PACIFIC PENSION INSTITUTE

2008 Winter Roundtable

China: ***Myths and Realities of the Middle Kingdom***

FINANCIAL TURMOIL: REVERBERATIONS IN THE GLOBAL MARKETPLACE

A Simulation by CENTRA Technology, Inc.

The Ritz Carlton Hotel, Marina del Rey, California
21 February 2008

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About the Simulation

On 21 February 2008 participants in the Pacific Pension Institute's 2008 Winter Roundtable took part in a simulation called "Financial Turmoil: Reverberations in the Global Market Place," presented by CENTRA Technology, Inc.

The simulation was designed to explore the effects of a deepening US credit crisis on China and other major economic actors. The goal of the afternoon was to allow roundtable participants to gain unique insights into the dynamics of finance, trade, and macroeconomic policy interactions among China, the United States, Europe, Japan, and other major economies and market actors. ***The simulation resulted in an outline of possible policy actions, market decisions and net spillover effects of a US-centered crisis on China and China's key trading and investment partners.***

Role-playing simulations force participants to think in new ways and to consider information and pressures that they would not normally consider. Simulations are not predictive devices but can do an excellent job of illustrating comparative strategy, decision-making processes, and the forces at work within and among different player groups. Two CENTRA staff members, acting as CONTROL, presented the scenario and assigned roundtable participants to teams and roles for the duration of the half-day simulation. CENTRA encouraged participants to embrace their roles' personalities, interests, and points of view to the greatest extent possible.

The simulation was played in two moves during the afternoon. Prior to Move One, CENTRA gave the participants a short organizational and "scene setting" briefing. ***Move One started at the future date of 21 April 2008***. Before the group split up into nine teams they viewed a mock video news report detailing a sharp drop in US retail sales. This report provided the initial "trigger" for team responses in Move One. Teams received updated "real time" information – in the form of a series of written news reports prepared by CONTROL– to help move the simulation along. Move Two began, after a short break, as ***CONTROL advanced the calendar to 21 October 2008*** and provided teams with a set of conditions and real time updates that built upon the scenario in Move One.

Disclaimer:
Names of individuals and organizations cited in this report and in the simulation itself were used only to illustrate fictitious scenarios. Our interest was in making the developments depicted in the event seem plausible rather than predicting actual individual or institutional behavior.

TEAMS AND INJECTS

The simulation took the form of an exercise in applied game theory. Roundtable participants broke out into the following nine teams, with which they played throughout the afternoon's two moves:

- ***The Dollar Team***
- ***The Euro Team***
- ***The Yen Team***
- ***The Yuan Team***

- ***The Tiger Team***
- ***The TNC Team***
- ***The Newport Beach Team***
- ***The City Team***
- ***The Oil and Cash Team***

During Move One and Move Two the teams received a series of "injects" in the form of videos, news reports, and press releases. The teams responded to the following headlines:

MOVE ONE

- ***GNN Interview: US Retail Sales***
- ***Stocks Plunge***
- ***AIG Credit Default Losses***
- ***China Investments Abroad***
- ***China Inflation***
- ***IDK Collapse***
- ***Dollar Weakness***
- ***China-US Trade Decreases***
- ***Japanese Recession Confirmed***
- ***US GDP Revised Down***

MOVE TWO

- ***Fed Chairman's Report***
- ***Export Labor Unrest in China***
- ***US Recession***
- ***China Rural Banks Pressured***
- ***SAFE Financial Scandal***
- ***Newport Beach Team Report***
- ***China Shares Drop 17 Percent***

For each move, CENTRA asked the participants to think about how the real-world groups and actors they were playing would respond to this information. Participants discussed the latest news and events, initiated meeting with other teams, and delivered public statements. At the end of each move, the teams handed in a detailed move sheet that listed all the actions taken, strategies formed, and differences among team members.

Executive Summary

The deep integration of the global economy in the 21st century will magnify the effects of a major downturn in the US economy, according to a simulation run by CENTRA Technology at the Pacific Pension Institute's Winter Roundtable in Marina del Rey on February 21, 2008**.** If the US economy sinks into a sudden and serious recession in 2008—after consumers, over-burdened by debt and declining housing values, finally "hit the wall"—fears of greater financial contagion will spread in Europe and Japan.

