporate complexity they have developed.

The small thing that surprised me was the extent to which the large investment banks had grown dependent on repos or collateralized short-term borrowing. I had always thought that one of the safest ways to borrow in the short term was repos or collateralized short-term lending, because you could divorce your need for funds from any potential lender's concern about your solvency. Yet the extent to which the large investment banks relied on this kind of funding surprised me: repos grew to 60 percent of demand deposits. If it had been known – and somebody from the government should have been tracking it – what was happening to leverage, maturity mismatch, and asset quality among the systemically important institutions – this crisis should not have happened. There is therefore a huge failure in regulation. Moreover, once the crisis started, they were totally unprepared to deal with it. So, while it was true that they had to fix the financial sector first, but they took such a long time to make the correct diagnosis that it wasted an enormous amount of financial resources and inevitably, gave rise to really painful contractions in the real sector. As early as September 2007, it should have been obvious that we had a solvency problem in our major banks. And yet, for a whole year, with the minor exception of the bailout of Bear Stearns, which was depicted as a liquidity problem, the government was concerned mainly with pumping liquidity into the system, even though it was clear that this was not working. Banks were choosing to hold excess reserves when they could have gotten a much higher spread lending to each other, or private non-bank borrowers, they were holding treasury bills. Implicitly, they were scared, and they had every reason to be, because many of them were sitting on toxic assets and knew that other important institutions, but not necessarily which other institutions were as well. Many of them did not know whom to trust among their peers, and they had pretty good reason to believe things were going to get worse before they would get better.

In my mind, the right way to tackle this early on would have been the traditional way of dealing with these problems – a good-bank / bad-bank split. It would have been a little different than the traditional model, because in this case, the bad bank would have basically been comprised of assets that could not be valued with any certainty. These assets would have been spun off to the shareholders, who could do whatever they liked with them. If they thought that they would recover eventually, they could hold on, or sell them to each other. But the good bank would have been comprises entirely of assets that were easy to value and regulators would at least, end up with a reasonable notion of how much capital they would have to provide to make them viable, going concerns, able to lend and serve a useful function in the economy. Much of the damage might have been limited to the financial sector if they had acted quickly and appropriately.

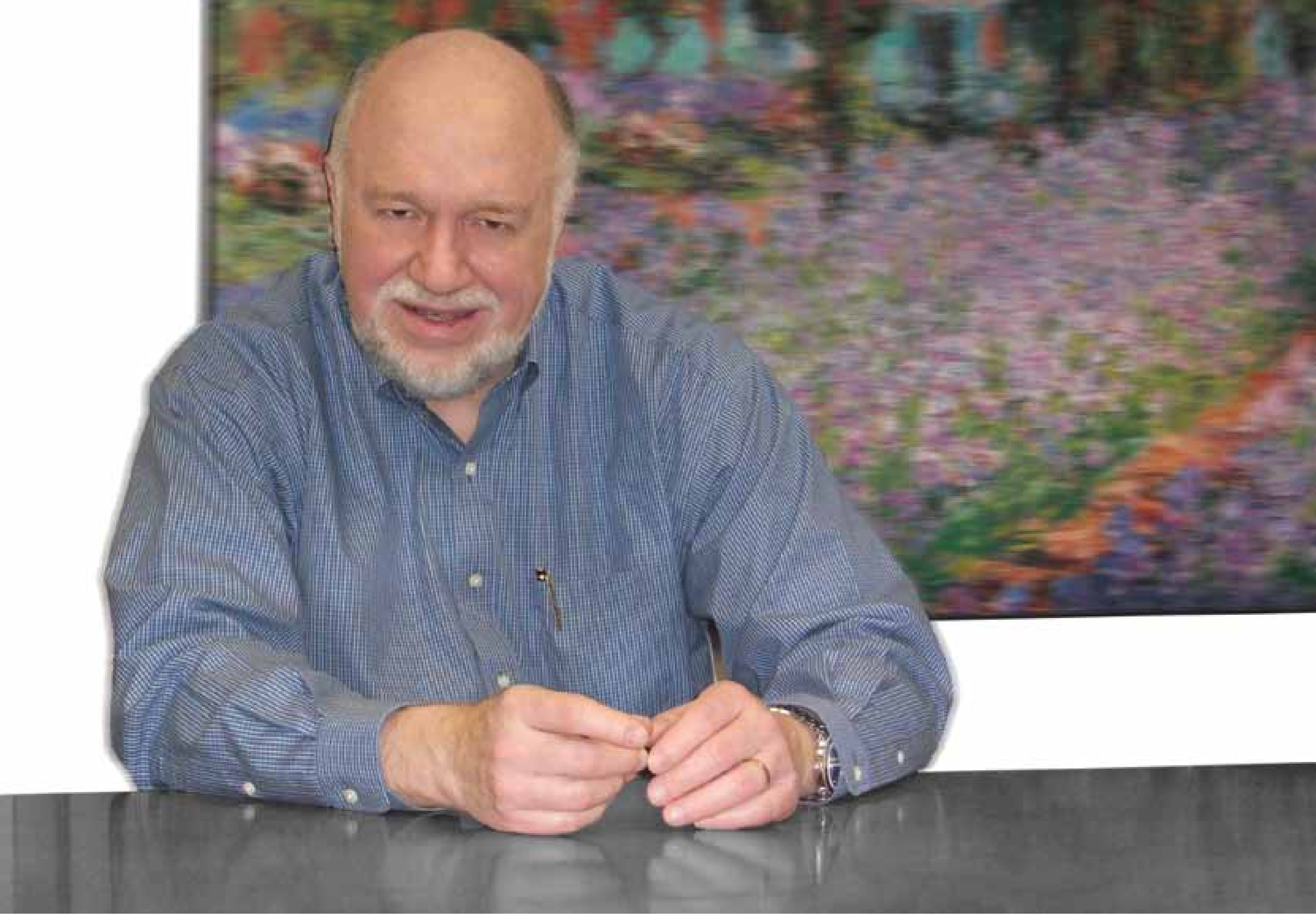
What happened instead with these asset classes? What they did instead was mainly warehouse dodgy assets on the books of these giant institutions, with very little transparency to the real economy. The real engine of growth in the US – and to a certain extent in Germany as well – has been the small business sector. Because banks were unwilling to lend, these small businesses were deprived of credit and bankruptcy rates began to soar. I think we have made progress since they finally decided to inject capital into the system. However, I remain concerned about the inefficient way in which they did it: instead of focusing capital on banks that actually needed it, and that were systemically important, they distributed capital more broadly, at times forcing institutions to take it which had no need for additional capital– and got nothing in return. The main reason they are getting paid back so quickly – and can now brag that it was such as success – is because when banks originally took the money, they didn't know that they would be subject to the pay-czar. Unintentionally, the pay czar became a very effective collection agent for the TARP fund, but in at least some cases, I think that the eagerness of executives to regain control over their compensation resulted in premature repayments.

Do you think that the attempts to regulate compensation have been effective? I think the main problem is that we frankly do not know how to structure incentives correctly. The two firms with the highest employee ownership, which we think is the ultimate form of alignment of management incentives with those of shareholders, were two of the biggest catastrophes: Bear Stearns and Lehman Brothers. In both instances the employees owned more of the firm than in any of the other banks. The senior guys owned what was once literally billions of dollars of stock, and in the case of Bear, they were not even paying attention when it was falling apart.

I am told that the British approach of restricting bonus payments is so full of holes that nobody really complains about it, because all you need are 30 minutes with a clever accountant and tax lawyer, and you can avoid the constraint. Moreover taxing the bank instead of the executive is really taxing the shareholders, usually pension funds, endowments, life insurance companies and other institutional investors. Maybe this will encourage us to pay more attention to salary matters, but it is a very indirect approach.

I do think it is perfectly possible for supervisors to recognize and penalize incentive systems that are poorly structured and which emphasize short-term returns, and take no accounted risk. We do know a number of incentives that can be perverse, but we don't really know enough to prescribe what is correct.

Is there any government or institution that has done a particularly good (or even decent) job either staving off or weathering the financial crisis? How did they manage to do so? Is there anything they did that could be applied more broadly—to the US in particular? Of the G-10, the Canadians and the Spanish have done the best. To some extent the Canadians have been lucky because it has been a really good time to be a producer of hard and soft commodities, but their banking supervision has also been more careful and cautious. There are fewer banks to supervise, and they have been less bound by tradition than our supervisors in trying to figure out the best structure for supervision to oversee the industry.



The Spanish have done very well in an even worse economy than we have. It's difficult to recall that only 35 years ago Spain was just emerging from the Franco era and a backwater of Europe. The transition to a modern economy brought with it a severe financial crisis during which they improvised a "banking hospital". Yet since that time Spain has produced two world class banks that are among the most valuable in Europe: Santander Central Hispano and Banco Bilbao Vizcaya Argentaria. Compared to their peers in other countries the Spanish regulatory authorities have had greater influence over accounting and tax authorities. They used these powers to prevent their banks from making some of the worst errors that were committed in other countries. First, they told their banks that they could operate Structure Investment Vehicles (SIVs), but that they would be subject to exactly the same capital charges as if the assets were held on the banks' own balance sheets. Consequently, the Spanish banks did not form SIVs. Second, they devised a policy of pre-provisioning that appears to offset to some extent the pro-cyclical effects of Basel II. What happens is that a bank is required to put aside a certain proportion of its profits as reserves for future years that may not be as profitable. This means that in good times, you are building up reserves and maybe have less of an incentive to expand lending, and in bad times, you draw down reserves. Oddly, drawing down reserves does not attract the headlines that drawing down regulatory capital does. Drawing down reserves seems to imply that the bank has planned for the problem even though there is technically very little difference between this sort of reserve and retained earnings, which are part of regulatory capital. It is difficult to emulate such an approach in the U.S., because both the SEC and the tax authorities are opposed to accumulating general reserves that cannot be associated with some anticipated loss. The SEC views its mission as that of trying to convey a true and accurate picture of current income to shareholders and views general reserves as a way of smoothing current income. Certainly in the twenty-five years ago, when the banks in Germany and Switzerland had hidden reserves in Switzerland and in Germany, that was undeniably true. And similarly, the tax authorities are concerned that the banks will take advantage of the flexibility of general reserves to manage their tax liabilities.

What is your opinion of the various administration and congressional financial reform proposals (Frank, Dodd)? What are the chances of passage, and are they likely to make a difference? What concerns me is that they have done nothing to deal with the part of the problem that is entirely congress' fault, which is the incredible distortion of the housing market: nothing about Fannie, nothing about Freddy, nothing about the FHA, which is now taking up the slack. And, although we may be getting some TARP money back, we are losing even more every day due to ongoing losses at Fannie, Freddy, and the FHA.

We have not very courageous in tackling the regulatory structure. Congress has left an appalling amount of redundancy in the regulatory structure because congressional committees are reluctant to give up regulatory oversight and the associated campaign contributions from regulatees.

Congress is also relying heavily on sharing information among agencies that have no history of doing so. Yet, if you think about it, it is only human nature and is actually much worse on the international level, where in addition you have actual bank secrecy laws and bank privacy laws hindering the sharing of certain kinds of information. If you are the supervisor who is responsible for an institution that is going through a rough spot, you are very unlikely to tell your peers about it, because once you do, you lose your scope for discretion in dealing with it, and you may even precipitate the kind of outcome that you wanted to avoid.

Do you expect Switzerland to come forward with changes regarding their banking supervision and secrecy laws? Yes, I do think so. The Swiss were so alarmed when they realized the size of their two biggest banks, relative to their GDP, that they have actually instituted some very tough regulatory measures, and are now requiring actual leverage ratios in addition to the Basel II ratios, as we have in the U.S. The leverage ratio generally kept US banks from being as de-capitalized as European banks. The shock to the Swiss system, particularly the vulnerability of UBS that, in addition to massive losses, was caught helping Americans evade US tax laws, undoubtedly contributed to their willingness to share a tax information previously unavailable.

What are the prospects for having a single systemic risk regulator? Would this be feasible, and, if so, what authority should the regulator have? I think the immediate response everybody had when the question was posed was that it had to be the FED. They have more resources, more economists, and more stability of management. But when you look at the job that they actually did with regard to the crisis, it is hard to have confidence that they would be a suitable systemic regulator, because the systemic institutions under their control did at least as badly as those that were not. And, how could they extend their reach into the non-financial sector? How do you deal with G.E. capital, for example? It does not really make sense to look at it in the context of all G.E., but, on the other hand, you would probably have to insist that it would be separable from G.E. Also, their performance with AIG does lend confidence that their competence extends much beyond the banking sector.

On the other hand, whether countries that actually have unified regulators performed better is also not so clear. The FSA did not do a superior job in the U.K., and BaFin did not perform with distinction in Germany.

