Restoring Trust in the Global Financial System

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Trust. Photo by Neil Sanche (CC)

Introduction

DEVIN STEWART: Welcome, everyone. I'm Devin Stewart from the Carnegie Council. Thank you for coming on this beautiful spring day. I have my purple tie on for the spring weather; it's celebratory.

Spring is a new beginning. Our panel on "Restoring Trust in the Global Financial System" will be an action-oriented panel, and hopefully we will make some progress toward restoring both trust in our financial institutions and Wall Street's trust in us and the world.

Indeed, here is recent news from the Chicago Booth/Kellogg School Financial Trust Index: In the last 24 hours, Americans' trust in stocks has risen, but, unfortunately, financial institutions and companies are still suffering from declining trust.

Trust is a non-financial or intangible element to creating economic growth. It's not necessarily the regulatory or the hardcore policy issue, but it is an ethical issue that makes things run, and it's very much a practical matter.

I want to thank our sponsors, Booz & Company, and their magazine, *strategy+business*; Merck & Company; NYU's Center for Global Affairs; and our co-organizer and sponsor, the U.S. Chamber of Commerce's Business Civic Leadership Center (BCLC).

Steve Jordan, who runs the BCLC, and I basically came up with the idea of this panel in October, so it has been a long time in the works. It actually came from an eBlast that Stephen did to his colleagues listing what would be necessary to get out of the financial crisis. The top requirement—I just went back and checked that email this morning—was restoring trust in the financial system. So Steve had enormous foresight. We are so fortunate to have such a high-powered panel from various perspectives.

I have had a good chance to see some of Steve's remarks. He is going to give a quick opening talk. It really gets to a lot of the points that the Carnegie Council tries to advance: the practicality of ethics and what I would call "the golden mean," trying to get away from extremes. All these elements are important to our work here at the Carnegie Council.

So, Stephen Jordan, I will turn it over to you. Then we will do a panel discussion and open it up for Q&A. Thank you very much.

Remarks

STEPHEN JORDAN: Be careful what you set in motion with emails. Wow.

Thank you so much, Devin. It really is an honor for me to be here this afternoon with you all. The topic at hand is very troublesome, very problematic. I had this halfway decent set of remarks that I had prepared for a while now, and I'm sitting there last night thinking about them and I said, "You know what? There are some fundamental ambiguities here that we're going to have to tease out." So I'm going to adlib a little bit, unfortunately.

But what I have are actually more questions than answers. There is a fundamental ambiguity in the question: restoring trust in the financial system. Who should be restoring that trust? To whom?

What I think is embedded in the predicate here is that there is no silver bullet, that there is no single shot that is going to solve all of the issues that we have. In a sense, we are all kind of like the blind people around the elephant.

Some people are looking at, say, the credibility of financial analysts. Other people are looking at the regulatory environment for hedge funds. Other people are looking at financial literacy for consumers. Other people are looking at what should be lent to whom, and in what circumstances and how?

There's a certain impatience in our public dialogue right now that is very jarring, when you consider that these problems didn't surface overnight and it wasn't just one thing that caused them. Yet somehow we expect, within two or three months or six months of the announcement of a stimulus package or something like that, that—poof—it's over.

Trust, unfortunately, is one of those issues that can take a lifetime to build up, and in a moment it's gone and then you have to start over again on a very long-term process.

This is an issue that we have been grappling with not just since six months ago. Look at Enron and the response of Sarbanes-Oxley. There have been several trust crises over the past century. Almost all of them have been game changers.

When you look at 1907, for example, if 1907 hadn't existed, our economic system might very well look like the Japanese *keiretsu* system. How many boards was J.P. Morgan on? Over 100? Wasn't the system very much like an interlocking system between banks as holding companies and the industrial companies that they worked with?

If you looked at 1929 and the Pecora hearings and what happened as the prelude before the establishment of the SEC, we might still have much more limited information disclosures than we do now.

You look at the 1930s, and there were some fundamental impacts on the financial system. You can look at incremental changes from the 1960s, the 1970s, the 1980s, and so on.

So trust, as we are talking about it, is a complex issue that can have fundamental, game-changing, altering impacts on the entire industry. It's a systemic challenge.

I know at one point Devin had wanted to have Nassim Nicholas Taleb join us today. He would say that actually, trust might be the wrong thing that you want to have.

What you might want to have is a certain amount of healthy skepticism. It might be the fact that we actually need to think in terms of layers of trust.

So it might be a healthy thing, actually, that we have so much litigation, if that means that while we don't trust organizations at an individual level, we have trust at the institutional layer or trust in the architecture framework or policy framework underneath it.

So we have to be very careful what level of this discussion we are talking about in terms of looking at trust.

The other thing is that we have to look at the intensity of the trust that we have. Let's just take it to the supermarket. Every time you pick up a gallon of milk, you trust that it's going to be good, or when you buy a package of a certain kind of product, you trust that that's going to be good.

While I think that a number of folks on our panel—and I'm very interested in what they are going to have to say from a public policy/governmental aspect, in terms of the actor being what should public policy leaders do to restore trust—from our standpoint, it's very interesting to look at what other industries' and what consumers' and what the general public's role could be in restoring trust.

If you look at it from that perspective, we have all kinds of trust substitutes:

- Warranties. I'm trying to buy a TV. It's worth $199 more for me to know that if it breaks down in the next four years, I can exchange it.
- Cars. There are 40,000 vehicular deaths per year, but there is a whole infrastructure that the auto industry has embraced to make people have a comfort level in terms of driving.
- Brands. When you look at a General Mills package or things like that, there is an implicit promise within those brands.

So maybe part of what we might be looking for coming out of this conversation is benchmarking what other industries are doing to build up trust and seeing how those might be adapted or applied in this context.

But at the end of the day here, it's not just about what regulators or what the industry itself is looking at; it's who is giving that trust. That is, of course, the public.

I would submit that one of the hypotheses that we have to look at is that we live in an age of entitlement. Perhaps it's better to look at a different industry than the financial services industry.

If you were to look at the automotive industry, consumers feel entitled. They feel entitled to buy Toyotas and Hondas and whatever else they feel like. The UAW [United Auto Workers] for a long time felt entitled. The retirees feel entitled. Management feels entitled. The investors feel entitled. The regulators feel entitled.

What happens when you live in a society where everyone feels entitled? GM right now is teetering on the brink of bankruptcy.

What I would say is that, as a society, one of the things that we might want to look at is, what are the kinds of things that you need to do to a culture to embed a sense of ethical restraint?

There has been tremendous work on this by folks like Hernando de Soto and Francis Fukuyama, about the fact that, in a way, we are engaging in a giant thieves' dilemma. You know the story about how they separate two thieves and they put them in different holding cells. If they trust each other, both are going to go free. The system will work for them if they have trust. But if one trusts and the other doesn't, the one that cheats wins.

Knowing this, both tend to cheat, both incriminate each other, and they both go to jail. You can see this with traffic: All of you all stay in line; I'm cutting to the front. But if everybody cuts to the front of the line, then you have a traffic jam and everybody loses. If everybody feels entitled, you have the equivalent of a virtual traffic jam.