On a more positive note, the increased integration of the global economy also means that ***the economic policy establishments of the United States, Europe, Japan, and China will have a greater incentive to work together and take coordinated actions to maintain order in international financial markets.*** During the simulation, there was a sense that all of these countries were in the crisis together, and as a result, they were able to negotiate several joint-policy statements and coordinated monetary and fiscal stimulus packages. Central banks and governments cooperated to inject liquidity into the financial system as transnational corporations scrambled to restructure in the face of declining demand and large investors with spare cash targeted buying opportunities.

The simulation's initial scenario and subsequent injects of updated information were linked to events in China, including: a precipitous drop in Chinese exports, export sector labor unrest, contagion from US and European credit defaults, financial sector losses due to unauthorized foreign debt purchases, scandal and violence over financial losses of the rural banking sector, and a plunge in the Shanghai stock exchange index.

Simulations are not predictive devices but they can do an excellent job of illustrating comparative strategy, decision-making processes, and the forces at work within and among different player groups.

These events grabbed the attention of China's policy establishment, which endeavored to tamp down domestic unrest and maintain economic and political stability as China's manufacturing export machine sputtered. Large overseas Chinese-dominated businesses and investment capital also focused on the China-connected effects of the building crisis. It was instructive that ***other countries and investors paid less attention to what was happening in China than to the core economic problems of the United States***, and to a lesser extent, of Europe and Japan, which appeared to threaten the global financial system.

As the year wore on, the subprime-related insolvency of Germany's IKB bank forced European regulators to ensure that bankers were fully disclosing their risks and did not suffer from the same valuation problems as their US counterparts. Feeling better about its fundamental economic position, the EU was not a keen supporter of proposed financial rescue packages by the US Government for distressed American assets.

Japan did its best to insulate itself from the deepening recession in the United States, but the prospect of an upcoming domestic election limited its options. ***The declining value of the dollar was of particular concern to Japan, but it did not intervene in international currency markets*** and held interest rates at 0.5 percent. At game's end, in the fall of 2008, with the US recession intensifying and dollar continuing to drop in value, Japan was poised to take much more dramatic action, including establishing its own sovereign wealth fund to buy up distressed US debt and equity.

China did everything in its power to thwart incipient US and European protectionism. The uncovering of a financial scandal involving the misuse of a Hong Kong conduit for European bank and real estate investments exacerbated social unrest triggered earlier by the downturn in export-oriented production. China's economic policy establishment concentrated on stimulating domestic demand while fighting inflation and managing internal unrest, even as it coordinated external policies with the other three economic policy teams.

In addition to tracking events in China, where they maintained large investments, the overseas Chinese-dominated businesses of China's near-neighbor economic partners—Hong Kong, Indonesia, Singapore, South Korea, Taiwan, and Thailand—urged OECD governments to take Plaza Two-style unified action and encouraged them to use both fiscal and monetary stimulus measures to abate the worsening global financial situation. At the same time, they used cash and solid credit ratings to acquire bargain-priced investments.

North American savers, investors, and professional money managers decided to proactively address the root cause of the global financial crisis: ***a lack of liquidity as a result of the US housing market meltdown***. They created a rescue fund—the appropriately named "Save America Fund," an RTC-like fund made up of a consortium of money managers, investment banks, and pension funds to buy up distressed debt from the marketplace.

The simulation resulted in an outline of possible policy actions, market decisions, and net spillover effects of a US-centered crisis on China and China's key trading and investment partners.

Declining economic conditions in the United States had a major effect on transnational corporations and especially supply-chain companies that did not have a product and were unable to control their means of production. Transnational corporations—represented in the simulation by GE/UT, GM/Ford, Toyota, Mitsubishi, HP/Dell, and BHP, among others—laid off over 13 million employees and engaged in massive restructuring. ***Transnational corporations were remarkably uninterested in the actions and statements of the four economic policy teams and the sovereign wealth funds*** because they were too busy restructuring their own companies.

The sovereign wealth funds and major oil companies benefitted the most from the global financial problems. Sovereign wealth funds cautiously waited to see how the United States would react to an infusion of foreign, state-controlled cash before they made aggressive moves into the US real estate, financial services, and manufacturing sectors. The state owned oil companies bought reserves and some small energy companies that would not be seen as politically sensitive. The oil companies and sovereign wealth funds were arrogant and drove a hard bargain when approached for policy endorsements or financial support, but at the end of the simulation they were the only ones drinking champagne.