But there are a number of problems with forming a systemic risk regulator. Can we agree on what a systemically important institution is? Some say that it is kind of like situational ethics in that it all depends on the context. I think that is overstating our uncertainty. Of course such judgments are always subject to type 1 and type 2 errors, but I could certainly name 10

“YOU HAVE TO HAVE SOME KIND OF INTERNATIONAL COOPERATION, BUT WE HAVE A FAR WAY TO GO…“

institutions that you would have to count as systemic under any scenario. Moreover, attention needs to be paid to the financial infrastructure as well because it may be at least as systemically important as any large financial institutions.

Not only is there a problem in identifying which institutions are systemically important, but there is also the question of whether you should actually disclose them. In my mind, you need to, because if you intend to regulate them differently, there is no way you can cover up that you regard them as systemically important. On the other hand, people will argue with equal force that to do so, you raise moral hazard. I think the kind of regulation you would have to impose on systemically important institutions has to be heavy enough to make it an unattractive category to be in. But this leads to a certain cliff effect: if you can figure out exactly where the line is drawn, you may have most of the benefits and none of the costs. I don't think anybody has resolved that question.

Many people have at least partly attributed the housing bubble and bust to the inability to track the deterioration of lending standards and the increase in leverage in real time. What data do we need that we don't have, and what data do we have that we don't use? Much has been made of that, but I think it is overstated. I think it was really a refusal to see the obvious. I think as early as 2005, it was pretty evident that we're headed for substantial problems, and part of it was a political problem because any action that the FED or any other regulatory authority would take at that time to stifle the boom would have brought an immediate response from congress. It is politically very hard to deploy these weapons to counter a bubble even if you have them. It really is quite shocking in a way; not only did they not see it coming, but when it came, they did not really understand the implications. They thought it was going to be a small problem only affecting a few parts of southern California. By 2006, it was obvious that it was a huge bubble. And even if you wanted to deny the data the seriousness of the problem could not be denied after HSBC reported in February 2007 why its U.S. unit was in such a terrible shape.

At this point, Alan Greenspan is very eager to argue that bubbles are inevitable and that there is nothing the Central Bank can do about it. His argument is that the Fed saw it coming, but nothing they could do seemed to matter. The yield curve shifted so that what they were doing in the short end had no impact on the long run, which had the stronger impact on housing finance and that, even if you had weapons like loan-to-value ratios, it might have suppressed the bubble in house prices only find it popping up somewhere else. There was such euphoria and such liquidity in the economy that nothing really could be done.

ARGUABLY, GORDON BROWN WAS THE FIRST WORLD LEADER TO SAY: "THIS NOT A LIQUIDITY PROBLEM; IT IS A SOLVENCY PROBLEM".

How would you characterize the importance of international cooperation when it comes to financial reform? Because of international competition, standards will obviously have to be standardized somewhat, but are we likely to get another Basel II if we're not careful? I think it has become critical. Unless you can have an international agreement on how you resolve one of those large firms with literally thousands of subsidiaries in possibly 40-80 countries in the world, there really is no realistic way for them to fail without creating huge spillovers. You have to have some kind of international cooperation, but we have far to go to achieve it. I think if we had been working on harmonizing resolution policies rather than Basel II we would be in much better shape. One of the problems is that legal entities bear no relationships to the lines of business in general. Even if you try to preserve a line of business, you may not be able to coordinate the necessary legal actions. Lehman, for example, had several lines of business that had genuine going concern value, but they were fragmented in scores of subsidiaries in dozens of countries. No one could actually re-assemble the line of business in order to sell it because the fragments were tied up in bankruptcy proceedings in several different countries. I think that there is a lot to be done in this realm, and the G-20, to its credit, has thought about it. They have urged every systemically important institution. But they should go farther. The colleges of supervisors they have assembled should be asked to simulate what they would do in the event that a systemically important institution failed. If the answer is that everybody would ring fence the piece of the group they could control, then it brings into question the entire Basel foundation, which is based on consolidated regulation and supervision. That implicitly assumes that in the event of a crisis, you could move capital or liquidity freely from surplus units to deficit units. If this is not true, we are building an international regulatory framework on a delusion.

I think there is no alternative to some degree of international cooperation, because as we saw with this crisis, it became global within weeks, almost within hours. Moreover, it showed up first in a place geographically remote from the underlying problem. The first bank to fail was in Germany, not in southern California.

Ben Bernanke was named Time's Person of the Year. Who would be your Person of the Year for 2009? I think that Ben Bernanke did a lot of very creative things, but there were certainly other very important leaders. Arguably Gordon Brown was the first world leader to say: "This not a liquidity problem; it is a solvency problem". I think he had a better perspective on it than, in fact, the FED seemed to have.

Unfortunately, I do not think the distinction of being Time person of the year is going to very helpful to Ben in congress where he and the FED as an institution are under attack. Many members are congress are angry that the Fed provided trillions in funding that was not authorized by congress, thus enabling the Treasury to do an end run around the appropriations process. The result is that even things as crazy as Ron Paul's proposal to audit monetary policy are getting a serious hearing.

It would not have been good for the governor of the Federal Reserve Board and the secretary of the treasury to show any daylight between them during the crisis. But at times it appeared that the Chairman of the Federal Reserve Board was subordinate to the Secretary of the Treasury. It may have been because he had fundamental reservation about the wisdom of policies such as TARP 1, but the optics were not helpful to maintaining the Fed's independence. Earlier FED chairmen have even refused to travel to the treasury, because they wanted to make clear that the FED was independent. I fear that some of this may have been lost in the current crisis, which would be unfortunate because you really do not want congress to have direct control over monetary policy.

What role will the ratings agencies play in whatever financial system emerges? Well, in this particular crisis, they were critical. I think what needs to be done there is to take them out of all official regulations, and to have them be used simply because they are useful, and not because they are required. That could restore a lot of integrity to the system. Plus, I think it could lead to new entrants that would bring new techniques, and better disclosure of what your really want to know about risk, which is not just probability of default, but also loss given default, the standard deviation around that mean, the skewness of the distribution, etc.

There is a sharp division between those who blame the crisis on the greed of private mortgage originators and securitizers, and therefore call for tighter regulation, and those who blame the CRA, Fannie/Freddie, Basel, and the overall ineptitude of U.S. regulators. How can they be reconciled? Well, I think you are exactly right. There is an element of truth in each of these charges. But I would point out that greed in the private sector has always been with us. One of the problems, obviously, is that we have regulators who are asked to do a multitude of things, so they cannot really be held accountable for anything. Moreover, we have very limited levers to motivate supervisors to act in the best interest of taxpayers. In virtually every country, regulators are paid on a bureaucratic scale. It is even harder than getting compensation right in public sector than in the private sector, and I don't know if anybody is tackling that problem. It is a problem, because, almost inevitably, the regulators are paid less, and that is the reason you need to bring more private discipline into the markets. The people who should have been constraining the risks being taken by systemically important institutions were their counterparties, usually other systemically important institutions. But under current circumstances, they really had no reason to do so. **iBR**

BY JUAN CARLOS IBARRA ('12)

MEXICO: SUSTAINABLE ECONOMIC GROWTH

The world's largest Spanish-speaking national economy is, by many fundamental measures, still stuck in its rocky seventies.

In 2009, Mexico's gross domestic product fell by more than 7 percent as world demand for exports dropped and as asset prices experienced a bewildering period of extreme volatility. But this wasn't the first time Mexico underwent a crisis, nor has it been the worst-felt yet: In 1994, the Mexican peso suffered a 50% decline in value, resulting in a record-breaking gross fiscal cost of 19.3% of GDP for that year. In 1982 and 1988, a massive debt crisis ensued; early on in 1976 and 1977, macroeconomic policy failures led to massive flights of foreign capital that deeply hurt the Mexican economy.

The world's largest Spanish-speaking national economy is, by many fundamental measures, still stuck in its rocky seventies. Antiquated labor laws, the proliferation of an underground economy, and crucial public energy decisions motivated by a misguided sense of national pride are the elemental structural reforms that loom in Mexico's post-crisis recovery. Without properly addressing these aforementioned institutional concerns, Mexico will not escape experiencing major economic and financial turmoil as it has during every single recent decade. Luckily, our southern neighbor's future does not seem so bleak, even despite its slow recovery.

Unlike in the U.S. and the United Kingdom, Mexico's crisis is not directly attributed to a downfall in the real estate market; nor was it a direct consequence of the financial sector's demise. Mexico's downfall can be rather linked to the global collapse of trade—especially involving the United States, its largest trading partner. It has long been said that a small hiccup in the American business cycle can induce pneumonia in Mexico's export-dependent economy. Recent events haven't presented the exception to this rule of thumb. However, as trade figures make a comeback, analysts have their eyes centered on pending legislative reforms that can singlehandedly result in one of the largest-seen impacts of the new decade on a single national economy. One of such decisive issues involves the urgent suppression of Mexico's colossal underground economy.

Mexico's unofficial economy is estimated to rest as high as about 60 percent of GDP. Some factors that help explain this staggering rate include the prevalence of open-air markets, street vending, no-contract labor, undue government diligence involving the proper preparation of tax returns, and most notably, overly-demanding labor laws that discourage competitive firms to employ "official" labor. In Mexico, employment legislation dates back to Article 123 of the Constitution of 1917. Some benefits that this document affords to workers include paid 20-day vacations per year, three months of severance compensation for certain layoffs, profit-sharing incentives, bonuses, and little to no room for pay-by-the-hour (part-time) labor. All too often, Mexican proworker laws are too taxing for a firm to incur, thus encouraging illegal employment or at times, no employment at all in order to avoid sanctions from powerful union leaders.

Another significant challenge Mexico faces in its efforts to subdue its disproportionately large underground economy is participation in organized crime. Last year, the U.S. Department of Defense estimated that nearly 100,000 Mexican citizens were directly involved in two of Mexico's major drug cartels. These figures are especially troubling, since these mob "foot soldiers" nearly approach the size of the full Mexican army (a corps of about 130,000). It is important to also note that apart from the terrorism and violence that criminal groups exert, cartels also represent an enormous fiscal cost. Proceeds from bribes, extortions, and other associations with corrupt officials among indirect players are not taxable.

Finally, Mexico's energy situation presents a time-bomb for a new crisis in the near future. Petróleos Mexicanos (Pemex) is the state-owned petroleum company in Mexico. Since its inception in 1938, Pemex has been perceived as a source of national pride and as a heritage to the Mexican people. However, oil reserves are currently declining very rapidly, and Pemex does not own the proper capital or equipment to fund further investments in oil fields. Moreover, foreign investment is strictly prohibited in this sphere. Estimates show that Mexico's petroleum reserves will deplete in about 3 years, unless deep oil targets, like the Cantarell and Chicontepec fields, are exploited.

The Pemex issue comprises one of the most complex public debates in Mexico. It frequently revolves around the government budget (Pemex typically pays for about 40% of the government's operating budget in taxes), issues with the reinvesting of funds back into the firm, workers' salaries, and a potential interest in privatization. Pemex is ranked as the world's tenth largest oil company. Like the rest of Mexico's issues, it will necessitate a timely decision of tremendous national and international scope.

"...a small hiccup in the American business cycle can induce pneumonia in Mexico's export-dependent economy"

During this critical point in Mexico's development, the United States should be willing to transcend the role of the hopeless spectator. It is a little-known fact that more than 90 percent of confiscated weapons used in illegal criminal activity in Mexico can be directly traced to American sellers-smugglers (firearms are not legally available for sale in Mexico). By virtue of Mexico's geography and due to its tremendous role as a trading partner and a national security ally, the United States should seek Mexico's prosperity—its ensuing transformation from a developing to a developed status economy—as a mutual interest. **iBR**

BY CARLOTTA SINISCALCO ('10)

EUROPEAN UNION: ARE ITALIANS REALLY P.I.G.S.?

The "illegal" portion of the unreported Italian GDP comes from criminal activities.

If you have ever lived in or visited Italy, you will have noticed that people there enjoy a quite high standard of life. In fact, Italians of every social class invest a considerable fraction of their disposable income on clothing and gourmet food; they also spend their six available weeks of vacation in a location other than their home; they own the most cars per capita of than any other EU country (scooters not included); and they have consistently enjoyed one of the lowest unemployment rates in the European Union.

With these apparently idyllic living conditions, it is not surprising to learn that Italy is one of the most popular countries for Americans to retire to and one of the top destinations on the American travelers "wish lists". As an Italian-born citizen who has also lived in other countries, both inside and outside of the EU, I am in complete agreement. Life in Italy is good.

Italy is part of the PIGS, that its Public Debt to GDP ratio is the highest in the European Union and that a fourth of the Italian adult population apparently has no income.