So then what happens when you have an intersection like this? Once you start having repeated traffic jams, you start getting a stop sign. Then you get the stoplights. Then you get the police officer. All of a sudden what would have been a free-flowing system, nine times out of ten, has become institutionalized more friction.

The transaction costs have become much more embedded in the entire system.

This, I'm afraid, is what is going to happen with financial services and with other industries if we don't think about our ethical posture. How do you start to embed a little bit of a culture of restraint so that you give up that last dollar or you give up that marginal benefit for the sake of being able to continue to receive that benefit over a longer and longer period of time?

All of these things are things that I don't know that we have the answers to. I would submit that although we want some actions to come out of this conversation today, we have the humility to know that this is going to be a much longer-term process and that we are going to have a lot of complex interactive things that we are going to have to do, a network effect that we are going to have to embody here—multiple folks pursuing multiple strategies at the same time—if we really are going to achieve what I think all of us want, which is a functioning financial system that manages risk and enables us to move forward in terms of economic and social progress.

With that, thank you so much for this opportunity to be here. We have a tremendously distinguished panel. I will turn it to Professor Donaldson.

THOMAS DONALDSON: Thanks very much. I'm Tom Donaldson. I am a professor at the Wharton School at the University of Pennsylvania, where I specialize in ethics and corporate governance.

Steve's remarks resonated with a fact, I think, and that is the appropriateness of our talking about this issue here at the Carnegie Council. Andrew Carnegie, more than 100 years ago, put in place this institution, which attends to issues of ethics in international affairs.

I was reminded of how another Scotsman, 100 years before that, a young professor of moral philosophy teaching at the University of Glasgow, was brought away from his work for a while to tutor students of the Duke of Buccleuch. He wrote a letter, which we still have, to a friend. He said, "It's boring tutoring these children. I've decided to write a book to pass the time away." Our young professor of moral philosophy, of course, was Adam Smith, and the book that he was writing to pass the time away was none other than *The Wealth of Nations*.

I mention this because Smith never forgot anywhere in his writings that this remarkable system of capitalism, with its capacity to harness the inevitable, if regrettable, self-interest of people and direct it towards the common good—even this remarkable system requires the moral cooperation of its participants. We may well be living through a period in which that lesson needs to be relearned.

We have three very distinguished panelists today. They will be talking not only about solutions, but causes, because, surely, to find solutions, we have to understand causes. In my own mind, there are at least three causes for the current economic crisis:

- One, a pattern of paying for peril—that is, a pattern of rewards, especially in the financial services industry, that didn't always align with the best interests either of the firm or of society.
- Something I refer to as "the normalization of danger." It's a reflection of a psychological phenomenon, fairly well studied, where in a group, in an industry, often essentially dangerous activities can be normalized to the point where people don't notice how dangerous they are. I'm reminded of Chuck Prince's famous remark, often quoted: "When the music is playing, you've got to get up and dance." Certainly it was very difficult for any of the participants in financial services to say no to some of the activities that we now know were deadly in the long run.
- The final item is what I refer to as "tech shock." It's the shock that comes as we introduce new innovative techniques or technologies, before we have our ethical, political, and social arms around them. We see this often in medicine, of course. The in vitro fertilization or cloning raises issues that we have difficulty handling, and it takes us a while to get our arms around them. It's the same way in business, whether it's off-book entities, which helped bring down Enron, whether it's

> collateralized debt obligations or a market of credit default swaps or some of the other very complex financial technology that is a part of the current crisis, we have yet to get our arms around that.

I would be remiss, however, in not mentioning a possible fourth, and that is people like me, academics. Do business schools, do economists, who created some of the models that were used and sent many of the people to Wall Street that engaged in some of these activities, share some responsibility in this? I'm inclined to think that no one is completely removed from responsibility.

At any rate, the old line goes, you don't, for the person who has wrecked the school bus, buy them a new bus. So one question is, do you hand back to the same institutions—government, industries as they stand, even academe—the tools with which to try to find a solution?

Helping us today to answer those questions are three eminently qualified people. I want to begin by introducing Christian Menegatti, who will talk, as each of our speakers will, for slightly more than ten minutes. They will be fairly brief presentations.

Christian is the managing editor and lead analyst at RGE Monitor. He holds a Ph.D. in economics, and he specializes in macroeconomic issues and also has a special focus on U.S. economic issues, including housing markets, mortgage markets, and so on.

Christian?

CHRISTIAN MENEGATTI: Let me start by picking up on some remarks that Stephen made about the trust in what, for example, we consume every day.

Some days ago, I got a phone call from a consumer association, and they were telling me that I shouldn't consume a certain product that I recently bought at a supermarket because there were some anomalies with it.

The same day I got a phone call from a financial adviser that was telling me that I shouldn't invest in a fund because there was some subprime paper in it or even prime paper in it.

The second phone call never happened. That's not true.

That tells us a little bit about what the mechanisms are that lead us to trust a system, whether it's a financial system, real economies, or just what leads us to the common behavioral patterns in everyday life, when we consume a meal, when we ride a bus, and so on and so forth.

But before we get into that, I would like to focus my considerations a little bit more on the macro side of what is going on, which is more my specialty, and look a little bit, perhaps oversimplifying, at how we got here and what has to happen, or what should happen or what will happen, for us to get out of here and restore the trust and confidence in our real and financial economy, not only in the United States—this is not only a U.S. problem, but a global problem.

That's why these days we are following with a lot of attention what's happening in the context of the G-20 rather than just in the domestic economy or in other economies in the world.

On top of that we not only have to restore confidence and trust, but we also have to make sure that in the future we don't fall back in the system of—I like to refer to "overconfidence" when I think about the housing market or the financial markets.

Before we brought up a famous quote from a CEO, "When the music is playing, you have to continue dancing." That's a little bit of the behavior that was taking place in the risk-management offices of large financial institutions in the last few years.

So we have to make sure that the system that we re-create is such that trust and confidence are back and that we don't suffocate the system with overregulation, because a lot of the financial innovation that has been brought about in the last few years by academics, as well as non-academics on Wall Street, is actually a welcome development that has brought liquidity to liquidity-constrained parts of the economy.

However, we have to make sure that this liquidity continues to flow to liquidity-constrained parts of the economy, but doesn't flow to parts of the economy where there are not just liquidity constraints, but actual constraints that go beyond their income.

Let me, for a second, make some remarks about how this started. I'm going to start from the real side of the economy rather than the financial side, the housing market.

If you look at Chapter 1 of Bob Shiller's book *Irrational Exuberance*, the Second Edition, there's a beautiful chart that shows the three main variables that dictate demand for housing services. They are interest rates, prices, and income. Interestingly, that's a nice time series, because those are real prices, so those are prices adjusted for inflation. If you look at the time series, what you see is that prices, from the 1970s—or earlier on, actually—until the beginning of this millennium, have barely kept up with inflation.