THE DOLLAR TEAM—UNITED STATES ECONOMIC POLICY TEAM

Nominally chaired by the ***President of the United States***, the Dollar Team adjusts US fiscal and monetary policy in response to and in anticipation of domestic and global economic trends. The ***Secretary of the Treasury***, the Chairman and Governors of the ***Federal Reserve Board***, the Comptroller of the Currency, and Congress—represented in this simulation by House Ways and Means and Senate Finance Committee chairmen—together determine the mix of US fiscal and monetary policy responses.

The Secretary of State, Secretary of Commerce, Secretary of Labor, Attorney General, the US Trade Representative, the National Security Advisor, and the Committee on Foreign Investment in the United States (CFIUS) among others, play roles in adjusting US international economic policy, including rules for movement into the United States of foreign goods, services, capital and labor.

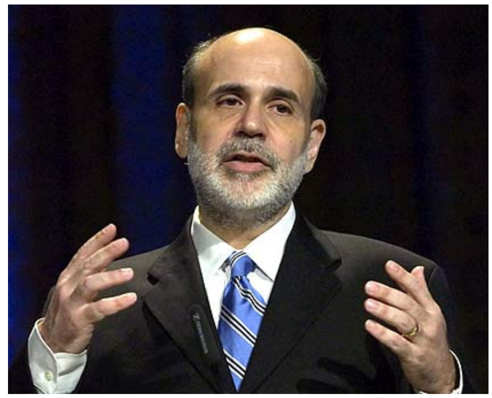
The President, Treasury Secretary, Fed Chairman, and the Congress have key roles. They rely on the advice of economic policy staff of multiple agencies and formal advisory groups, such as the President's Council of Economic Advisors, and informal business and academic advisory groups such as the US Chamber of Commerce, the National Bureau of Economic Research, and economic think-tanks. The President and Fed Chairman, respectively, coordinate any fiscal and monetary policy responses to the shocks posed in this simulation.

Confronted by mounting evidence of a serious downturn in the US economy, during both Moves, the Dollar Team focused on taking measures to forestall a deeper US recession, prevent a further decline in US asset values, and reform US lending practices. At the same time, the US President, Secretary of the Treasury, and Fed Chairman quickly concluded that in a 21st century financial crisis the United States would have to work cooperatively with its economic counterparts in Japan, Europe and China to take coordinated action and maintain order in international financial markets.

The President deputized the Secretary of the Treasury to engage the other three economic policy teams in discussions. Several times during Move One, CONTROL injected suggestions for such consultations only to discover that the policy teams were already engaged with each other in spirited ad hoc consultations about the road ahead.

Following Move One, the Chairman of the Federal Reserve Board, at CONTROL's request, gave an oral briefing to representatives of all teams in the plenary conference hall. He outlined progress made through ad hoc consultations among the Dollar, Euro, Yen, and Yuan Teams.

The Fed Chairman announced that:



- The Federal Reserve and other central banks wish to inject greater liquidity into the global financial system in light of the deepening US recession and credit crunch

- The Federal Reserve had lowered the federal funds rate by 50 basis points

The Fed Chairman also announced that the Dollar, Euro, Yen and Yuan teams had reached agreement on the following:

- The US and Chinese Governments would each undertake fiscal stimulus measures equal to 1 percent of GDP.

- EU nations also agreed to undertake fiscal stimulus measures

- The European Central Bank (ECB), Federal Reserve, Bank of England (BOE), and Bank of Japan (BOJ) issued a joint statement on their efforts to maintain orderly foreign exchange markets.

- The ECB and BOE both eased their key lending rates by 25 basic points

In internal Dollar Team deliberations, the US Comptroller of the Currency was particularly concerned about the effect of the US housing crisis and credit crunch on the stability of the US banking system. He separately announced that, in coordination with Congress, the US administration would do everything in its power to keep Americans in their homes, including taking measures to provide homeowners with greater latitude to work out their mortgages. He issued a statement that the Office of the Comptroller of the Currency (OCC) would loosen bank reserve requirements to facilitate lending.

The OCC also proposed that after banks wrote down the value of troubled mortgage loans and loan-backed securities, the government, through HUD and Fannie Mae, would assume an unspecified amount of distressed mortgage instruments under a "Son of RTC (Resolution Trust Corporation)" program. He stated that these would be the only securities that the government would take on, however, and that they would be restructured and sold on to the private market.