How can this be possible? Where is the trick? Are the numbers lying? Is it really the case that 1 in 4 Italians has no disposable income? How could I have failed to notice how serious Italy's economic situation really was?

The answer is simple: the official data provides a very accurate picture of only the official economy. It does not account for the GDP generated by "hidden" (illegal or non-reported) economic activities.

While it is true that GDPs never include profits from illegal activities, Italian "hidden" activities represent a larger percentage of GDP than any other European country. Official data cannot be adjusted for this discrepancy and therefore simply ignores it. The result is a picture of the Italian economy that does not fully coincide with reality.

What are these clandestine activities and how do they constitute a bigger percentage of GDP than other EU countries?

It is common knowledge that Italians are naturally inclined to get around rules. It is part of their *arte di arrangiarsi*, the art

Comparison: Italy and the EU

	2008	2009	2008	2009
Unemployment Rate	6.20%	6.80%	8.50%	7.40%
GDP Growth	-1.00%	-4.70%	0.80%	-4.10%
Debt / GDP	105.8%	n.a.	61.5%	n.a.
At-risk of Poverty Rate*	19.00%	n.a.	16.00%	n.a.

* At-risk of poverty rate after social transfers

of getting by, doing what it takes to survive. They learn it in primary school and thanks to it they manage to survive intricate bureaucratic processes such as obtaining a national ID or sending a package at the post office. The *arte di arrangiarsi* plays an important role in the GDP, becoming the biggest Italian "company" measured by revenues and net profits, and one of the largest in terms of number of employees and services provided.

There is another, non-quantifiable effect that the Mafia has on the Italian economy.

In 2009, Italy was the country with the highest percentage of tax evaded, 51.2% of the total, and 34.8% of all legal activities.

Italian culture because it somehow justifies breaking the rules. It is important to take this into consideration when analyzing the latest report on tax evasion in the European Union: in 2009, Italy was the country with the highest percentage of tax evaded (51.2% of the total, 34.8% of which being income from all legal activities), followed by Romania (42.4%) and Bulgaria (39.5%). A quick conclusion to draw is that 34.8% of the Italian GDP is not reported in official statistics: this has a considerable effect on the public debt-to-GDP ratio and an equally sizable effect on various indexes such as poverty and productivity. This represents the "legal" part of the economic activities not reported in the GDP.

The "illegal" portion of the unreported Italian GDP comes from criminal activities. The overwhelming majority of crimes are performed by Cosa Nostra, 'Ndrangheta and Camorra, criminal societies based in Southern Italy, but operating throughout the peninsula, and broadly known as Mafia. In 2008, the Mafia generated a net profit of € 78 billion, equal to $ 106 billion, over 5% of the Italian

It is the way it influences free markets and competition. Imagine the construction business in Southern Italy, which is practically solely owned and operated by the Mafia. Use the magnificent "Porter's Five Forces" framework, a famework that is though in introductory management courses. Is there any threat of substitution or competition? What about the bargaining power of suppliers and customers? Are there really going to be any new entrants, if the "barriers to entry the market" are the lives of your family members, or even your own?

In conclusion, the numbers depicting the Italian economy are skewed due to the Mafia and the phenomenon of tax evasion. While eradicating the Mafia is impossible, at least in the short run, Italy could eliminate, or at least decrease to EU-levels, tax evasion related to legal activities. And Italians would not be considered pigs anymore. **iBR**

BY JĀNIS KREILIS ('11)

Jānis comes from Riga, Latvia and is studying International Relations in the College of Arts and Sciences, with emphases on Political Economy and languages.

UKRAINE: A CHESS TABLE FOR GEOPOLITICS

The US missile interceptors will now be more focused on the threat from Iran.

The root krai in the Slavic languages means end, edge or border. Ukraine, as traditional theory goes, means the land on the border. However, geopolitical realities suggest that Ukraine has, in fact, most often been on two borders at the same time, always being the rope in a large-scale tug-of-war between the major powers in Eastern Europe. In the early 17th century, the largest part of modern-day Ukraine formed the outer regions of the Polish-Lithuanian Commonwealth, yet a century and a half later, the power balance had shifted; Russia had gained the upper hand, and its direct rule over Ukraine essentially lasted until the dissolution of the USSR in 1991. But only for less than a decade or so, along with the traditional East-West divisions on the lines of language (Russian vs. Ukrainian) and religion (Russian vs. Greek Orthodox), internal politics have created another schism among the people of Ukraine.

The political upheaval which started with the Orange Revolution in 2004 (when the pro-Western coalition of Viktor Yushchenko and Yulia Timoshenko began shifting the country closer to the West, but eventually came to fundamental disagreements between themselves) seems to have come to an end. The largely pro-Russian Viktor Yanukovich beat Timoshenko on February 7 by 3.5% in the second round of the presidential elections, and, while Timoshenko and her party have decided on contesting the legitimacy of the election in the court, institutions which monitored the elections, such as the Organization for Cooperation and Security in Europe, have deemed the election fair, and world leaders, including President Obama, have already congratulated Yanukovich on his victory.

The election and its outcome signify that Ukraine has changed internally since 2004. The latest election was a laudable example of democratic process. The power shift is also likely to be peaceful, as Timoshenko has promised not to take her supporters to the streets, which is an achievement in itself, considering Ukraine's turbulent politics in recent years. And, although Yushchenko's political career has come to a definite end, this does not necessarily entail that the ideals of the Orange Revolution have been forgotten entirely; Ukrainians still remain very positive about the European Union, with the strong economy of Poland—a current EU member with the same communist past—serving as an illuminating example as opposed to Ukraine, weakened considerably by the recent crisis; The Economist estimates a 15% fall in the GDP in 2009, compared to the previous year, the unemployment has tripled since 2008, reaching 9%, and the hryvnia has fallen by almost 40% to the US dollar since mid-2008.

However, in terms of power politics, Ukraine has clearly returned to the Russian sphere of influence. The talks about Ukraine's joining NATO, started by Yushchenko, have been taken off the agenda by Yanukovich. The current lease for Russia's Black Sea Fleet, hosted in the Crimean city of Sevastopol, expires in 2017, but the president-elect has already stated that the lease might be prolonged, and Ukraine will be looking for a solution that would not "harm Russia." Moreover, during his campaign, Yanukovich endorsed Ukraine's joining the newly-established customs union of Belarus, Kazakhstan, and Russia, which would increase Ukraine's already pronounced economic dependence on Russia.

Such an outcome of the election seems natural, given the reluctance of the Western Europeans to embrace Ukraine full-heartedly. Despite engaging in talks and integrating Ukraine into the European Neighborhood Policy, the European Commission has lacked enthusiasm to talk clearly about Ukraine's accession to the EU as a full-fledged member, thereby decreasing support for the pro-Western forces in Ukraine; the same can be said about the failure of NATO to adopt a Membership Action Plan for the country, mostly because of the strong opposition from Germany and France.

At the same time, Ukraine is crucial for Russia. Its territory—about 230 thousand square miles—is the third largest only to Russia and Kazakhstan among the former Soviet republics, while its population is about a third of the population of Russia. A pro-Western, anti-Russian Ukraine, less than a day's drive away from Moscow or Volgograd, would pose a serious security threat to Russia; to avoid that, Russia is ready to pull whatever strings it has to influence the European core (France, Germany, and Italy, to an extent, all of which maintain strong economic links to Russia) and weaken the West's support of Ukraine, despite the American and Eastern European efforts to bring Ukraine closer.

The outcome in Ukraine has a wider geopolitical meaning, too; now that Russia has finally healed this most painful sore on its back, it should be able to turn its attention to other problems it has on its periphery. Last fall, Finland and Sweden gave the green light to the Nord Stream gas-line project, which is scheduled to start working in 2011, directly supplying Germany with natural gas from Russia. In March, France and Russia are about to conclude a sale of four Mistral-class warships which can carry helicopters and tanks, and conduct amphibian landings, hence considered on the offensive side of military technology. These developments, in combination with the joint military exercises Zapad-09 of Russia and Belarus in the Baltic Sea, have made some of Russia's neighbors—prominently the Baltic States and Poland—increasingly nervous.

"Yanukovich should fix the divide between Ukraine's East and West..."

The Poles have finally persuaded the USA to deploy Patriot-class missiles in Poland, and, if the decision is approved by the parliament, Romania is also likely to host NATO's missile interceptors by the end of 2015. Later this year, the Baltics—justly called NATO's weakest members—should receive their official defense or "contingency" plans from NATO, which France and Germany have been opposing in fear of upsetting Russia. The U.S. is also planning a bilateral military exercise in the Baltics this summer.

But for the time being, the big battle in Ukraine is over, and it is up to Yanukovich to fill the trenches and mend the cracks caused by outside sources pulling his country in opposite directions. The major powers will continue to play their games elsewhere, but, pro-Russian or not, Yanukovich should fix the divide between Ukraine's East and West, lest this become the beginning of a krai for Ukraine as we know it. **iBR**

BY MANTAS NEMANIS ('13)

EUROPEAN UNION: THE GREEK APOCALYPSE

Starting with the year 2007, Greek annual gross domestic product growth began declining.

I am sure that in this day and age, there is no longer a need to talk about the underlying causes of the recent economic crisis. Excessive media coverage has turned us all into well-versed economists. Previously unheard of terms like "subprime-mortgages", "toxic assets" and "institutional bailouts" have all entered the public discourse. Every morning, instead of saying the usual "good morning", we call our financial advisors; instead of having tea, we go to a "tea party". Similarly, thanks to Zack Snyder's bluntly–titled blockbuster "300" and the accompanying "This is Sparta!" internet phenomenon, I am just as certain that there is no need to introduce Greece. The country of Socrates, syrtaki and the Olympic Games; the cradle of Western culture and civilization. After the introduction of our two research subjects, let us see how they interact. What happens when the descendants of Alexander the Great meet The Great Recession?.. T'ain't pretty, I tell you that.

The 2007-2010 period was marked by failures of key businesses, declines in consumer wealth (estimated in the trillions of U.S. dollars), substantial financial commitments incurred by governments, and a significant decline in economic activity. This was happening all across the globe, and Greece was no exception. Starting with the year 2007, Greek annual gross domestic product growth began declining. GDP contracted by 0.8% in the final three months of 2009, which was by far the sharpest fall reported by a Eurozone country. Greece's unadjusted unemployment rate jumped to 10.6% in November from 7.8% a year earlier, reaching its highest level since March 2005. The jobless rate was particularly high among the young - a factor in fuelling street protests in recent years - with 27.8% of 15-24 year-olds unemployed. Could things have gotten any worse? "You betcha", - As Sarah Palin would put it. The country's budget deficit reached 12.7% of GDP, more than double of what was previously expected. Over-lending added some fuel to the fire and Greece's cost of borrowing started to pick up. In December of 2009, Moody's cut Greece's debt rating to from A1 to A2 over soaring deficits, becoming the third major agency to downgrade the highly-indebted country's rating. Bond investors were further unnerved by the revelation that Greece's debt had been understated by keeping unpaid bills off the books. The country's credibility was shot. It had managed to achieve the impossible – overtake Latvia in the "countries most affected by the economic downturn" list.

When people started talking that Greece might default, it became clear that the economic crisis, which seemed to have eased off in the latter part of 2009, was once again in full swing. Only this time, it wasn't the banks that needed saving. The world transgressed from bailing out banks to bailing out entire countries. Iceland's example proved that the sovereign default issue is very real and has to be dealt with. However, the problem is that no one really knows how. Geórgios Papandréou, the Prime Minister of Greece, outlined policies to cut the country's ballooning budget deficit and try to regain the trust of investors and EU partners. On the 14th of December, he announced a 10% cut in social security spending in 2010, promised to abolish bonuses at state banks and slap a 90% tax on private bankers' bonuses. Papandréou also vowed a serious fight against corruption and tax evasion, calling them the country's biggest problems. He also announced a drastic overhaul of the pension system and a new tax system that will make the wealthier carry more of the burden. However, the very next day, markets fell in reaction to Papandréou's announcements and workers immediately protested the cuts in social security.