But in 2003, when Bob Shiller and Karl Case, the two famous names behind the Case-Shiller Index, were making surveys around whether individuals in the markets believed that the housing sector was a safe investment, a large percentage, over 80 percent, of the responses was, yes, it's a safe investment and brings strong returns that we trust, that we have confidence in, and so on and so forth.

Actually, if you look at the time series, prices have barely kept up with inflation. So it wasn't as high a return on investment as everybody thought.

From the beginning of the millennium, you see a disconnect between income and house prices, where income was correlated one to one with home prices until the beginning of the millennium, then home prices started spiking up while income continued to be flat.

That was the first signal to us that there was something wrong, something that was getting out of hand, and that we were developing a dangerous bubble in the real-estate market. But the most important part was that it wasn't only the real-estate market, which is only 5 percent of GDP, but the real-estate market was just the collateral of something perhaps more harmful, which was this huge bubble in the credit markets and derivatives.

I don't want to go into the details of how this developed and how we got here. Let's fast-forward to today. Today we are in a situation in which the economy is in a sharp recession, and probably only halfway towards a sharp recession that will continue well into 2010.

We are in a situation in which credit markets are frozen and businesses are not lending because they are holding cash. They are afraid of the uncertainty in the future. Banks are not lending. Consumers are credit-constrained, but there is also a lack of demand in credit.

Let's look again at the housing market. Affordability is at an all-time high, but demand in the housing market is not coming back. Actually, the fact that we could read some positive news on the supply side, where housing starts are starting to pick up a little bit, is actually very dangerous, because we run the risk of reinflating those inventories that are still at an all-time high.

If demand doesn't pick up and housing starts on the supply side start increasing before then, then the risk is really that the price correction in the housing market will continue.

Let's go back for a second to what I said at the beginning on home prices. Not only the trajectory of prices, but the expectations are the crucial variable behind everything. Just like before, when the expectation of an increase in home prices was driving this boom on several dimensions, in the same way, right now, the fear that home prices will continue to fall is preventing demand from restarting, even if affordability is at an all-time high.

So there are several dimensions around which trust and confidence need to be restored. As Thomas reminded us a second ago, it's not just by looking at the fiscal stimulus that magically overnight could take us out of this. It's not just by looking at monetary policy, with the Federal Reserve monetizing the deficit or trying to manage expectations efficiently so that we don't fall in a deflationary expectation spiral—not just a deflation spiral, but a deflationary expectation spiral—that would bring us back to the specter of Japan.

It's not just the Geithner plan, the plan to unfreeze credit markets, that will bring back credit flowing. As I said, it's not just a supply problem, but it's also a credit demand problem. It's all of them together, and much more. It's all of them together, as well as considerations around moral hazards.

Let's, for example, just focus around unfreezing credit, this Geitner plan. Will it be successful? Will it not be successful? It might be successful. What's really interesting is that it's still using a market-based mechanism to set a price to these toxic assets, in the attempt of freeing capital from the financial institutions, and therefore they start lending. That's very interesting, although behind this there are huge government guarantees. That's the price that we have to pay in order to relieve these balance sheets from toxic assets in a market fashion, using the private sector to purchase this.

What message, in some sense, is a market-based solution sending in this moment? Think about what's on everybody's mind when we speak about nationalization or socialism.

We are in a system in which—we have heard this a lot—we privatize the profits and we socialize the losses. What kind of message does that send to Main Street, going back to executives' compensation, certain incentives, and so on and so forth? Is this the way to restore trust and confidence in public authorities, for example?

This plan has actually a market-fashioned way of finding a price, if that will be possible for these toxic assets. If that will not be possible, that means the market failure is so large that we are going to rely on a more public-based solution, and the specter of the "N" word—nationalization—comes back.

Let's think about the implications of nationalization, for example. Nationalizing a bank doesn't mean that the U.S. government is going to become the largest financial institution in the world. It's already the largest insurer in the world. We don't want to go back to that.

But it means simply that banks are going to be split. The good parts of the business are going to be sold. Shareholders are going to be wiped out. The management is going to be wiped out. For example, this is a signal that not always are losses socialized and profits privatized. This sends a signal that a no-market-based solution sometimes can be a market-friendly solution, where, actually, fairness can help in restoring trust in the system.

With this, I think I'm going to stop my remarks and leave it to the next speaker. Maybe we can go on and discuss this further during the Q&A.

THOMAS DONALDSON: I would like next to introduce Neal Flieger. Neal is the chairman of global public affairs at Edelman. He manages a team of professionals, with a client list that includes GE, Pfizer, Wal-Mart, and the United Way.

Thanks for being here.

NEAL FLIEGER: Thank you.

The reason I'm here, I think, is that Edelman has, over the past nine or ten years, commissioned a study through our research company that tracks trust in institutions.

We have done it since 2001. We have measured trust in business and government, in the NGO community and in media.

For the past nine years, the survey has always been quite interesting, in informing us about what kind of latitude clients have to move forward—I'm speaking as the chairman of global public affairs—where government is, with respect to what business wants to do.

This year, not surprisingly, the data was more interesting and more compelling and a little bit more stark than it has been ever before. We have seen some interesting things in this year's data.

We test this, by the way, with about 4,500 or 5,000 people in 20 countries around the world. The survey this year was fielded between the second week in November and the first week in December. Our sample is the people in this room. They are highly educated. They are the top 10 percent of income in each country. They are heavy consumers of information. They read five or six different sources of information on a weekly basis. That's who we sample.

Every year that we have done this in years past, when there has been a rise or a fall in trust among those groups in either the institution of business or government, it is offset by the other side. The trust relationship between business and government, for the past nine years—and in those nine years, you saw 9/11, you saw Enron, you saw the Iraq War start and the hostilities against the war, so we have seen some fairly great fluctuations—but it has always been a zero-sum game.

In the past two years, trust in government, not only in the United States, but around the world, was at an all-time low, in what we consider to be the structural basement, which is that about mid-30 percent numbers of respondents were saying they trusted government to do the right thing.

That was offset by the fact that trust in business was globally at about 52 percent; in the United States, it was close to 60 percent. The drop was almost 30 percent this year. There was a similar drop—not as high, but to the structural basement—in government.

So for the first time this year, you see among this respondent group a structural lack of trust in business to do the right thing and a lack of trust in government. The notion that they are not offsetting one another, for us, was particularly compelling.

I'm going to highlight a couple more findings and then talk about some implications.

We asked respondents, "Given what's happened, given this lack of trust that you have, who do you view as being responsible for addressing the problems of the financial crisis or other large societal, global problems—global warming, energy, things like that?"

First, we asked them who was responsible for causing it. What's very interesting is that business and government are equally seen as responsible for causing all of these problems.

Who is responsible for solving it? Although there is more fluctuation and although the respondents lack trust for both business and government, when we ask them what should be done about this, they want business and government to lead in defining what those solutions are.

To us, that's interesting, because what we have seen in the preceding nine years or ten years has been, whenever there is a lack of trust, the audience looks someplace else to try to find a way to rebuild it. This is an instance where we have reached, we think, such a structural basement that the trust-holder community can only look to the institutions in whose trust they now lack to rebuild that trust.