The President and Congressional leaders expressed concerns about the potentially large costs of the OCC-proposed Son of RTC solution; but other advisors counseled that there were lessons to be learned from the 1990s savings and loan crisis. A "sweet spot" selection of assets could result in a much-needed self-sustaining increase in housing market confidence. This could in turn help to improve the creditworthiness of private sector financial institutions and even support the credit ratings of US agency securities.

At the conclusion of Move Two, reflecting continuous collaboration among the four policy teams and discussions with the sovereign wealth funds represented on the Oil and Cash team, the Secretary of the Treasury issued the following statements:

Joint statement on Foreign Exchange Markets

> "The governments of the United States, Japan, and the Euro areas reiterate the importance of orderly currency markets. We continue to monitor developments closely and stand ready to take all necessary measures to maintain orderly markets."

Joint Statement to Promote Global Growth:

> "With a view to strengthen domestic consumption in each of our economies the governments of the United States, China, and the Euro areas will implement additional fiscal stimulus. In the United States fiscal stimulus will be at least 3 percent of GDP (including what has already been done); in China fiscal stimulus will be 1 percent of GDP; in Japan fiscal stimulus will be 0.5 percent of GDP."

Joint Statement on Open Investment Policies:

> "The governments of the United States, Japan, China, and the Euro areas—in coordination with the sovereign wealth funds from the Middle East and Europe—would like to reiterate our longstanding policy of welcoming foreign investment. We also agree that investment from sovereign wealth funds and state enterprises should be done on a solely commercial basis."

THE EURO TEAM – EUROPEAN ECONOMIC POLICY TEAM

The ***European Central Bank President*** (Jean-Claude Trichet) leads the Euro Team and, with the advice of the ECB Governing Council, sets Eurozone monetary policy. The few other European central bankers, principally the ***Bank of England Governor*** (Mervyn King), play independent roles but they and the ECB President mutually consult.

The European Commission in Brussels, on behalf of the European Union, is the principal actor in adjusting the EU's international trade policy towards China and the rest of the world. The EC President (Jose Barroso) is the Commission's chief spokesman, although other EU officials, such as the EU Monetary Affairs Commissioner (Joaquin Almunia) provide independent policy advice. Major European national governments—France, Germany, Italy, Spain, and the UK, represented by their ***Finance Ministers***—are also members of the team, with the main role of adjusting national fiscal policies. They are most definitely not under the direction of either the ECB President or the EC Commissioner, but will communicate their views to them both and lobby for particular monetary and trade policy actions.

While the Euro Team expected a US economic downturn, the recession and the liquidity crunch were worse than they had originally planned for. They were concerned with a contagion effect from North America as well as from China, and the possibility that some of the European banks might have valuation problems similar to their US counterparts. Their strategy was to investigate the ownership and liabilities of European banks and to make sure bankers were fully disclosing their risks. This strategy was sharpened after the failure of IKB, which it turned out, had received non-transparent investments from Chinese sources.

The Euro Team injected financial reserves to keep European banks afloat and lowered benchmark interest rates 75 basis points. The goal was to provide support for bank depositors and facilitate consolidation. While taking steps to improve banks' balance sheets, members of the Euro Team, notably the Bank of England (BOE), were concerned about the moral hazard connected with such assistance. The BOE's serious concerns over the health of the City of London financial center and potential vulnerabilities of UK banks balanced the moral hazard factors.

The Euro Team's biggest concerns were the possibility of a contagion effect from the deepening recession in the United States, a decrease in Chinese exports to the United States, and the strengthening of the Euro and British pound against the dollar. As Chinese exports to the United States decreased, the Euro Team, concerned about trade diversion, considered placing import duties on the flood of Chinese goods coming into the region. They were initially worried that the bankruptcy of the German bank IKB was the first of many subprime related insolvencies to come, but when this did not turn out to be the case, the Euro Team's fears of a contagion effect diminished. In fact, the Euro Team was content to entertain visitors from other teams and take very little action in the second half of the simulation, thinking that they had already taken adequate and appropriate measures to defend themselves against any contagion effect. The Euro Team was amused by the Newport Beach Team's "RTC fund" announcement and pledged to contribute a paltry 100 euros to the fund.