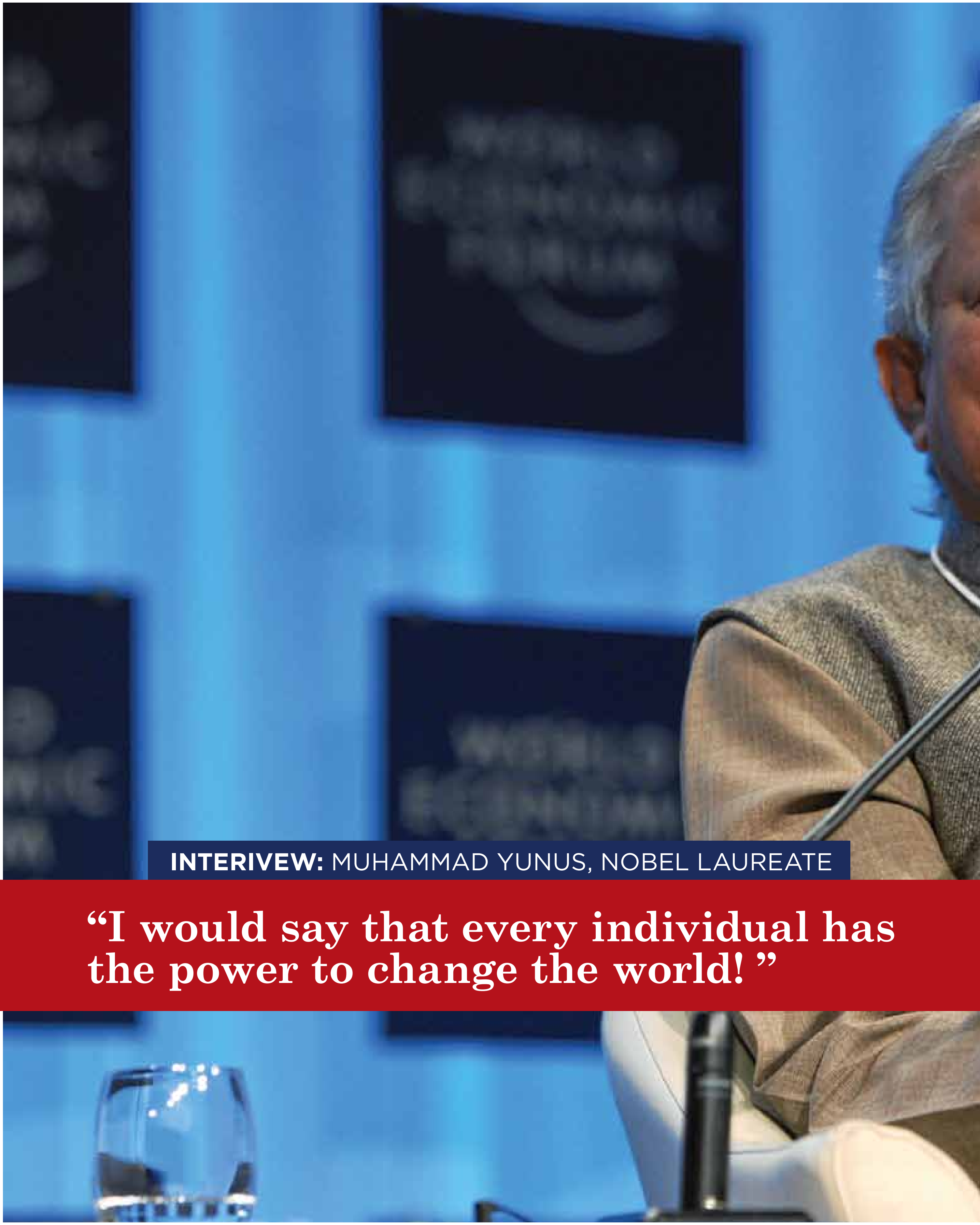
European leaders were also struggling to avert the biggest financial disaster in the euro's 11-year history. If Greece defaulted, it would be the first EU and Eurozone member to do so. Besides the obvious aspect of humiliation, other severe consequences would soon follow. Equity markets would go on a free-fall, as would the Euro, stock markets would plummet and we would be saying "auf wiedersehen" to investor confidence. There is a danger that the entire concept of the common currency would be compromised. In fact, this has already begun to happen and that is precisely why the major European powers decided to step in. On February 11th, EU leaders attended a special summit in Brussels and noted that "Euro area member states will take determined and co-ordinated action, if needed, to safeguard financial stability in the euro area as a whole."

As we have learnt from past experiences, bailouts are a sticky business. You are damned if you provide them and equally damned if you don't. According to Jochen Felsenheimer, a credit expert at Assenagon in Frankfurt, things could spiral out of control if Greece was not given financial support. "Economically, we are in a very risky situation. Greece is close to default. We face systemic risk like the Lehman collapse and unless there is a bailout for Greece, there will have to be a bailout for the whole European banking system within two or three months," he said. Indeed, French banks have $76bn of exposure to Greece, the Swiss - $64bn, and the Germans - $43bn. But this understates cross-border links. There are large loans between vulnerable states, interlocking claims within the Eurozone zone are complex. Contagion can spread fast and a domino effect is not out of the question. On the other hand, a Greek bailout would create a very dangerous precedent and increase the risk of Eurozone break-up, because a monetary union can only work if everybody sticks to the rules. Other vulnerable European countries, like Portugal, Italy, and Spain (along with Greece, they are sometimes humorously referred to as PIGS) might soon come knocking on the door for another bailout. And who is to say that they are less important than good old Greece?

Only this time, it wasn't the banks that needed saving: the world transgressed from bailing out banks to bailing out countries.

It seems that the European leaders are good poker players, trying to get the best out of two conflicting worlds. They want to boost consumer confidence and rebound the Euro by guaranteeing Greece's economic stability, yet at the same time they are not willing to actually provide the money necessary for a bailout. So far, they have been relatively successful: after the afore-mentioned Brussels announcement, the Euro finally stabilized and moved out of its record-setting decline. As for the Greeks, they have several equally gloomy options. They can introduce severe budget cuts and sink into a depression for a few years. Or, they can default and go into a depression for more than a few years. This would have the advantage of reducing the debt burden, depending on what terms the government settled on. But it would also most assuredly mean they would not be able to get new debt for some time to come, forcing severe cuts in government spending. The third option is that they could vote to leave the European Union. While this is unthinkable to most Europeans, it is an option that may appeal to some Greeks. They could create their own currency and effectively devalue their debt. It would make their labor and exports cheaper. However, they would still be shut out of debt markets for some time, any savings left in Greece would be devalued overnight and political consequences would be catastrophic. The final and probably least painful short-term strategy is to play poker, just like the EU. Promise to make the budget cuts, get some form of guarantee on their bonds, and borrow enough to make it another year - but not actually cut as much as promised; just make some cuts and then promise more next year in return for more financial help. Maybe it will simply delay the problem for another year or two, until European voters (mostly German) get tired of taking on Greek debt, or maybe growth kicks back in and solves all problems.

Whatever course of action is taken, one thing is for certain: there needs to be an apocalypse, in the ancient Greek meaning of "cleansing". We must learn from our mistakes, see the error of our ways, reanalyze our trials and tribulations, so that we never again end up in a dead-end like this one. **iBR**



INTERIVEW: MUHAMMAD YUNUS, NOBEL LAUREATE

"I would say that every individual has the power to change the world!"


10
Muhammad
Yunus

BY ESTELLE MERLE ('11) + RAPHAEL LANGENSCHEIDT ('10)

SOCIAL BUSINESS: THE NEXT BIG IDEA

Prof. Muhammad Yunus received the Nobel Peace Prize in 2006 for his pioneering work in microcredit, which has helped millions of people out of the poverty cycle. The first businessman ever to receive such a high honor, Yunus and the Grameen Bank he founded revolutionized conventional ways of banking, creating a system of lending money to the poor, mostly women. The editorial staff of iBR had the opportunity to meet Prof. Yunus in London, and chat about his upcoming initivatives and projects.

IBR: Very recently at the World Economic Forum in Davos, you stated that for social business it is important to understand that human behaviour is not only characterised by the selfish behaviour of profit maximisation, but also by selflessness. Don't these two aspects of human nature stand in direct conflict with each other?

Prof. Yunus: Yes, they conflict, but they still coexist. At times we are selfish, at other times we are selfless when we see people in distress. For example, after the recent disaster in Haiti, millions of people reacted emotionally; they wanted to help, give money or contribute in any other way to the rebuilding process. But on another day, the same person will probably not give a dollar to a beggar, because he/she wants to keep it for himself. We are all human; we have many different kinds of emotions inside us.

Some people believe that microcredits work especially well because of the pressure that originates from the moral obligation instilled by the closed, local communities in India. Many western countries, including the United States and Germany, are rather based on individualism. Since you are now introducing microcredits in western cities, such as New York, how can these two views be reconciled?

Those who are saying that it would not work did not go and do it. They are merely speculating. We go into the different cities and do it and we have seen that it works the same ways, whether in Bangladesh or New York City. Recently, we started a project in Omaha, Nebraska and we see the same thing. It works beautifully.

Has there been any country where microcredit schemes have not worked?There are many countries where it did not work, but it is not because of the country, it is the people who are trying to implement it who do not know-how to do it. There were many projects that failed to be implemented in the USA, so people said it would not work. But we decided to take our people from Bangladesh into the US to teach them to do it and since then it has been working very well. So it is not the system or the methodology that is the problem, it is the way somebody applies the methodology. And it is not easy, people need to be open-minded and ready for change.

Ludwigshafen, Germany, March 5, 2009: BASF SE and Grameen Healthcare Trust have announced the establishment of a joint social business venture.

To what extent are the programs different in NY than for example in Bangladesh?

Exactly the same, because we send the people from Bangladesh, they do not know anything about the US, its people or its culture; so they do exactly the same as in Bangladesh.

To what extent do you see the financial crisis as an opportunity to redesign or rather a setback to previous efforts?

I am always pointing out the opportunity side, because as I said the system is not working and a lot of problems were accumulating without us doing anything to fix them. This is a good time to use our understanding of what has gone wrong, apply new ideas, redesign the system, start new, fresh; rather than go back to the same old place we are coming from. If we do not do anything it will lead to the same disaster again. It is our responsibility now to correct it and we have the freedom to do it, because people cannot argue anymore that nothing is going wrong. And all of us have to realise that it is obligatory rather than a passing thought. But so far not enough attention is being paid to the designing side yet and that is a misfortune.

Do you think in general politicians have so far rather been trying to find scapegoats and people to blame, rather than thinking of the opportunities the financial crisis has created?

Politicians have to work to contain people's frustrations, so they have to find some explanations, sometimes they pass on the blame so that people see there is an explanation, so that they feel happy. I do not think that they are trying to cheat people, but what they are trying to achieve is to bring in some hope. They have to say, "yes we now know what is the problem, it will be fixed", because if people can regain their confidence, then the situation can go back to normal. There is a lot of psychological management involved. Politicians have to always be upbeat even if they don't know the solution.

What was your general feeling (the general consensus) at the World Economic Forum now in Davos, was there a positive vibe towards social business? Was it mentioned as part of the solution to get out of the crisis?

Yes, at least they were discussing social business and we were promoting that. That was our main goal to bring it to their attention. And we have seen a lot of attention, 3 years ago nobody paid attention, but today there is a lot more attention, understanding and curiosity among the economic leaders, which is a very positive development.

What exactly is the concept underlying the Grameen Creative Labs and to what extent do you believe the 2015 targets can be reached?

Grameen Creative Labs is an initiative how to promote the idea of social business and how to bring businesses into getting involved. It is mostly young people who run these labs, explaining the concept to other people. No matter how simple it may look, it needs a lot of explanation. Business people in general are very sceptical, they have to see every case, somebody has to make presentations, answer their questions, so that at some point they will be satisfied and feel closer to the idea of social business. So the Grameen Creative Labs have taken on that responsibility of communicating the idea of social business to potential investors. It is young people voluntarily getting together and gradually spreading the idea of social business. So far we have got Grameen Creative Labs in Japan, the UK, Germany, Bangkok, a lot of places and many more will come...Hopefully soon at Oxford, or at the Wharton School in Pennsylvania, too...(laughs)

After the apparent success of the Danone joint venture in nourishing children, you recently announced a new joint venture with Adidas with the suggested goal that "every human being should have a pair of shoes". What does the future of this project look like and which other ones can be expected?

Pretty exciting, there is a great need for it, the concept looks reasonable, cheap so everybody can afford it. Shoes are important so that people feel comfortable and most importantly, they protect them from diseases. Adidas is the best company to do that, because if Adidas does it Nike and other companies are likely to follow. Hence more and more companies will come into the spirit of social business and make it part of their competitive strategy.

Recently you mentioned the long-term vision of having something like a "social business stock market." What would that actually look like?

It could be a stock market just like the traditional financial stock market in theory, but here people will not come to make money, here they would invest to

make a big impact in the world. The goal would be that poverty is reduced and in order to help achieve this, they can evaluate the best social company to invest in and hence encourage them, applaud them by putting money into their stocks. The more companies start receiving such applause, the more encouraged they will feel, the more successful they will become, because now they have money and support.

How far away do you think we are from that?

This should not be too difficult to achieve, it only needs a certain number of social businesses to list and the right mentality of the people. Once there would be enough companies listed, people could start buying shares and selling shares, not for making money, but for underwriting their support for the various companies.