I think that, to us, means that we are in a bit of a moment in time when both of those institutions can recalibrate what the foundations are and what the frameworks are on which the expectations and the trust are based.

If systemic trust is that an institution or an entity does what you expect it will do, arguably a reason that there is a lack of trust in both the business sector and in the government sector is that in both of those cases they didn't do what we expected them to do. The markets did not continue to rise, although we expected them to do that, and government did not protect us, although we expected them to do that.

I think that, to a certain extent, both of those expectations were unrealistic. In both cases—and I'm now speaking both as somebody who has studied the data and also in terms of global public affairs and working with people who work with governments—there is a tendency on the part of the articulators, the mouthpieces, the spokespeople for institutions, to try to rekindle trust through optimism. This is particularly political, but it is not exclusively political. There is a tendency to say, "You should trust me because things are going to be a lot better."

The president that I worked for, who was Bill Clinton, had he been faced by this problem, would have set a deadline by which point we would have solved this problem, which is one of the reasons that he left office with a certain lack of trust, as he did.

Interestingly, in Washington, we saw this drive towards increased regulation, which the business community initially rejected or was concerned about. You said it yourself: "Okay, but you have to be very careful not to overregulate us because you'll kill the goose that laid the golden egg."

Now what's happening is that business is beginning to recognize that, first of all, they have an opportunity to participate in creating whatever the new regulatory frameworks are. But I think there's also a danger there, too, because there is the presumption that the regulatory framework that is created will create the hard wall against which any growth engine bumps up. It is the tendency of growth engines to look for ways around hard walls.

This is not a business-regulation issue, but it's comparable.

The United States erected, since 1972, the most stringent regulatory system in the world on funding political campaigns. We have the toughest system, the most rigid system about funding political campaigns of any democracy in the world. We also are evidently the political system where money is allowed to pour into the system around all of the rules. No sooner was McCain-Feingold enacted than there was a cottage industry figuring out a way to get around it. That cottage industry has become a Newport Beach cottage industry; they are pretty big cottages now.

One of the points there is that if the business community—and I'm not as much of an expert on the financial markets as my colleagues are—intends to erect a set of rules and have those rules define what we can't do, and take the view that "we can do anything that isn't specifically proscribed by the regulatory structure," then I think the business community is defaulting a little bit on its opportunity and on its obligation.

This meeting is sponsored by an organization about business ethics. I think the business community has to define for itself what some parameters are. That's what I meant when I said we have this opportunity, I believe, to recalibrate what the frameworks are on which the expectations and the trust are based.

I will, as Christian did, stop here and let it go on to questions.

THOMAS DONALDSON: Thank you, Neal.

Our next speaker is Seamus McMahon. He is a partner at Booz & Company, in the financial services area. He is especially appropriate, I think, as an expert on this panel, because he heads the practice for Booz in the area of commercial banking.

Seamus?

SEAMUS MCMAHON: Thank you.

I've got the cleanup crew. The bad news is that a lot of the things I wanted to say have already been said, better than I would have said them. The good news is that I got to listen to everybody else and might be able to pick up on some points.

Trust is a slippery concept. I think of it simply as the expectation that you hold that something will work out the way you anticipated it would, whether it's buying milk or a financial contract. And it only takes one bad jug of milk to make you think four or five or six times about whether it will be okay the next time. I think it's pretty asymmetric, and we are in a world of hurt on that.

So the first point I come back to is, I think we have a social and political problem, as well as a business problem.

The second point—and I'll expand on each of these—is that I think it's pretty important that we don't throw the baby out with the bath water. There was a period during the early Industrial Revolution in England when a group of people known as the Luddites went around actually breaking the machines which they perceived to have stolen their opportunities for deploying their own labor. I think we have to be careful not to do that, no matter how upset we are.

The third point is, this is a global problem. We have really been talking more or less domestically about it. I got back from the U.K. last night, and they are fixated on pensions and teachers' salaries and the like, as well they should be. We are really worried about unemployment, we are worried about small investors, we are worried about borrowers, as well we should be.

But we don't live in that world anymore. We live in a world where all these flows move about incredibly quickly, and I don't think we have fully addressed that. So we'll talk about that a little bit.

I'll try to be a little bit prescriptive about the four pieces of a solution, not so much in the ethical realm—I'll leave that to the experts—but in the regulatory or rulemaking world that I know a little bit better.

In terms of evidence of mistrust—this is a little bit old, and I'm sure it would be a little better now—Reuters did a survey in January and found that only 22 percent of Americans had faith broadly in the financial system; 12 percent in the stock market. That may now be up to a dizzying height of 20 percent or something. What was really disturbing to me was that 80 percent of the people surveyed felt that government interventions to date had actually undermined their trust in the markets.

I do work for a congressional oversight panel. I barely understand the interventions today. I'm fairly confident that most people don't either. What that says to me is that the signaling effect of, "We're here from someplace and we're here to help you," has a negative impact. Nobody really believes anybody is here to help them right now.

We see it in the professional markets as well. With corporate bonds, the spreads, although they have narrowed, are up way above historical levels, which tells me that even professionals don't fully know who is going to pay that interest and for how long.

For example, at one level, Ireland assumed the obligations of the banks, and the interest expense on Irish government bonds went almost cent for cent with the cost of the banks' debt. They just moved it from one pocket—i.e., they nationalized the obligation and they nationalized the cost of it. It didn't go anywhere. They just moved it.

Arguably—I really worry about this—if you look at the increased leverage at the state level, at the country level, it has pretty much one-for-one gone up as we have reduced the levels of individuals and companies. So we have created a sovereign debt problem that may be every bit as big as the individual company and consumer debt problems that we are solving.

I don't know how you feel about that.

A final point on this trust business. My perception has been that the CEOs of these big banks, big financial entities, just don't get it. They really did not understand that the game had changed. I'm sorry. I know there are representatives from these institutions here. Maybe I'm completely wrong, because I don't play golf with them. They may be totally getting it around the poker table on the weekends. But the things that they have said in public lead you to believe they did not understand that they don't have free right to do what they want with the capital entrusted to them.

We may see it as a turning point when Lloyd Blankfein, CEO of Goldman Sachs, made these very points, I think, late last week or early this week. That's actually a pretty hopeful sign.

Coming back, we clearly got ahead of ourselves, but I don't think we can turn back the clock. It's pretty clear that product and process innovation got way ahead of the ability—or interest, maybe—of the people we entrusted to look over it. To Tom's point about wrapping our arms around innovation, we didn't even have our hands out, let alone around them.

We had AIG. Their derivatives unit was supervised by the OTS, the thrift supervisors. I have to say, they are arguably the weakest of the supervisors. They have the least technical ability. They are absolutely the last group I would have picked to look after an area like that.

We had a push for homeownership, supervised and prodded by congressmen and some senators, who were in charge of managing the GSEs, the Fannie Maes, the Freddie Macs, that were expanding their operations way beyond their own ability to manage them. So we had the gamekeeper and the poacher colluding to raise chickens and leave the coop open. It doesn't exactly inspire confidence.

Then the rating agencies—I don't know if you all know this; I didn't know this until recently—get paid by the people they regulate. What are they going to say?