THE YEN TEAM – JAPAN ECONOMIC POLICY TEAM

Nominally chaired by the ***Prime Minister*** of Japan (Yasuo Fukuda), the Yen Team represents the collective monetary, fiscal, and international economic policy levers of the Japanese Government. Japan's mix of fiscal and monetary policy responses is determined by, among others, the ***Governor of the Bank of Japan*** (Toshihiko Fukui), along with the BOJ's Deputy Governor and Policy Board of banking executives; the ***Minister of Finance*** (Fukushiro Nukaga), his Vice Minister of Finance for International Affairs, and the ***Budget Bureau***; and the ***National Diet***. International economic policy players also may affect the decisions of the Yen Team, and they include: the Minister of Foreign Affairs (Masahiko Koumura), and the Minister of Economy, Trade & Industry (Akira Amari).

The Yen Team's strategy was to minimize the impact of the US economic downturn on the Japanese economy, but they were frustrated by their limited options for a response. The upcoming LDP general election meant that the government was forced to defer raising the consumption tax until after the election. The chairman of the Bank of Japan was strong enough to maintain interest rates at their current level of 0.5 percent but after meeting with the Deputy Secretary of the Treasury, the Yen Team agreed to introduce a Japanese fiscal stimulus package of 0.5 percent of GDP. Despite suffering from a rising yen, they took a passive strategy of watching events unfold in the markets and did not intervene in foreign currency markets.

News of the increasing credit crisis, the weakening dollar, confirmation of a Japanese recession, and rising inflation in China all had a major impact on the Yen Team. As the yen continued to strengthen against the dollar, deflation became more and more difficult to avoid. The Yen Team pushed forward on deregulation to encourage domestic demand but it did not raise the consumption tax rate for political reasons. If the domestic and international economic situation had continued to decline past October 2008, the Yen Team would have considered creating a Japanese sovereign wealth fund to inject liquidity into suffering US financial institutions and keep the dollar from declining further against the yen.

The Yuan Team – China Economic Policy Team

Nominally chaired by the ***Premier*** of the People's Republic of China (Wen Jiabao), the Yuan Team represents the collective monetary, fiscal, foreign exchange, and international economic policy establishment of the Chinese Government. Important players in monetary policy include: the ***Governor of the People's Bank of China*** (Zhou Xiaochuan) and his deputies, including the PBOC Deputy Governor in charge of the ***State Administration of Foreign Exchange*** (Hu Xiaolian); the President of China's main foreign currency bank, the ***Bank of China***; and the presidents of other state-owned commercial banks. The newly-formed ***China Investment Corporation*** (CIC) is a de facto tool of international reserve management.

In fiscal policy, the Chairman of the Standing Committee of the ***National People's Congress*** (Wu Bangguo for now), the ***Minister of Finance*** (Xie Xuren), the ***Chairman of the National Development and Reform Commission***, (Ma Kai) and the Director of the National Bureau of State Taxation all play roles is setting government taxation and spending policy. The ***Governors and Party Secretaries*** of China's 30 provincial-level regions, insofar as they strongly influence local taxation and spending policies and lobby the Central Government on national monetary and fiscal policies, are a background chorus of this team who may raise their voices from time to time.

In light of the deepening US recession, the Yuan Team decided that immediate measures needed to be taken, including the convening of the G-7 plus plus, (with the Middle East) for discussions on preventing protectionism among the participating countries, fiscal and monetary coordination, global inflation, and retaining international reserves in dollars. The Yuan Team also agreed that China would invest abroad strictly on a commercial basis.

The Yuan Team's key strategies were to have China stimulate international action and draw on their foreign exchange resources to stimulate the economy both in the short and long term. The politics and current trends of the People's Republic of China (PRC) were kept foremost in mind. Domestically, the Yuan Team emphasized strengthening the social safety net and assuring the liquidity of the Chinese banking system. They cut China's bank reserve requirements from 15 percent to 12 percent to stimulate lending, even while the PBOC worried about inflationary pressures. For the longer term, they emphasized that funds should be allocated for environmental protection and renewable energy.

Confirmation from PRC authorities that banks in China's hinterland had made unauthorized investments in risky projects in Europe – through a Hong Kong subsidiary of the State Administration of Foreign Exchange – led to the resignation of the well-regarded Governor of the People's Bank of China, a further shock to the banking system.

Factors that had the greatest effect on the Yuan Team were the reports of the rising US recession, a drop in US imports, the growing impact of Chinese inflation, and signs of domestic disquiet in China—especially in certain manufacturing areas. The Yuan Team did everything in their power to thwart protectionism in the United States and elsewhere to meet the prospects of declining exports to the United States and other parts of the world and to shore up China's domestic demand as a protection against social unrest at home and economic shocks coming from abroad.