Many students, especially in business school today, want to be investment bankers or consultants, how do you think it would be possible to change their motivation away from solely monetary terms towards more social responsibility?

Young people always like to be achievers, but they have to be presented with the opportunity to achieve in a certain area. If we can add another line of achievement besides financial goals, some will choose this direction, like social business. Here the achievement would be not only making money for oneself, but solving problems, using one's talent and ideas to solve some of the most severe issues of the world. Then people would start to recognise this is a great thing to do; this person has changed the world, has changed the whole way of looking at the problem and that person would immediately get recognition. That opportunity does not exist today, but social business is becoming more popular and some business schools are now creating social business chairs and are opening institutes for social business. Gradually students will have the opportunity to make the decision whether they want to go into social business activities or they will go do the traditional activities.

Do you find that business schools so far are quite receptive to that idea?

Yes, very receptive, all the ones we talked to so far have been very open-minded and receptive. Some have adopted it already; others are on the way to adopting it. They listen, because they know it is a serious matter and the times are calling for changes. They want to include it into their curriculum, introduce specialised courses. We have only been promoting this idea to introduce social paths into business schools for the past 3 years, and there has been a lot of change already. It is important to change the mentality and attitude of the new generation, tomorrow's leaders.

As of today, how can university students realistically get involved with the social business concept?

One easy way would be to start a nucleus of Grameen Creative Lab. It would start like a club to begin with and gradually become more formally organised. Then faculty members could be brought on board, as well as academics, business people. Then you could see if you can create a social business, try to network with other social businesses or Grameen Creative Labs, get to know each other, participate, observe and support each other.

What single piece of advice would you like to pass along to our student readers still in university today?

I would say that every individual has the power to change the world! So we do not have to feel small by thinking "What can I do? These are big, influential people, they can do it." This idea has to go. I may be small in the context of large, but I have the same mind-power and creative power as everybody else and if I come up with one idea it might be that it is my idea that can have the spark to change the whole thing.

We all have a tremendous capacity to achieve, we just have to believe in ourselves and go out and try it. If you can get 3 or 5 people out of poverty or create 5 new jobs then other people will start looking at the way you did it and your idea will spread and affect more and more people. And your idea might work in a lot of situations, no matter whether in NY or a remote village in Guatemala.

Do not give up, use your capacity, you have got it in you, use it and do not let it go. **iBR**

"SO FAR WE HAVE GOT GRAMEEN CREATIVE LABS IN JAPAN, THE UK, GERMANY, BANGKOK, A LOT OF PLACES AND MANY MORE WILL COME - HOPEFULLY SOON AT OXFORD, OR AT THE WHARTON SCHOOL IN PENNSYLVANIA, TOO..."

BY LUKAS F. STREIFF ('06) + JULIA COHEN ('10)

Lukas F. Streiff is a Master of Public Policy Candidate at the Harvard Kennedy School of Government, focusing on security and energy policy. In 2009, he spent two months in Pakistan as a Visiting Research Associate at the Institute of Strategic Studies Islamabad, conducting research on the geopolitics of energy in the region.

Julia Cohen is a senior in the College of Arts and Sciences at the University of Pennsylvania, and majors in PPE (International Relations) and Hispanic Studies.

PAKISTAN'S GAS CRISIS: PIPE DREAMS & EMPTY PIPES

Pakistan's economic woes lie at the center of the fight against jihadist radicalism.

While the spotlight of global media centers on Pakistan's struggle with fundamentalist insurgency, few observers in the West grasp the complex pattern of factors that underlies the country's instability. The Taliban and other radicals in the rugged Afghan borderland are by far the most visible threat, but they are not the source of Pakistan's instability. Never have they influenced the affairs of the Pakistani heartland – in fact, the relationship is the inverse. The Pakistani Taliban are an outgrowth of radical Sunni networks in the political and economic heartland of Pakistan: the Punjab, Pakistan's most prosperous and industrious province.

Radical groups in the prosperous population centers have supported the Taliban in the border regions, and they have attracted ever more supporters and funds. This country of 160 million has failed the people's hopes for better governance and a prosperous future for decades . There is no doubt that this subtle slide into desperation goes a long way to explain the increasing instability of politics and society.

So many pipes, so little gas

Pakistan's economic woes lie at the center of the fight against jihadist radicalism – a fact that the Obama administration is keenly aware of: the United States will pour $7.5 billion of non-military aid into Pakistan in the coming five years alone. Yet, some of the highest barriers to economic progress in Pakistan cannot be solved by money alone.

Take the electricity crisis: for decades, industry analysts have urged Pakistan to put a sensible strategy for investments in electricity generation on track, but one government after another has insisted on starting from scratch, only to outdo its predecessor in corruption and mind-boggling mismanagement. The result: electricity is rationed all over Pakistan, often for over half of the day. "Load-shedding", as the government terms the loathed practice, has caused hundreds of thousands of layoffs in industry and countless violent demonstrations.

With no end to the electricity crisis in sight, Pakistan is now facing yet another serious energy crisis: the state is unable to provide sufficient amounts of natural gas. This winter marked the beginning of a serious gas crisis in Pakistan – and again there is no easy way out. The Pakistani people and their economy will face the pressure of the gas crisis for years, if not decades – a formidable barrier to economic progress and another source of social unrest and vulnerability to radicalization.

Pakistan is one of the most gas-reliant countries worldwide. Decades ago, it made a strategic decision to base its energy mix on domestic gas reserves. Industry, electricity generation, the production of fertilizer and chemicals, residential heating and cooking all rely heavily on natural gas. In addition, Pakistan has the most gas-dependent transportation sector in the world: over two million compressed natural gas (CNG) vehicles are now struggling to fill up.

Fallout from demand-side responses

With the gas crisis looming in the fall of last year, the Pakistani government announced a policy designed to limit gas supply and increase the price by 26%. The measure restricted gas supply to industry and mandated that CNG gas stations must close for eight days a month on a rotational basis.

Commerce and private consumers reacted in uproar. Industry, trade, and business associations immediately warned that the competitiveness of Pakistani products in the global market-place would take yet another hit: as gas cuts slow down production schedules, costs are expected to rise between 15% and 20% in the winter months alone. Naturally, slowing production schedules cause cuts in the labor force – especially in a country with little labor protection like Pakistan: 32% of all workers are daily wage earners, especially vulnerable to layoffs.

The Pakistani government could scrap the generous gas subsidies that were originally put in place to incentivize private consumers to retrofit their vehicles to CNG and heat their houses with natural gas. The people have proven beyond the shadow of a doubt, however, that they will meet subsidy cuts with fierce and even violent opposition. In a country like this, where over 80% of GDP relies on industries and services with heavy dependence on primary energy, measures to reduce demand and restrict supply are met with intractable domestic opposition – a proper reorganization of the Pakistani gas market is virtually impossible.

The Balochistan Problem

Pakistanis falsely believe that they sit on abundant domestic gas reserves. The largest gas deposit, the Sui gas field in Balochistan, will peak in output this year, dropping continuously after that. All other existing gas reserves together cannot compensate for this marked loss. Frantic search for more gas fields has proved unsuccessful, and so a very inconvenient truth emerges: all the substantial gas deposits that remain are likely to be located in the province of Balochistan, the restive province on the Pakistani border with Iran.

In the words of a prominent industry journalist, the Sui gas field in Balochistan is "a war zone". The ugly conflict between Balochi secessionists and the Pakistani government that festers since the independence of Pakistan in 1947 has made the development of further gas fields utterly impossible. With Balochistan blocked and no other deposits in sight, Pakistan is unable to increase domestic supply – as rich in gas as Balochistan may be.

The Pakistani Taliban are an outgrowth of radical Sunni networks in the political and economic heartland of Pakistan: the Punjab, Pakistan's most prosperous and industrious province.

At the heart of the gas crisis lies Pakistan's inability to develop its domestic reserves of natural gas while demand continues to rise. The result: an imbalance of supply and demand. Domestic supply, currently at around 3.9 billion cubic feet per day (bcfd), is expected to drop to only 2.11 bcfd by 2020, while demand already exceeds 4.7 bcfd and will continue to grow at around 10% per year to 8.6 bcfd by 2020. Worse in winters than in summers, Pakistan will be short of an average of 2 bcfd this year. By 2020, analysts expect a shortfall of between 2.9 billion and 6.5 billion cubic feet of gas per day – a multiple of domestic production.

Pipe Dreams

In the absence of domestic supply, only imports can satisfy demand. The cheapest and most sensible solution to the gas crisis lies in pipelines that would allow Pakistan to import from its neighbors, the most notable being the Iran-Pakistan-India (IPI) pipeline. Even though President Zardari approved the IPI pipeline last year, construction remains an elusive dream.

The challenge of Pakistan's gas crisis is daunting and cannot be evaded - the country is too dependent on natural gas for a drastic shift away from the resource.

The scale and financing of the pipeline depends heavily on the question of whether India will join the project. So far, India has remained reluctant, claiming concerns about the high gas price demanded by Iran but probably facing strong pressure from the US, as the pipeline would open up lucrative markets for Iranian gas. Furthermore, it remains unclear how Pakistan intends to finance its share of the costs, estimated at $3 billion. Most importantly, 90% of the Pakistani part of the pipeline would run through the instable province of Balochistan. Many analysts fear that it will be utterly impossible to protect this pipeline over hundreds of kilometers. These security concerns link back to the problem of financing, as potential investors shy away from the incalculable risk.

An alternative pipeline project is being discussed by Turkmenistan, Afghanistan, India, and Pakistan. Promoted by the United States as a substitute for the IPI pipeline, the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline project intends to link India and Pakistan to the world's third largest gas deposits in Turkmenistan. However, security trumps all here as well: with the abhorrent security situation prevailing in Afghanistan, the TAPI pipeline remains wishful thinking.

No way but forward

The challenge of Pakistan's gas crisis is daunting and cannot be evaded – the country is too dependent on natural gas for a drastic shift away form the resource. Therefore, Pakistan has no choice but to engage all levers: The government should reduce demand by courageous cuts of subsidies to the extent that public pressure permits. It must make rapid and substantial investments into the port infrastructure necessary for gas imports in the form of liquefied natural gas (LNG). It must work tirelessly toward the rapid conclusion of negotiations about the IPI pipeline – with or without India – and start a serious bid for financing. Beyond all else, though, the Pakistani government must realize that it cannot afford its confrontational stance against the Balochi separatists while a gas crisis lagues the country. Pakistan's Balochistan policy is diametrically opposed to its energy policy.

The West must place enormous priority on helping Pakistan mitigate the detrimental effects of the gas crisis on its economy and the hearts and minds of its people. Of course, only dependable data could clarify the exact correlation between economic underperformance and radicalization in Pakistan. Western nations have no time to squander, however: we must realize that any and all help we can offer the Pakistani people as they try to overcome the gas crisis would help reverse the disconcerting trend of economic frailty, political instability, and sliding radicalization. Does this mean that we should relax our opposition to the idea that Iran makes good money from a new gas pipeline to Pakistan? Maybe. Tough calls on conflicting policies have always been the stuff of high-stakes politics. **iBR**

BY CHENG-WEN (CHARLES) TSAI ('13)
Charles is a Taiwanese freshmen in the Jerome Fisher Program, concentrating in Actuarial Science and majoring in Materials Science & Engineering.

2010 YUAN RELATIONSHIP STATUS: IT'S COMPLICATED WITH THE USD

With Facebook blocked and Google censored, China continues to appear on headlines with more controversies in 2010. Most notably, the Chinese Yuan's future draws attention from students and adults alike. According to the latest 2010 Big Mac Index, the Chinese Yuan remains roughly 50% undervalued against the dollar. Recent Chinese news report that despite mounting external pressures for stronger Yuan, China will remain firm on its stable currency in 2010. However, several recommendations and expectations from renowned economists and officials in January have refocused spotlights on this economic "Peking opera".

Circumstances for China are intensifying by external and internal factors alike. In his November visit to China, President Obama reemphasized to President Hu that the Yuan is seriously undervalued, "disadvantaging competitors and distorting global economic flows". He wishes China to "make an essential contribution to the global re-balancing effort" by strengthening Yuan. Such claim is not purely political. As Citigroup (Greater China) Chief Economist Shen notes, unemployment rates topping 10% in US and Europe raise stronger protectionist pressure against China, thus stimulating pressure for stronger Yuan. In addition, as Standard Chartered Chief Executive Peter Sands predicts, "dollar is likely to weaken this year". Consequently, China's domestic inflationary pressure will heighten if Yuan remains unchanged against USD, as Yale professor Zhiwu Chen asserts. The Department Research Center of State Council also revealed another hidden circumstance. It predicts that while China's CPI might not rise significantly, asset prices are likely to rise greatly, and risk of bubble burst calls for revalued Yuan in 2010.