On the other hand, if we break up the machinery without stopping to think about it, because we are angry, we are going to have shards of metal and glass all over the floor, and maybe we won't have the plans to restart everything.

For example, derivatives have a terrible name, but at their simplest, they are a bet that allows one person to hedge something in the future, like the price of corn, as we were talking about at lunch, off against someone who will take the bet on the other side. That's not necessarily a bad thing. There are legitimate purposes for derivatives, and they can reveal valuable information, assuming that the person taking the bet, unlike AIG, actually kept enough money to back up their side of the bet.

For large and simpler financial businesses—cards, some other processing businesses, deposit-gathering branches—despite what academics say, and I have seen a lot of work in the academic field, our work convinces us that there is economy of scale. Bank of America simply has lower processing costs for its core business than anybody else right now.

Maybe it's worth it for society to break that up, but I think we should be thoughtful.

On the other hand, large, complex, multi-line businesses—and Citigroup certainly fits that pattern—may need disassembly if society can't estimate and contain the risks at a reasonable price. By risks I don't mean the risks to Citi; I mean the system-wide risk, where they are at the center of a spider web and it breaks at the center and the filaments break in many places.

Taleb makes the point that complex systems are prone to explosions and unpredictable breakdowns. I agree with that. I think the math is pretty clear. But we don't say, "Oh, that's too bad. Let's go back and live in a cave." What we do is, when a system requires more energy to manage, we put more energy into it.

The Great Fire of London in 1666 was pretty good proof that you couldn't just build all over town and not have a massive problem. But they didn't say, "Well, forget the idea of a city. We'll just move back out to the countryside." They put in place regulations, fire brigades, insurance.

We are going to have to step back, if we want these complex systems, and put a bunch of infrastructure in. We are going to have to wrap our arms around it, but thoughtfully.

I mentioned before that it's a global problem. Obviously, the United States is taking a lot of heat, and the U.K. is second. It wasn't just a subprime mortgage problem in those two countries. We have had excessive leverage and lax institutional oversight in many countries that didn't have a subprime mortgage problem: Holland, France, Ireland, parts of the German economy. Whether you like it or not, it's affecting everyone.

Again, the bailout costs globally of having a few countries make big mistakes and many countries make small mistakes are such that the debt of the United States, the debt of Ireland, the debt of many of these countries is going to double in the next two years. In a way, all the imbalances, with the Chinese lending us money so we could buy things we couldn't afford, they are now funding our bailout. I don't know how happy they feel about that, but I suspect, over time, not particularly.

It feels to me overall that this is a bit like the global environment. It wasn't until, I suspect, Chinese pollution hit Newport Beach that people in certain echelons in America finally took seriously that we had to have a global solution to a global problem, even if we didn't like the allocation of the costs.

The problem, of course, is that we don't have any easy way to coordinate what's needed globally. I think, first of all, we have institutions like Citi, like HSBC, like UBS that are in 60, 70, 80 countries, and there is almost no coordination in how to manage them. I think we need a home regulator and then we need a team of regulators to manage their global activities from the major markets they are in.

We have to have the same regulation for derivatives and other instruments across countries. For example, if we put in a clearinghouse for derivatives in the United States and they don't put one in the United Kingdom, where do you think the derivatives business will go? It's like water. It's just going to go downhill to the jurisdiction with the least control.

Accounting approaches have to be the same, not to a minuscule level, but very largely, or we will find people moving their activities and their bean counting to where the treatment will be most favorable.

FASB [Financial Accounting Standards Board] and the IASB [International Accounting Standards Board] have got to get together. I think the most important decision they have to make right now is how to value hard-to-value items on people's balance sheets. Just the confusion alone isn't worth all the IQ thrown at it.

If we have bank insurance in the United States and they don't elsewhere, we are effectively subsidizing banks here. If banks can borrow from their central banks at different rates around the world, that's a form of subsidy. If either the explicit or implicit promise in a crisis is different around the world, then investors understand that and they know that their risk/reward ratio is different for different banks around the world.

So at least those three pieces have to be within spitting distance of each other globally. That would be my view.

The response to the asset bubble and collapse in the 1930s was local, local, local. Everybody retreated. We put up trade barriers. We dealt with domestic banking problems. We put in social programs, ultimately, in different countries. It wasn't until Bretton Woods that we really took a breath and began to coordinate. I would say we are not out of those woods. In fact, if we look at the EU, they don't have one regulator. It's very hard for them, even there, to coordinate. This isn't going to be easy.

But the note of optimism here is that the richest financial markets, the ones where there is most to gain, set common and high standards, like we basically do for cars. In the EU and the United States, you have slightly different lighting standards and the like, but they have converged. If you want to sell into the biggest markets in the world, you have to meet fairly high standards. It's really not worth tooling up to do something much less than that for other markets. So I think this is soluble.

Finally, turning to the domestic front, there have been four major shortcomings, as I see it:

We have not had competent regulation. We had this rush to innovate, but actually the regulators were outgunned, often not as sophisticated. They weren't paid enough. There weren't enough of them. They were absolutely understaffed and sometimes intimidated by the people that they regulated. I think we have to fix those issues.

Secondly, I agree with the suggestion that if you take a large institution that is systemically important—a hedge fund, an insurer, a bank, et cetera—we have to limit the amount of leverage that they have, because their costs when they blow up are not just restricted to their investors or debt holders or shareholders. We all pick it up. It's like having big buses on the road and we don't know how the brakes are going to do. We are all on the road with these folks.

I think, third, the incentives for senior managers, key traders, people who get to make major bets in institutions have to be symmetric, or as close as we can get within the confines of law. In other words, we need to take money from their bonuses and hold it aside. There need to be callback provisions. We may need to extend the liability beyond simply what they earn from that institution. Otherwise, you are going to take a bet with other people's money and you are going to go further with it than you ever would with your own. That's just human nature.

What I don't understand—I'm not an accountant—is, if our accounting methodologies were so sophisticated, how did they lead us to believe that all the risks these banks had taken had been handed off to somebody else, when, in fact, they hadn't? Whether it was liar loans, over-the-counter derivatives, or these off-balance-sheet vehicles, they basically took all this obligation and put it someplace else so that it didn't count for capital, and then they guaranteed the holders of the paper for that thing that if they got in trouble, they could come back and get the money anyway.

In terms of regulation, we're half-pregnant. Unless we get rid of all the regulation and say there are no guarantees for anyone, we have to fix these problems.

One final thought is, are we all too close to this? Am I too close? Is everyone in this room too close? Are even the brilliant people in industry too close? Maybe we are.

Maybe we need a panel—and it could report to Congress—that looks at all the threats in the financial systems, not just from malfeasance and bad accounting and poor regulation. We had the bird-flu concern a couple of years ago. Maybe we need to actually raise the periscope up and look a little further ahead, because I don't think we will spot all these problems coming.