THE TIGER TEAM

Led by Li Ka-shing, CEO of Hong Kong's Cheung Kong Holding and one of the wealthiest businessmen in Asia, the Tiger Team includes the Overseas Chinese-dominated businesses of China's near-neighbor economic partners Hong Kong, Indonesia, Singapore, South Korea, Taiwan, and Thailand. For the purposes of this simulation, major Thai and South Korean companies that have invested heavily in China, such as Charoen Pokphand and Samsung, are on this team rather than the Transnational Corporation (TNC) Team. However, the large multinational banks with local roots that are active in the region—such as HSBC and Standard Chartered—are represented on the City Team. The governments and monetary authorities of these near neighbors—the most important of which for China are Hong Kong, Singapore, and South Korea—are also players on the Tiger Team, although business dominates decision-making.

The Tiger Team was focused on maintaining global growth and political stability, both of which are necessary for capitalism to flourish. They coordinated with the world's financial leaders to urge governments to take unified action on the scale of the 1985 Plaza Accord, in which five governments intervened in global currency markets to depreciate the dollar. Throughout the simulation, the Tiger Team stayed on a course of encouraging governments to use both fiscal and monetary stimulus measures to abate the worsening global financial situation.

As the threat of the financial contagion effect increased, the Tiger Team's greatest concerns became possible protectionist sentiment in the United States and Europe and making sure that the governments of the United States, Europe, Japan, and China realized that they were all in this financial crisis together. To this end, the Tiger Team was delighted by the amount of coordination between the four economic policy teams and their joint statements to maintain orderly markets. Social unrest in China was also a major concern for the Tiger Team and they sought assurance from China that it would first stabilize any domestic unrest and then increase liquidity in the banking system.

The Tiger Team urged the Chinese government to increase the number of projects and volume of investments in infrastructure. They offered to help the Chinese government create a social stabilization fund that would allow local governments to provide assistance to unemployed workers affected by the decrease in Chinese exports to the United States. They also used their quality credit ratings to leverage the economic and political situation and acquire cheap assets; the Tiger Team bought both US equities and strategic companies in China.

THE TNC TEAM

> Led by Jeff Immelt, CEO of GE, the TNC Team includes large global corporations—mostly from Australia, Europe, Japan, and the US—that have sizable investments in and/or trade with China.   The team includes individuals who represent the principal sectors of global business that have a stake in China, including: gaming (e.g. Sands of Las Vegas), manufacturers that have invested heavily in China (e.g. GE, GM, Nokia, Philips, Toyota), and companies that export a large volume of resources and capital equipment to China (e.g. Airbus, BHP Billiton).   They can play as individual company representatives or in seminar style, talking through the moves that team members think TNC member companies would be making in light of events that unfold in the simulation.

The TNC Team displayed little public spirit and was remarkably uninterested in the actions and statements of the four economic policy teams. Surprisingly, the TNC Team did not have much interaction with the sovereign wealth funds – the TNCs were too busy restructuring their own companies. The TNC Team made a lot of transformational moves, selling and buying, and laid off approximately 13 million employees worldwide during the deepening and spreading 2008 recession. However, the TNC Team was interested in sovereign wealth funds such as Singapore that had a more neutral political leaning than the Middle Eastern and Chinese funds.   Their strategy was to wait, watch, and then pounce.

The TNC Team was very concerned about US protectionism and the political impact of job losses. They were upset at what they saw as the institutional dysfunction of the US Government and a lack of assistance from the Federal Reserve. The TNC Team was offended that nobody from the US Government came to meet with them during the initial stages of the simulation, and when the government finally sent the Deputy Secretary of the Treasury over, they treated him poorly.

The TNC Team did not act as a collective unit. The companies that suffered the most were the supply chain companies. By the second half of the simulation they were in serious trouble because they did not have easy access to product and had no way to control their means of production. BHP Billiton—proxy for global non-oil resource companies—was quick to abandon its merger with Rio Tinto and cut production in the face of slowdown in commodities purchases. In the second half of the simulation BHP Billiton started buying up assets and became close friends with Mitsubishi, which made a lot of money on its natural resource investments. General Electric (GE) made some interesting moves: it eliminated the GE Credit division and acquired some cleantech assets. General Motors (GM) underwent some leadership changes and relied heavily on the US Government for assistance. Toyota suffered major financial losses and looked to create new alliances anywhere it could. Proctor and Gamble made a surprise decision to move into the defense industry and the Sands Corporation was happy because people continue to gamble, even in a recession.