Despite such circumstances, China remains firm on keeping Yuan stable according to January Chinese press releases. The People's Bank of China(PBC) announced that it will "keep the Yuan at a reasonable and balanced level in 2010". Premier Wen also reiterated that "we will not submit to any pressure for revaluation, especially given the protectionist measures we now encounter, as they will stymie China's growth". He substantiated with "stable Yuan's contribution to global community during the 1998 economic crisis", and he believes stable Yuan is currently "in the best interest of the international community". PBC Governor Zhou Xiaochuan expressed similar stance, noting China is currently financially unsuitable for significant currency reforms. He does, however, highlight in his New Year's Address that China will move towards more accommodative policies, stressing 2010 as the critical year for financial recovery.

Measures on Yuan's future are thus now defined as "moderate" and "progressive" by Chinese officials. The recent Central Economic Conference concluded that the Yuan will be allowed to strengthen slightly in 2010. According to Chinese press, foreign exchange analysts predict the Yuan will remain hovering around 6.83 in first quarter, but appreciate 1% to 6.75 in second quarter, and may strengthen 3% by end of 2010. They also asserted that while Central Bank won't change given stagnant exports in first half of 2010, the potentially recovered net exports will bring about higher chances of stronger Yuan and greater fluctuation. In response, Governor Zhou announced that PBC will increase interest rates at most twice this year, each time by 0.27 percentage points.

Given these new year projections, China's Great Wall against foreign influence appear to remain firm, but not without flexibility. Truth is, no one can accurately predict the Yuan's future. As a Chinese proverb goes, "It's not economical to go to bed early to save the candles if the result is twins". Therefore, 2010 will be an intriguing year, especially for Big Macs in China. **iBR**

BY LINFU (FRANK) ZHANG ('12)

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UNITED STATES AND CHINA:

TRADE IMBALANCES

China's trade surplus with the United States for the year 2009 is estimated to be around $198 billion, significantly lower than the record $295 billion in 2008.

There are few topics more frustrating for U.S. policymakers than the country's growing trade deficit with China. The China-U.S. Strategic Economic Dialogue initiated by President Bush in 2006 has produced few tangible results, and despite his campaign promises, President Obama has made little progress in altering the trade relations between these two nations. In more recent news, Chinese officials responded to the U.S. imposing a 35% tariff on Chinese-made tires by announcing an investigation into the alleged dumping of U.S. automobile parts and chicken products in China. While this situation is not expected to further escalate, it is a good reminder of the strained relationship between the two nations.

China's trade surplus with the United States for the year 2009 is estimated to be around $198 billion, significantly lower than the record $295 billion in 2008, but still a substantial source of friction between the two countries. Unfortunately for both sides, the economic relationship between the two nations has become far too complicated for there to be any obvious solutions. While the U.S. points its finger at China's undervalued yuan and protectionist policies, China counters by blaming American citizens for habitually spending beyond their means. Neither argument is without merit. There is no doubt that China is keeping its currency artificially low to help its exporters. On the other hand, China is right in saying that if the U.S. borrowed and spent less, the trade imbalance would be smaller.

What is perhaps more interesting is that these two arguments are not unrelated. For over a decade, China has been fueling America's spending habits by lending increasingly large sums of money to the U.S. through its purchase of U.S. Treasuries. Americans, in turn, spend this money on Chinese imports, sending the dollars back to China, who lends it to the U.S. again. This continuous cycle has resulted in China accumulating close to $800 billion of U.S. Treasury securities, surpassing Japan as the largest holder of U.S. debt. At the same time, China's purchase of U.S. government debt and mortgage securities has allowed it to keep the yuan from appreciating too much against the dollar.

Because of its enormous reserves in U.S. Treasuries, China has been growing increasingly concerned with America's burgeoning deficit and its ability to guarantee the safety of China's holdings. Despite continued assurances from U.S. Secretary of the Treasury Tim Geithner and President Obama, Chinese officials realize they stand to lose billions if the U.S. dollar continues to weaken against the Chinese Yuan. Unfortunately, there is little that can be done to improve the situation. While China would like nothing more than to be able to decrease the size of their holdings of U.S. debt, any sign from the Chinese government that they would stop purchasing these Treasuries will lead to an immediate decline in its value and consequently the value of China's own reserves.

For the U.S., one of its major concerns is how to get China to let its currency appreciate. China's currency, unlike that of most developed nations, is not determined by market forces but rather set by the Chinese government and currently pegged to the dollar. Though China has allowed the yuan to rise 21% against the dollars from 2005-2008, since the economic crisis it has kept the rate fixed despite that fact that almost all economists agree the yuan is still undervalued. The U.S. has repeated argued that the current exchange rate of 6.83 yuan/dollar is much too high and strongly favors Chinese exporters over U.S. manufacturers, resulting in the current trade deficit and a steady loss of jobs for the U.S. Further, the U.S. has been trying to convince Chinese officials that a stronger yuan would benefit China but reducing its dependence on exports for economic growth.

China, however, has rejected the accusation that its exchange rate policy gives it an unfair advantage. Chinese officials have noted that, by tying their currency to the declining dollar, the yuan has actually risen against every major currency except the Japanese yen. Furthermore, Beijing argues that it has already played an important economic role in the financial crisis last year through its highly effective monetary and fiscal stimulus. Additionally, the fact that China's current account surplus has declined almost 50% since 2007 combined with the struggles Chinese exporters are facing in the difficult economic climate makes it unlikely that the government will change its current stance. Finally, many Chinese economists believe that the benefits Americans hope to gain from a yuan revaluation are exaggerated because there is relatively little overlap between Chinese and American manufacturing, which means American consumers would simply end up paying more for the same amount of Chinese imports.

Any sign from the Chinese government that they would stop purchasing these Treasuries will lead to an immediate decline in its value and consequently the value of China's own reserves.

Though there is no immediate solution to these problems, there have been some positive signs of change. The recent financial crisis has produced at least two beneficial results. First of all, Americans are changing their lavish spending habits, marking at least the temporary end to the zero or negative personal savings rate. While this may be painful in the short run, an increase in savings in the long run will lead to more investment and thus more capital for domestic businesses and of course a reduced trade deficit. Secondly, the financial crisis woke China up to weakness of their export driven model. Though this model has been very successful over the past 15 years, to sustain its economic growth China has been focusing on encouraging its citizens to open their wallets and increase domestic consumption. Both of these factors combined could potentially reduce the trade imbalance and lessen the political and economic tension between the two nations. **iBR**

Dubai World tried to restructure its debt prior to the announcement.

BY HAMAD A. ALMUDHAF ('11)

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MIDDLE EAST:

DUBAI WORLD'S MORATORIUM: ...A SURPRISE?

Last November, a statement from the DubaiDepartment of Finance stunned financial markets across the globe.The announcement stated, "Dubai World intends to ask all providers of financing to Dubai World and Nakheel to 'standstill' and extend maturities until at least May 30th." In a short trading session(day before Thanksgiving),the DJIA fell 155 points, the FTSE 100 dropped 3.2%, andHong Kong's Hang Seng index tumbled by 2 percent. Oil prices rapidly dropped by 7 percent that day but eventually made a modest recovery. The cost of Dubai contracts doubled, landing the emirate high on CMA's Sovereign Risk Monitor Highest Default Probabilities list. This leads us to ask the simple question: did this news of the company's$26 billion debt moratorium warrant such a shock?

Before addressing the question, it is important to note the company's brief history. Dubai World, one the emirate's global investment vehicles, came into existence in March of 2006. The holding company includes several notable subsidiaries, including Dubai Ports (DP) World and Istithmar, owner of high-end luxury retailer Barneys New York. DP World made headlines in 2006 whenit secured a deal to operate six major American ports, stirring up a national security controversy. Despite presidential support, DP World resold the contract to AIG. Dubai World's property branch, Nakheel, is another major subsidiary and the main entity entrenched in the current debt restructuring. Responsible for ambitious projects such as the largest man-made islands,Palm Jumeirah and The World Islands, Nakheel was one of many Dubai World subsidiaries to be heavily downgraded by rating agencies.

The announcement should not have come as a surprise. The signs of a financially strapped Dubai World wereevident long before the debt moratorium'sannouncement.

The first sign wasthe real estate bubble burst, as itposed adefinitedetrimental affect on Dubai's largest property holder and developer, Nakheel. The Knight Frank Global House Price Index stated that, globally, "Dubai recorded the largest annual drop (-47%)." Additionally, a myriad of Nakheel's grand projects were haltedin early 2009 because of the credit crisis, such as a to-be world's tallest one-kilometer tower in January, the Worlds of Discovery theme park in February, a $3 billion mall expansion project in March, and the famous World Islands.

The second signal wasthe preparation of contracted engineering companies since April of 2009 for a possible Dubai World default. The "New Civil Engineer" magazine's April edition ran an article stating thatgovernment-backed "real estate developer Nakheel has not paid debts amounting to more than $290 million" to engineering companies in the UK. One of these companies, Atkins, released a statement in the third quarter of last year saying, "We expect that cash collection will remain challengingfor at least the next few months." At the same time, the WSP group, an engineering consultancy and another company that Nakheel owed money to, announced implementing"appropriate and prudent provisions in respect of potential impairment of trade receivables and unbilled amounts due on contracts in the Middle East."

The third indication was the fact that Dubai World tried to restructure its debt prior to the announcement. The company attempted to restructure in-house with massive layoffs and project postponements and cancellations. Additionally, according to the Reuters News Agency, in April of last year, Dubai World hired Rothschild investment bank "to advise on $20 billion support fund to help indebted companies." In May, former Dubai World Chairman Sultan Ahmed bin Sulayem was quoted, "everything that cannot currently be financed will be delayed." A month later, the company contracted Alix Partners to aid in the restructuring process. In September of last year (two months before the 6-month standstill), Dubai World entered into talks with its primary lenders to rearrange approximately $12 billion in debt. That same month, Nakheel's properties abroad were transferred to Dubai World's investments division, Istithmar, yet another indication of the company's distress. Lastly, a month before the announcement, the government issued another Islamic bond for $2 billion dollars.

The fourth sign was the general nature that Dubai was built on: excessive spending, overbuilding, and extreme overleveraging to finance its tourism industry. Add the debilitating effects of falling oil prices and a liquidity crisis on such an economy, and the outcome appears less and less of a surprise.

Although a warning could have mitigated the announcement's effects, the standstill ought to not have come as a surprise, especially since Dubai 'soligarchic nature benefits from it. Not to mention that with the multitude of high-level position shuffling across Dubai World's subsidiaries and organizational restructuring, a change was imminent. By Mid-December, Abu Dhabi, the nation's capital, announced a $10 billion bailout of Dubai World. The oil-wealthy state recently faced a bombardment of Moody's downgrades of government-linked companies such as Mubadala and Etisalat. Dubai World's bailout money will run out in April of this year and the committee formed in response to the debt standstill announced it will "present creditors a 'fair' plan to protect long-term relations with banks and contractors."The prospect of another bailout isbleak, however despite this, the business community awaits Dubai World's restructuring proposal due at the end of April. **iBR**

The signs of a financially strapped Dubai World were evident long before the debt moratorium's announcement.

BY HAMAD A. ALMUDHAF ('11)

MIDDLE EAST: DUBAI'S DEBACLE

Pakistan's economic woes lie at the center of the fight against jihadist radicalism.

In a continuation of the iBR's special topic on Dubai, this article explores the major causes and remedies behind what we term, "Dubai's Debacle." While the business community awaits Dubai World's six-month restructure proposal, this article also presents a point of view on the optimal restructure plan.

The first and primary cause of the debacle can be traced back to the corporate structure created to develop the Dubai Empire. This structure, established to achieve the Ruler of Dubai's long-term vision, remains obscure. The emirate's corporate structure is marred with vagueness, as company ownerships remain uncertain and the legal status of its entities remains ambiguous. Unfortunately this structure is even more unclear to the outside world, specifically to the world of finance and money.

One example of the problems caused by this lack of structure transparency is the misconception that loans to government-linked entities were government-backed. It also allowed for relaxed lending requirements to Dubai's companies. This misconception also affected credit rating agencies that tended to overlook the matter. Many of the same agencies—who are now currently withdrawing their ratings on the grounds of transparency and sharing of information—had initially given companies the best of ratings. The transparency and information sharing nature of Dubai remains unchanged and vague.