THOMAS DONALDSON: Let me ask one question of the panel. It's a question that I mean to focus on the banking sector. There are many sectors here. But it strikes me that bankers are especially despised today. I was in London last week. The bankers were wearing jeans so they wouldn't be attacked. This was during the G-20 meeting. When I met Sir Philip Hampton, the guy who just took over as the new chair of RBS, the Royal Bank of Scotland, I couldn't help noticing that his security retinue—bodyguards and so on—exceeded, at least in appearance, Gordon Brown's. And he's not even a person who caused this in any way, shape, or form.

I recall, as an academic, all the studies that show that in banking your key competitive advantage, what your investors and customers prize more than anything else, including rate of return, is your integrity—that is, the amount they can trust you.

So we have a serious problem, gentlemen. Seamus has already talked a little bit about some of the changes—mostly, interestingly enough, regulatory. What does the banking industry itself—and I want to include hedge funds—need to do, if anything?

To take two controversial topics that Seamus may or may not want to comment on, should there be more transparency around these toxic assets? Should we imitate, as our European friends are doing, government regulations for bonuses and compensation arrangements?

What do you think?

CHRISTIAN MENEGATTI: There should definitely be more transparency around these toxic assets and these books, and not only towards the public.

Just to mention an episode, without naming institutions, during the Lehman bankruptcy, that weekend I was personally in touch with some institutions that were trying to understand what the repercussions for them would have been in the case that bankruptcy was actually going to happen.

Thirteen different books, coming from 13 different sections of this institution, were kept, each with totally different standards. So there is no transparency within the institution. They couldn't match each other. They couldn't understand the differences between the repercussions on one section versus another section.

So transparency doesn't necessarily mean the likes of hedge funds that, in my opinion, if systemically important, should be regulated. We can discuss how.

Transparency means also that we reach some standards, that without eliminating a competitive edge, we reach a point in which the regulators are able to have the proper oversight and regulators put everything in place in order to be able and willing to have the proper oversight on these institutions.

NEAL FLIEGER: I'll talk about compensation for a second. I recently saw some research that looked at issues of senior-executive/CEO compensation in the wake of the financial crisis, and what people think, looking at compensation as being one of the factors that drives personal, individual distrust.

Several different samples asked about several different ideas on what should be done and what would cause people to again feel better about these executives.

The same idea scored both off-the-charts up and off-the-charts down. If you say, "Do you think that the CEO of a publicly held company that is experiencing hard times should cut their salaries excessively"—and insert particularization here: take a dollar every year, forswear bonuses, cut salaries by 95 percent, whatever—about 90 percent of people think that that is a really strong thing to do.

In another sample, we asked basically the same question, but we asked if the government should require it. Fewer than 15 percent of people thought that that was a good idea.

This was U.S. research. This wasn't international research. But I think what that says, at least about the United States, is that people don't really want to see structural, legal limits—other than punitive—on the opportunity that could exist for somebody who is capable of doing well.

We really want to punish people, and I think your guy was right to have his retinue of bodyguards. But if you remove punishment from the equation, how do we want the system to work? I don't think most Americans want the system to have these kinds of hard iron walls around it that restrict what CEOs can do or how they can grow.

CHRISTIAN MENEGATTI: Perhaps it should be related to performance.

NEAL FLIEGER: It should be, right.

SEAMUS MCMAHON: I think this is a point where views in Europe, in particular, and the United States are very divergent. I think views in continental Europe, and even now in the U.K., would say there is a taste-test limit to how much senior people should get paid. That may ebb again.

But I also think that there are two ways you can get at that control. The most intrusive, in one sense, is to say you can do what you want for a living, but we're going to cap how much you can make. Another way to do it is to say that we're going to restrict what you can do for a living.

If you are a big institution, you had better be dull, because we are going to restrict the variability of outcomes. I think between increased leverage and more regulation, the variability of outcomes is going to go down, and banking, as we know it, and other business sectors are going to become much less volatile, and the opportunity for three-sigma earnings, and therefore five-sigma bonuses, will drop.

I think we will see some convergence of those regulations on activities and compensation—a bit like two blades in the scissors. Where it will cut will vary from country to country.

NEAL FLIEGER: You're completely right on the difference between the United States and Europe. In the United States—I don't even mean high-income or highly educated people—mainstream Americans believe they have this entitlement right to feel that they can someday be hugely rich.

A couple of years ago, I was working on the campaign around the repeal of the estate tax. I was working for people who wanted to repeal the estate tax. There was research that was done in which you talked to people who made $35,000 and $40,000 a year, and you say to them, "Look, your taxes go up in order to subsidize the fact that extremely wealthy people can avoid the estate tax."

When you make that argument, hugely, the middle-class, the $40,000 and $50,000 people, would like there to be a repeal of the estate tax. The reason they want there to be a repeal of the estate tax is because they think that one day this will apply to them. It may never apply to them, but they don't want any kind of structural limit on their ability to imagine themselves as multimillionaires one day and to imagine that these things might apply to them.

I think that goes back to the CEO idea. Nobody wants a regulatory system that says I can't make a gazillion dollars if I run a really good company and have the right ideas. If I blow it, punish me. But nobody wants laws that restrict that, I don't think.

THOMAS DONALDSON: Very helpful. One of the nagging questions that I'm still left with, however, is the extent to which, if at all, industries and the professionals in them, be they bankers or others, have a responsibility to create a world in which crises like the one we are going through either don't happen or are less severe. I note historically that every time we design regulation, smart people find ways to get around it.

We do need more regulation. I believe that. But I think of how knowledge in an industry races ahead of the knowledge of the regulators. Asbestos is a classic case in business ethics, where people inside that industry knew of its dangers long before regulators could manage it.

If we look at Sarbanes-Oxley, it was certainly imperfect but definitely an attempt to handle some very serious issues. Yet I note that it essentially didn't touch the evolution and genesis of the current crisis.

Questions and Answers

QUESTION: My question would go to the mention by Mr. Jordan about embedding a culture of restraint and the humility to be mindful of the long term, and also what you talked about, *The Wealth of Nations* and harnessing self-interest for the common good. How do we do that embedding? Where do we begin?

SEAMUS MCMAHON: I'm an idealist about individuals in their personal lives and a pragmatist about their business lives. I think that different countries start with different cultural legacies and a greater or lower likelihood of imbuing more restraint. I think in some of the Scandinavian countries, some of the continental countries, the psychic rewards for success are different and happen to be more restrained.

I know I'm throwing a very broad blanket. I think in the United States, to Neal's point, it's going to be very difficult in a few years—maybe in a generation we'll see a difference. In the next three, four, five years I think we'll need more than cultural revitalization, although I think that's important. I think we are going to need more formal restraints on people's behavior.

CHRISTIAN MENEGATTI: I think this crisis clearly has shown that the battle for self-regulation is lost, especially if we think about the bubble on the alternative investment side.

If we think about large institutions that are systematically important and can actually cause harm to the whole system, not only domestic, but global, that calls for more oversight and regulation, such as limits on leverage and attention on the procyclicality of leverage that has brought us to this large credit boom that has turned into a bust, and that we are all going to pay for at the end of the day.

Regulation doesn't have to be seen necessarily as restraining this laissez-faire type of economy. It doesn't necessarily have to be something that suffocates the system. It can be something that reduces the volatility of returns. But reducing the volatility of returns means that perhaps we are going to make a little less money during booms, but we are going to also lose less during busts. Let's think about this.

Leaving the financial system on the side for the second, if we just look at economic performance in countries that are maybe more regulated and in which financial systems are less deep than in the United States, volatility is much lower. There are less rich. They make less money during booms. But perhaps they don't suffer the kinds of busts that we can feel over here.

Thinking about Europe, for example, there are important differences, but it's also the system with the deepest financial system and closer, perhaps, to the U.S. system.

I'm not saying necessarily that that's the best model. But in terms of unemployment, for example, unemployment is higher than in the United States, but it's much less volatile, whether that's good or bad.

So regulation is not necessarily something that needs to suffocate the system, but it's something that can reduce the volatility in the system. Is that something that could be appealing? During busts, the answer would be yes; during booms, perhaps we all want to ride it, right? It's a fine line, and we need to find the right equilibrium there.

STEPHEN JORDAN: Since the questioner referenced my comments, maybe I should say something.

I have been doing a lot of reading lately about manias, panics, cultural mindsets, attitudes. None of them, as far as I know, have lasted forever. Maybe this one will. We go from periods of panics to periods of euphoria. Different cultures have different attitudes about different things.

Whenever you talk about ethics and you ask how you inculcate a culture of restraint, people start thinking normatively. They start thinking, what he is saying is a moral judgment here. But I was actually thinking about it more like a poker player.

The best poker players don't clean you out. The best ones always leave a chip or two on the table. They have enlightened greed. They want to come back and almost clean you out again in the next game. They look at the person as a sucker or an idiot, as a bad player, not necessarily as a good or evil person, who does clean somebody out and then ends the game on this.

Part of the culture of poker playing is that you really punish the cheats and you really punish the idiots.

As I said in the beginning of my remarks, what was keeping me up last night wasn't so much the topic, but how we were going to structure it so that we could stay on one line of discussion at a time.

There is a regulatory piece. There is a role around here for industry practices, for peer-group practices, for a kind of cultural level of this. You are going to find, as we try to follow this conversation, that people are going to be talking at different planes on different pieces of this as we go through.

It's not saying that it's sufficient, but saying that, as a hypothesis, it might be necessary to look at the culture that we are examining, is just something that I'm throwing out there. It might be important to look at that as a dimension of what we mean when we are talking about the ethical dimensions of restoring trust here.

QUESTION: I just want to come back to compensation for a minute. There are two sides to the marketplace. There are the financial services and there are the investors. Doesn't the impetus for this reform have to come from the investor? Are you seeing that sort of groundswell, that the investor community demands this reform? I call it the "heads-I win-tails-you-lose" compensation model. I just think, from the investor side, we have to be fed up with that.

Are you seeing any sort of swell from that perspective—not government, not self-regulation, but the investor community?

NEAL FLIEGER: If you look at the cost of top management paychecks and star trader paychecks, they are really big for the broker-dealers as a fraction of total costs. They are not actually that big for commercial banks. So it depends on the investor class.

For the commercial banks, I think their investors are most upset about the bets that those management teams have taken that they didn't fully understand they were taking. For example, Wachovia got into West Coast jumbo mortgages long after it was clear that the housing market had collapsed, by buying Golden West. What were they thinking?

I don't know whether the ire is more focused on the absolute structure of the compensation or on how we can rein in this risk appetite.

QUESTION: First of all, on the issue of voluntary restraint, I think that's something of a cultural matrix. Just ask yourself a simple question: If you are out on the road and you see a bunch of huge recreational vehicles and you are trying to enjoy the scenery and they are blocking your view, what is the first thought that occurs to you?

"Gee, I wish I had one of those," or, "Gosh, it's terrible that everybody else has one. Why can't we take them away from everybody else so all of us can enjoy the scenery?"

What I think is probably the case is that in the United States most people will answer that with the first answer—"I wish I had one of those for myself"—whereas in Switzerland and various other parts of Europe, I think the answer will be the second.

My question to you is this. Across the panel, I heard this in varying different ways. The zero-sum game between government and business in terms of confidence, it seems to me, at least historically, has been essential to the Americans' overall trust in the system, because they expect these systems to be hostile to one another and for the best result to come from their arm's-length, knock-down-drag-out contention with one another. But what I hear in the polling is that the public has made a rather dramatic change in its view and it now expects them to cooperate.

How is this going to work? I think everyone in this room is conditioned to the thought that it's from their adversarial mode that the best outcome will result.

NEAL FLIEGER: I don't have the prescription for how to make that happen, but I think that's what needs to happen. I think there is established this oppositional framework. As you say, it's that the best will come when that is the framework. Business tends to believe that what it has the opportunity to do and the right to do is, as I said, everything up to the point where government tells it that it can't, and then figure a way around that.

Government views itself as the sole policeman and watchdog. I think this is an opportunity, not just for the individual company wearing a hair shirt, but for multilateral organizations, peer groups, to start partnering with the regulators or the policymakers to be able to design mutual frameworks. If we are in this moment when that could happen, that would make a huge difference, I think.

QUESTION: I have been a member of the Bar for some 50 years. I tried murder cases as a living. I come from a completely different perspective here. I see that financial people rely on lawyers for some of their decisions. Isn't the system as strong as its weakest link? I know some of the top lawyers in the biggest firms, not only in the United States, but in the world, who routinely violate Section 2.1.

I realize that to the laymen that may sound kind of esoteric, but to the lawyers it's very important. Lawyers advising financial people routinely violate that section, which is a very important part of the ethical component. They advise clients wrongly about the potentialities, about the implications of some of the advice that they give.

Unless you and the general public demand that lawyers adhere to the canons of ethics, you will never solve this problem.

THOMAS DONALDSON: In the Enron meltdown, the law firm of Vinson & Elkins has been argued by some to have played a role. It got almost no attention.

QUESTION: On this whole subject of restraint, I heard recently the Conservative prime minister of Canada who said that government regulation has worked very well in Canada, and the banks there are either not allowed or they choose not to sell mortgages. They hold them to their own portfolio.

My question to the panel is, maybe we should look at Canada to see how we regulate our financial institutions.

I just want to add one other thing. There is a strong entrepreneurial element in Canada. It's called BlackBerry. They have a vibrant entrepreneurial economy, and they have restraint among their financial institutions.

SEAMUS MCMAHON: In between stints as a consultant, I have been a banker regulated by OSFI in Canada, OCC and the OTS here, and by the FSA in the U.K., and have friends in many other countries. I think, personally, the Canadian regulators have been the most consistently sophisticated and thoughtful, which is interesting, because the country is a tenth the size. I'm not sure of all the reasons for that, but it's a very prestigious and reasonably apolitical career. It's a technocratic but also politically pragmatic career, and you can go a long way.

I mentioned this in my remarks. Maybe this is a part of the culture of restraint where we can do something reasonably quickly. We have demeaned and diminished the role of banking and financial regulators—the SEC, the OCC, and so forth—in this country in the last ten years in a way that I think was bound to end in tears.