A second cause of Dubai's Debacle was leverage. The excessive leveraging was simply unsustainable. History provides us with many lessons, and excessive leveraging has precedence. The collapse of South Korean business conglomerate SSangyong during the Asian Financial Crisis is a lucid example of extreme leveraging and its effect. Unfortunately,

Outstanding Public Sector Debt

As of December 2009

US$ million	Disclosed Debt	Other Est. Liab.	Total Est. Liab.
Dubai World	26,219	7,866	34,085
Dubai Holding	15,090	4,527	19,617
ICD	28,275	5,655	33,930
Dubai Government	18,700	0	18,700
Other Entities	1,885	0	1,885
Total	**90,169**	**18,048**	**108,217**
Total (ex-Gov)	71,469	18,048	89,517

Source: Dealogic, Loanware, Bloomberg, Morgan Stanley Research the lesson was ignored. According to the Dow Jones newswires Dubai faces $61.1 billion of debt maturing over the next five years, which accounts for corporate entities. However, uncertainty still surrounds how much Dubai, as a whole, owes financial institutions.

The third reason reflects upon project financing. Infrastructure and massive projects need long-term financing. Constructing a city such as Dubai is not a short-term scheme, and one cannot structure such long-standing projects with short-range financing. Massive projects with long development time need properly designed project finance, which takes into account all risk factors. In the case of Dubai, such long-term financing was lacking. As a result, many projects were stalled in the advent of the crisis such as the World Islands and Burj Dubai (later renamed Burj Khalifa).

The final cause revolves around the incorrect usage of Islamic Finance by corporate entities such as Dubai World. Such entities followed a classic case of "use of good words for bad purpose". The entire business model of Dubai does not fit into the model of Islamic Finance. The Sukuk structure was constantly in dispute and all the financing and servicing of finance did not come from halal sources, therefore nullifying its Islamic Finance structure.

Restructuring is an intricate, painful, and time-consuming endeavor. Large scale restructuring in the region is unprecedented and will provide a great framework for future restructuring. Dubai's restructuring plan must come from the root of the emirate's problems:

1. Structure

Restructuring must start with Dubai's firms' corporate structure. It should be fully transparent and independent of the government in article of association itself. The organization must be fully professional with very high ethical standards and moral values. Holding companies should separate companies with clear business lines and synergies. These entities should have an understandable distinction between the corporate entities and their debt, the laws that govern these entities, their debt, and their bankruptcies. The assets of these companies should not be considered assets of the Ruler, especially since assets of the Ruler under present law cannot be publicly auctioned. All these laws and their provisions must be clearly defined.

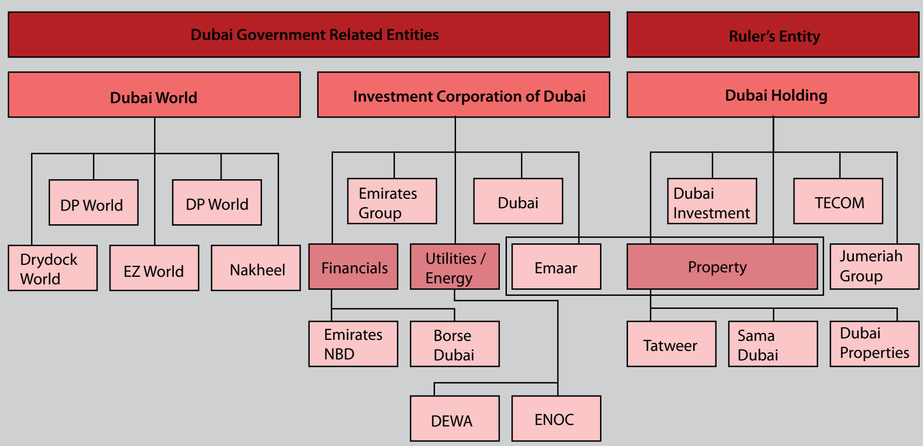
2. Leverage

Companies need to define their core business assets. All non-core assets should be placed into a single Special Purpose Vehicle (SPV) under an escrow account with lenders. Lenders also need to be more transparent and should have the transaction rights on these assets (with full ownership). These assets should be sold over the time frame of three to five years and entities should proceed to pay lenders at base value.

3. Project Financing

All ongoing projects must be studied and revaluated. Lenders should be given maximum equity in these projects, without considering any inflow during execution period. Debt should be converted to long-term project financing on a project-to-project basis. These should be in a 15 to 20 years plan.

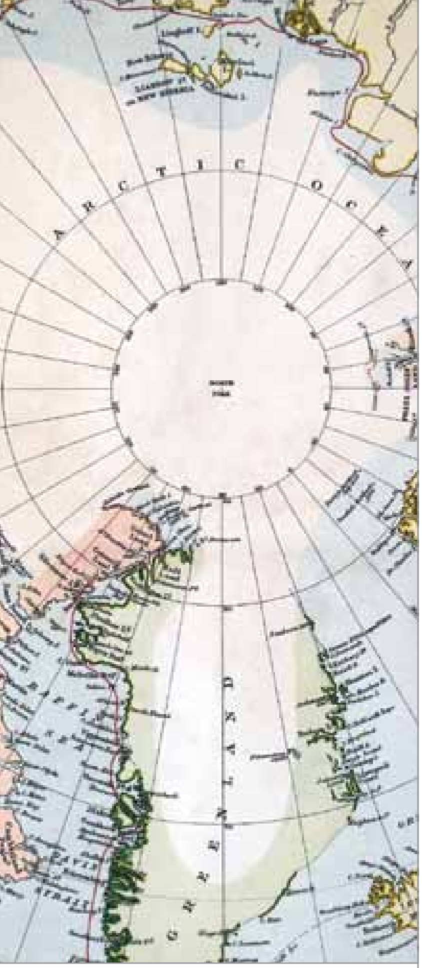
Organization Structure of Dubai's GREs



Source: Morgan Stanley Research

4. Islamic Finance

Entities such as Dubai World must create a separate unit whose complete business follows Islamic jurisprudence as defined by Shariah. The best hybrid structure of project financing, an SPV of a hybrid Murabaha/Musharaka Sukuk (Islamic bond), should be used to finance projects. An alternative hybrid structure of project financing, such as Istisna along with Ijara and a Sukuk structure that is fully compliant with the Shariah of long maturities, can also be used to refinance. **iBR**



Some estimates say the Arctic Ocean is home to 13% of the world's undiscovered oil.

BY DAVID VINNIKOV ('13)

David Vinnikov is a student at the Wharton School. He grew up in New York City.

TAPPING THE NORTH POLE: THE "NEW" COLD WAR

A lone protester holds a sign outside of Huntsman Hall, asking people walking by to take a flyer. She asks them to listen about the consequences of global warming in the Arctic Ocean; receding ice, rising sea levels, and hungry polar bears. But while climate change has occupied the minds of activists and the public for years, chances are that the receding sea ice she warns us about is revealing far more than anyone ever expected. A geopolitical land grab, unseen since Europe's 19th century colonization of Africa, is slowly emerging for the shipping lanes and natural resources that are no longer blocked by Arctic ice. It is a game with a pot worth trillions of dollars, with Russia as the biggest player at the table.

Russia's focus lies on trade routes sought since the 16th century, the Arctic Bridge, running along Greenland's coast, and the Northern Sea Passage along her Arctic coast. In 2009 these two routes, along with the Northwest Passage between Canada's northern islands in 2007, opened to cargo ships without the assistance of ice breakers. With these lanes no longer blocked by arctic ice, shipping from Murmansk to Churchill, Canada by the Arctic Bridge takes as little as 8 days, a 50% reduction from the 17 days it takes a ship to travel through the toll-charging St. Lawrence Seaway. The Northern Sea Passage allows a 40% drop in transportation time from the Korean Peninsula to North Europe, while the Northwest Passage shaves 2500 miles off routes between East Asia and West Europe and lets shippers avoid the $1.44 bn the Panama Canal charged in tolls in 2009.

Control and development of these routes has great significance to Russia. Murmansk, Russia's chief arctic port, has been in constant decline since the fall of the USSR, seeing its population fall by 35% in 20 years. The reestablishment of these two routes would remake Murmansk as one of the shipping capitals of the world. The Arctic ports abandoned after 1990 would be revitalized. The staggering falls in shipping time would make the use of, and taxation by, Russian land and waters irresistible to exporters throughout Europe, Asia, and the Americas; a cargo shipment through the Northern Sea Passage by the German company Beluga Shipping claimed savings of $300,000 per vessel over the Suez Canal route. Lastly, control of the Northern Sea Passage would give Russia geopolitical power over her neighbors, who would have no choice but to jump at the ability to cut shipping times in half, avoid the pirate-riddled Strait of Malacca and the Gulf of Aden, and use cargo ships exceeding "Suez Canal"-max capacity. Russia's Eurasian location, once on the outside looking in, would transform into a central highway for the world's trade.

Even more importantly, the North Pole has vast amounts of oil and natural gas. Some estimates say the Arctic Ocean is home to 13% of the world's undiscovered oil; in 2000, the United States Geological Service suggested that number may be as high as 25%. The Shtokman gas field in the Barents Sea, currently under $20 bn Russian development, is believed to house double all of Canada's gas reserves. Large amounts of minerals are believed to be located on the seabed. In a world of falling supplies and hostile suppliers, the Arctic may prove to be a "Black" Gold Rush.

Russia is well positioned to win this race. 80% of oil extraction and nearly all gas extraction in the Arctic are currently done by Russian companies. Russia has significantly more Arctic coast line than any other country. Its national champion, Gazprom, is well capitalized, fully supported by the government, and has already begun exploration and drilling in many areas. Russia appears ready to back its claims, planting a flag on the seabed of the North Pole in 2007 and declaring it annexed.

But Russia faces major opposition. The Canadian government ordered $7 bn dollars of naval patrol vessels to "defend its sovereignty over the Arctic," according to Prime Minister Stephen Harper. The United States is using Alaska as a spring board, while The Commission on the Limits of the Continental Shelf, run by the UN, has suggested Norway may have geographical claim to much of the Arctic Ocean, including parts Russia has claimed. Even Denmark ordered a $20 mn investigation to see whether its possession of Greenland's continental shelf extended far enough to give it control of all the vital parts of the Arctic land regions.

The heart of the conflict lies in the application of the UN Law of the Sea. According to it, all nations are given a 200 mile exclusive economic zone (EEZ) from their coasts. This arrangement works well in the lower latitudes, where overlaps between countries are minimal and the seabed is fully mapped. But like a pumpkin, where the different pieces of the shell start off wide and distinct but grow increasingly narrow towards the top, the lines separating territorial claims begin to overlap more intensely in regions around the North Pole.

The claims become even more involved in light of the 10 year UN statutory limit to submit territorial claims, which many nations have missed, and the exemption given to "extended continental shelves." Under this exemption those countries that can show the underground terrain linked to their coasts extends past the 200 mile limit can claim up to 150 additional miles for their EEZ. But this is hardly a clear issue to resolve, as much of the North Pole remains uncharted due to the ice covering the surface. Most bids for territory past 200 miles are based on various hypothetical, unverified scientific statement.

For instance the Lomonosov Ridge, lying beneath the North Pole and extending over 1100 miles, has been claimed by Russia to be connected to the Eurasian Continent, claimed by Denmark to be connected to Greenland, and claimed by Canada as part of North America. The high altitude observation and sonar that discovered the Ridge are blocked by the remaining ice from making a more accurate picture of the geography.

Even a proper geographic analysis will not solve this issue. Since all of the Earth's Crust is connected at some point, Canada's connection to Lomonosov and Lomonosov's connection to Eurasia would mean, under the Law of the Sea's logic, that Canada could claim the entire Eurasian subcontinent as an extension of its shelf. There are considerations for the environment to be taken into account. The North Pole is one of the most fragile environments, any introduction of drilling and commerce would be highly disruptive. Oil spills would be a pressing concern, as the conditions of the Arctic Ocean would slow response times. Maintenance of pipes would be extremely difficult; should a pipe rupture oil would be much harder to remove than in most warm water zones. Such a disaster occurred in 1994, where a pipeline in Russia's Komi region ruptured, spilling over 100,000 tons of oil.

The North Pole is one of the most fragile environments, any introduction of drilling and commerce would be highly disruptive.

And with the degree of uncertainty surrounding many estimates of Arctic wealth, there is concern that the rush for resources will come at great cost with significantly lower benefit. The possibility of cost overruns as companies move into a more demanding environment is substantial; the Norwegian Snøhvit gas field has cost $8.8 billion dollars, 50% above original estimates.

This is an issue unlikely to be resolved for some time. The rate of the ice's recession is uneven, and it may take years for lanes to open to shipping and drilling. The murky legal situation may postpone full use for years after that. But the riches here measure in trillions of dollars, setting the stage for a saga best referred to as "The New Cold War." **iBR**

BY SERGE MORELL ('10)

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Drilling rig in the Caspian Sea.