I don't think it's as simple as saying a single regulator will fix everything. The U.K. has had a single regulator, and they were, if anything, even cozier with the problem children than ours were.

But I agree with you. I think we can look to Canada and ask some fairly deep questions about why that's working.

CHRISTIAN MENEGATTI: Yes, we should ask some questions about why that's working. At the same time, they are restraining banks from selling, basically suffocating securitization. It might not necessarily be the solution.

If you think about the structure of incentives, just like a bank has an incentive to issue a loan when it's not going to keep it on its books because it's going to sell it to somebody else, whoever the counterpart of that transaction is who buys the loan, why would they put it on their books? What happened on that side? Why did that happen? Because the regulation in the system allowed off-balance-sheet vehicles, for example. That's just one of many components.

We can't just stop at condemning securitization and think that that's going to be the solution of all the problems. Clearly, going back to the savings and loans system would have maybe made it so that this credit boom would have never happened. But is that the best of the worlds? Probably not. We can do better. I think derivatives and securitization can do better, if properly regulated.

STEPHEN JORDAN: I'll just say that as a political matter, in terms of the Republican Party in the United States, from health care, drug prices, social services, military intervention, across the board, one way you can guarantee Republican opposition is by suggesting that the Canadians do it better. That's a tough sell.

QUESTION: The theme is about restoring trust in the financial sector. I think there's something deeper that some of you are touching on but not really addressing. I don't think it's only a question of regulation.

By the way, I would say I don't think the man or woman in the street would think that there is this adversarial relationship between regulators and business, because they know about lobbying and they know about people going from one to the other.

They know, as well, that the Republicans have been arguing that the government is the problem and can't do anything right. And Bush made the government so it didn't do anything right. So there's a big hole.

But I think the issue, as I say, is deeper. For example, in the effort of the United States to get the Europeans to have a larger economic stimulus package, the politicians in Europe who are objecting reflect, I think, a mood, which is, "It's your problem. You deal with it. You pushed these ideas on everybody. Eastern Europe is collapsing. They bought into your problems. Don't ask us in Old Europe to rescue New Europe," et cetera.

The countries that are the bellwethers today are China and India, which may be inefficient and so on, but they are not going through a crisis. The crisis in China is that it will only grow 6 percent this year, or something to that effect.

I suppose the last point is that maybe people are figuring out now that the idea that they can become rich is pretty impractical and that, in fact, their real wealth and real incomes have deteriorated over time.

What has happened in housing and the stock markets and 401(k)s—the whole idea of making pensioners bear the risk of losses in the pension funds—I think there is a period of adjustment that is beginning here, and that, at some point, there is more of a shakeout that has to happen. Confidence in business is not going to happen soon. That's my main point.

Thank you.

CHRISTIAN MENEGATTI: Regarding the changes in consumption patterns, for example, in the United States—and then I'll touch a little bit on Europe as well—clearly that is happening. That's not just a domestic phenomenon, but that's going to translate itself into a global phenomenon. We are a deficit country. I'm referring to current account deficits. That's the mirror of surplus countries, like China, which have been the drivers of global growth in the last few years.

This change in consumption pattern is going to come and is going to be brought about by this sharp recession, by the fact that not only Americans, but in other surplus countries people came to terms with the fact that there is budget constraint and that credit cards are not going to break this budget constraint ever.

So there is going to be a change in the consumption pattern. We are seeing it already. The savings rate went from negative to already close to 5 percent, and that will increase further. This is going to bring a rebalancing within the global economy. It's not going to close the surpluses that China and India have, and it's not going to close the current account deficits that the likes of the United States have.

These countries, let's remember, still need the consumer of last resort, which is the United States, to start their recovery, being export-led economies, where 40 percent of their aggregate demand comes from exports. I'm thinking about China.

Regarding Europe, this attitude of not being willing to take on one's shoulders the mistakes of others. It's a global crisis. It's not just a domestic crisis. It's a global recession. Europe is very much exposed to U.S. paper and Europe is very much exposed to Eastern European paper.

Eastern European paper has nothing to do with U.S. paper but has to do with the erosion of lending standards that was taking place in those countries as well in the years in which they were playing catch-up, hoping that one day they would end up under the umbrella of the monetary union.

I think Europe should think a little bit more wisely about the effects of a demise in the Eastern European economies. Think of Austria. The loans that have been originated in Austria and extended to Eastern European countries amount to 70 percent of the GDP of that country. So we can imagine how increased default rates can be very hard for that country.

That doesn't mean necessarily that Europe has to come out with a large fiscal stimulus, where the Germans, who are in better shape, are going to save the Italians, the Greeks, or the Portuguese—the "Club Med" countries. But Europe has also to come to terms with the fact that they decided to navigate towards a common market, a common currency, and that at this point in time the weakest link of the chain is the country that sets the value and the trust in that common currency.

Think about California in the United States. It's just as bankrupt as any Club Med country in Europe. But that does not affect the value of the dollar. That's a matter of trust in our reserve currency. It is the most widely used and is issued by a system that still is, or is perceived to be—and it's another matter of trust—the most politically stable in the world.

It's a matter of a currency that is probably still perceived as the safest. Let's think about the deleveraging that is taking place that is causing capital to flow out of these emerging markets that have been growing fast for the last few years. It's going where? It's going into riskless dollar-denominated assets, where yields are at all-time lows.

So trust plays an important role and historical patterns play an important role in this whole system. All the economies in the world, Europe included, G-20 economies, have to react somehow. Even if they are not going to issue a large fiscal stimulus, they have to think that, selfishly, they can't allow any of those countries to default if they want to preserve the unity of the currency at this point.

THOMAS DONALDSON: I want to apologize. In order to let you out on time, that has to be our last question.

Let me, in closing, make a pitch for ethics, in contrast to some of what has been said. There are not a lot of people here who don't like ethics. But there is a concern, I think, that we ought not to rely on self-regulation. That concern is well placed. But we can only expect from regulation what it's capable of delivering.

Seamus mentioned that he thought the bankers themselves, because of the complexity of what had been done, didn't have a clue. I hope that's wrong, because if that's true, more regulation will not help us. I assure you, if they don't know inside the industry what's going on, the regulators won't.

I would add, this is not a view that everybody holds. Even Greenspan himself, when asked, "Did they know?" said, "They knew. They thought they could get out in time."

As somebody who reads the literature, I have been reading about systemic risk over the last six or seven years.

Ethics can't do everything, but expecting professionals to take some responsibility—and we need to do this in business schools—I think is an important part of the equation. If you look broadly around the world, for example, at software piracy ratios, people who steal software, the ratio between pirated and legitimately purchased software, the regulations are pretty much the same around the world. The ratios of software piracy vary immensely, depending on the culture and the attitudes about the ethics of software piracy.

I have arranged this so nobody can respond.

I tried to summarize some of the main points. Just looking at my list, I don't know. See what you think.

Lawyers are bad. Greed is good, at least the enlightened kind. The United States is better than Europe, and Canada is better than both the United States and Europe.

Maybe not.

Join me, won't you, in thanking our distinguished panel.