GERSCHENKRON'S BACKWARDNESS:

E-COMMERCE IN FRONTIER MARKETS

Central Asia, a region tucked away between China, India and Russia, has been a source of contention over the past two centuries. From the intrigues of the Great Game of the 19th century between the British and Russian Empires for control over the famed Silk Road region to the current day struggle, known as the New Great Game, to secure the vast fossil fuel reserves buried in the Caspian Sea, this region remains a frontier market. However, most fail to recognize the potential the region has in areas other than natural resources. With more and more talk of the wireless providers loosing their importance in the next decade with players such as Google and VOIP coming online the chase after growth in the telecom sector is shifting to frontier markets such as Central Asia. There are two major trends that are being witnessed today in Central Asia. The first is the advent of cheap and accessible technology that will allow these developing nations to access the web from their mobile devices and skip over the "desktop and dialup" phase which lasted for 2 decades in the developed world. The second is the growing geopolitical importance of the region attracting both private and public investments from abroad to support either military or commercial interests of major superpowers in the region.

China Mobile, a relatively unknown company in the west when compared to the likes of AT&T and Verizon, can claim more subscribers than all of the American providers combined. Mobile internet revolution is indeed upon us, with some predicting close to 1 billion devices to be online by 2013. Chinese telecoms are signing up some 10 million customers per month and Central Asia seems as the most logical next step. Mobile web has officially taken off in Central Asia and telecoms in the entire region -- Kazakhstan, Uzbekistan, Tajikistan, Turkmenistan and Kyrgyzstan -- are rolling out mobile broadband. Amazingly, these countries got started with next-generation wireless services even earlier than Russia, which is usually first in the former Soviet Union to adopt new technologies.

This phenomenon may be in part explained by the "backwardness model", a theory of economic growth developed by Alexander Gerschenkron in 1950's.

The theory underlines the positive role of economic backwardness in inducing systematic substitution for the prerequisites for industrial growth with state intervention compensating for the inadequate supplies of capital, skilled labor, entrepreneurship and technological capacity encountered in follower countries seeking to modernize. To put it in laymen's terms, emerging economies can learn from the mistakes of the developed nations and make a great leap forward. Throughout history there have been many cases of this phenomenon, i.e. Germany in the 19th century, Soviet Union in the 1930s and the Baltic states in 1990s. Today it is the turn of the frontier markets in Central Asia to catch up to the developed world in the field of telecom and the ability to connect with the rest of the world. In practical terms, that would mean a Craigslist in Kazakh or Uzbek.

Today there are the first signs of eCommerce taking root in some of the most isolated states in Central Asia. Turkmenistan, a country that is ruled by an authoritarian regime that builds golden statues of the president made to rotate towards the sun is ranked as one of the most unfriendly places in the world to start a business. However, Arzuw.com, which in Turkmen means hope or wish, is one of the first online stores to open in the country. The service delivers flowers and jewelry within the limits of the Turkmen capital, Ashghabat. However since no credit cards exist in Turkmenistan, the target audience is the Turkmens living abroad, who want to deliver gifts to their relatives back home through the internet.

Mobile payment is another important trend to watch in Central Asia. In fact this one of the few last hopes for the telecom providers to stay in the game. This method of payment which allows people to transfer cash using their mobiles has become increasingly popular in countries where there is no regular access to banks or the internet. In fact, the front line of the mobile payment market is currently in Kenya, where the revolutionary mobile payment system M-PESA is already the world's most successful with 9 million users. NGOs in Africa actively use the system to transfer payments to remote areas and microfinance institutions use it to make and collect loans.

So what are the benefits of these changes? Aside from the obvious economic benefits such as job creation and Foreign Direct Investment, the West could help boost civil society discourse in the region by providing connectivity that is not vulnerable to censorship. With millions going online in the near future in Central Asia, an opportunity opens up for the U.S., and the EU, which have in the past decade set up several military bases in the region to wage the war against terror in the neighboring Afghanistan and to promote democracy. This will allow for outside content to bypass the established government censorship and would thus expand the region's links to the outside world. Although most countries in Central Asia are ruled by authoritarian leaders who do not want to give up control, even North Korea has recently set up a 3G network, which shows that new technology will be allowed and deployed because technological compatibility with the rest of the world is increasingly essential today.

Currently there is no strong legal foundation, regulations or banking sector to support the development of eCommerce...

e-commerce. Instead of the decades spent building the copper or fiber optic backbones, Central Asian nations will adapt wireless Internet which is cheaper and more effective. The rollout will be seen as a mere upgrade by millions of consumers who already have a cell phone. Given the falling costs of hardware, manufacturers, facing saturated markets in the rich world, have been focusing their attention on developing nations. Already extremely popular in Asia, netbooks will also have a major role in this market.

Most of the populace in Central Asia that speaks English is already online, so the newcomers to the Net will demand content in local languages. While the type of content demanded by users in BRIC countries using mobile web is primarily entertainment, Central Asians will most likely be attracted to

The free flow of information within the region will lead to a more active citizenry and greater transparency, which one day will lead to efficient and transparent capital markets. Web use in Central Asia would probably repeat patterns elsewhere such as China and other emerging economies and the demographics would also favor a speedy up take, given the young population. Currently there is no strong legal foundation, regulations or banking sector to support the development of eCommerce, but once the legislation is established and the major players emerge, one would be stupid not to go long their stock in the new decade.**iBR**

BY PENNY METCHEV ('12)

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ON THE WAY TO ECONOMIC RECOVERY:

AUSTRALIA IN THE CLEAR

The Australian Bureau attributed the rise in employment to, "the rise in part-time employment, up 36,900 persons to 3.3 million .

A man once said that the most unclear part of history is the time that just preceded us. We will only be able to decipher it once we place into the entire context of the past. Similarly, the past eighteen months will not only be analyzed by economists, but also scrutinized by historians. Where did we go wrong and how can we fix the situation? Whether you call it the Global Financial Crisis or the Great Recession, defining this period of time will be contested. Nevertheless, on February 11th the Australian Treasury Secretary Ken Henry declared that the global financial crisis has passed.

One of the key indicators for Australia's recovery and Ken Henry's response was the recent unexpected drop in the unemployment rate. The Australian Bureau of Statistics announced that the seasonally adjusted jobless rate fell by 0.2% from 5.5 to 5.3 percentage points.

This meant that around 57,700 new jobs were created in January, with the majority of them being on a part-time basis. This result was unanticipated since it was the largest rise in employment since December 2006 and representative of an improving economy. The Australian Bureau attributed the rise in employment to, "the rise in part-time employment, up 36,900 persons to 3.3 million together with a rise in full-time employment, up 15,900 persons to 7.6 million." This was the third consecutive month of rising employment.

The ASX responded well to the reported growing labor force, as other developed economies continue to struggle with employment issues. Australia's unemployment rate is significantly lower than the American and British figures of 9.7% and 8.3% respectively.

The current Australian Government was quick to take credit for the positive signs, especially since unemployment tends to lag behind other economic indicators during the recovery period. Employment Minister Julia Gillard praised both employers and employees for their, "strength and resilience" during these trying times. The Treasurer, Wayne Swan, attested the results to the Government's prompt $42 billion stimulus package.

The conservative Opposition responded with the notion that record recession spending had to stop and a more conservative fiscal policy be adopted in the near future, if we were in the recovery phase.

While the current Government's swift actions and stimulus plan are major factors for the mildness of the Australian recession, the actions of the previous administration cannot be discounted. Under John Howard, who was Prime Minister from 1996 to 2007, firm economic policies paved the way for the Australian economy and financial system to be more resistant to failing markets elsewhere. Furthermore, a large stimulus package is not the sole answer to economic downturn. If it were the case, the other developing economies would be following Australia's improvements. For example, Aspirin cannot fix an injury resulting from years of poor health. Just as bones need exercise and good nutrition, the economy requires support (beyond stimulus) to soften cyclical and non-cyclical shocks.

The difference between Australia and other developed economies was precisely the healthy state of the banking sector prior to the crisis. The Australian financial sector had undergone regulatory reform as a result of the previous Howard government.The most significant development was the founding of the Australian Prudential Regulation Authority (APRA) in 1998. It combined the functions of 11 previous agencies to supervise not only deposit-taking institutions such as banks and credit unions, but also life and general insurance companies.It oversees about three quarters of Australia's total financial assets.

As a result Australian banks did not partake in risky over-leveraging or issue sub-prime mortgages like their foreign counterparts. While Australian banks did invest in American institutions (and experienced losses), the recent reporting period has shown that they now on their way to healthy profits. On February 16th, Australia's second largest bank reported a 33% increase in profits for the first quarter, as they sold more loans and had less defaulting customers.

Another positive economic factor, apart from the strong labor force and banking sector, is the national budget. The Howard years were known for their budgetary surpluses, with the public national debt being fully repaid and privatization of government-owned companies occurring.

This is important in noting since the United States and other European countries already had large budget deficits before the crisis hit. Hence their Stimulus packages, running into the hundreds of billions, added further strain to their accumulating debt. In addition, significant parts of their stimulus spending were used to bail out banks, which Australia did not have to do at all.

The need to pay off debt and place suitable reform on the financial sector will be issues which will affect the rate at which developed economies recover. Also, Australia's close economic ties with China have helped it recover quicker, as China continues to experience increases in exports and domestic demands for energy.

In essence, for an economy to fully recover from the global downturn it needs to not only withstand but have the ability to adapt to future downturns. Structural changes, appropriate investment in the public sector and an independent Reserve Bank are all necessary for this.

Treasury Secretary, Ken Henry, echoed the positive employment news saying that "what people have called the global financial crisis" has passed. He noted that while future adverse shocks for financial markets may occur, their impact will not be as widespread and harsh as that of 2008 and 2009. With the positive employment figures it seems that Australia is heading towards to an overall improvement in the economy. Unfortunately, we will only find out if we are truly "in the clear" in the months to come. **iBR**

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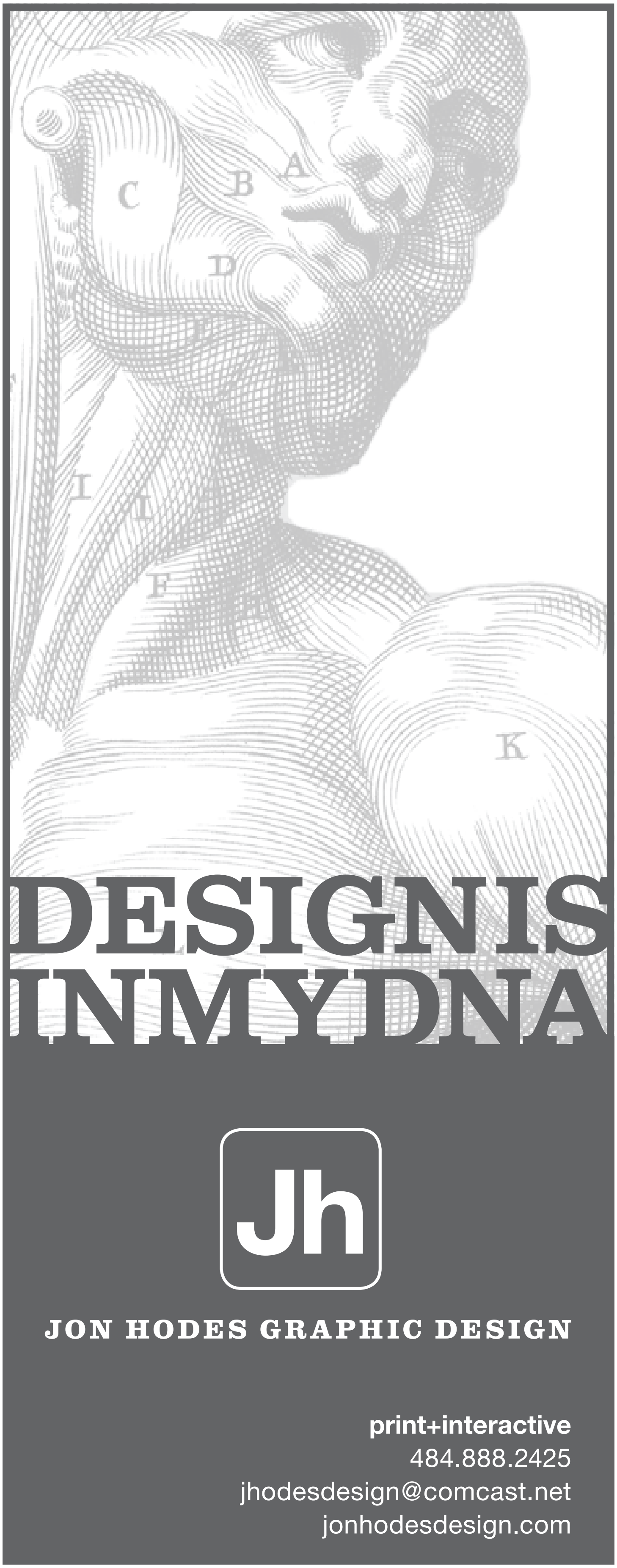

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