THE NEWPORT BEACH TEAM

Led by Bill Gross of PIMCO, the Newport Beach Team represents North American savers, investors, and professional money managers—including endowment, hedge fund, investment bank, mutual fund, pension fund, and private equity company managers. The team also includes roles to represent particular segments of the North American savings and investment community, such as employees contributing to 401(K) and IRA plans, homeowners, high net worth individuals, public sector employees (e.g. teachers and state employees' unions), and speculators and traders who take long and short positions in the securities and commodities markets.

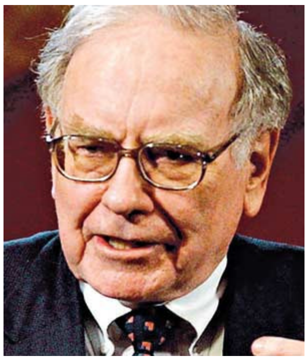
Early in the simulation the Newport Beach Team concluded that its main objective should be to address the root cause of the global financial crisis: a lack of credit liquidity as a result of the US housing market meltdown. They also worried that rising global inflation and a short-term panic by investors could combine to challenge the stability of the financial system before normal lending activity could be revived.

In order to inject liquidity into the market, they proposed the creation of a $40 billion rescue fund called the "Save America Fund", to be managed by a consortium of money managers, investment and retail banks, and pension funds. As the simulation proceeded and the economic news from China, Europe, and Japan added to the negative US picture, their views were only reinforced, and the salability of their rescue fund proposal only improved.

Newport Beach approached the Dollar Team for support and obtained US Government agreement to create this RTC-like fund that would take distressed debt from the mortgage marketplace. The Dollar Team agreed that US banks would be allowed five years to write down their mortgage-related debt in order to accommodate bank capital ratio requirements. Securities issued and sold on to investors by the fund would be government-guaranteed.

The Newport Beach Team managers, including Merrill Lynch and Fidelity, designed a campaign to educate investors about the excellent opportunities this fund could create, with possible 12 percent-plus investment returns and managers' fees of 85 basis points. Some high-net-worth individuals on the team were not in favor of this approach in the early stage of the simulation.

Continued negative news reports of bond insurers' difficulties caused the Newport Beach Team to become increasingly concerned that a bond insurance collapse would lead to lower the ratings for their fund. In this context they approached the Oil and Cash Team, especially the sovereign wealth funds represented there, for assistance.



The sovereign wealth funds initially responded to the Newport Beach Team that they were would only invest money in a US-centered rescue package if Warren Buffett or Bill Gates first showed a true commitment to the Save America Fund.

The Newport Beach Team got buy-in from both its high-net-worth representatives, Buffett and Gates, who publicly expressed their support for the creation of the fund and announced that their foundation would make a substantial investment in it. Aside from Buffet and Gates, the fund also attracted investments from the endowments of Harvard and Yale and received support from state pension funds in California, New York, Washington, and Oregon.

At the conclusion of Move Two, the Newport Beach Team made a public announcement confirming the establishment of the Save America Fund, its US Government sponsorship, and named its several private and public sector supporters and investors.

THE CITY TEAM

Led by the Chief Executive of HSBC Group, Michael Geoghegan, this team represents European savers, investors, and professional money managers—including managers of endowments, hedge funds, investment banks, mutual funds, pension funds, private equity firms, and one major sovereign wealth funds (Norway's). Included are major commercial banks, brokers, and money managers of the City of London and continental European money centers in Amsterdam, Frankfurt, and Paris. The team also represents particular segments of the European savings and investment community, such as private and public sector employees, homeowners, high net worth individuals, and speculators and traders who take long and short positions in the securities and commodities markets.

The City Team was not caught off guard by the US recession and attempted to take a calm approach to extricating themselves from global financial problems. Their biggest concern was assessing their current and short term losses. The Team found it challenging to identify new sources of capital and avoid becoming too reliant on the European central banks. In an attempt to stop capital losses and ease expectations of slow growth, the City Team reviewed their asset allocations. Their strategy was to review risk management practices, make changes as necessary, and seek out sources of capital for bailouts and future investments and losses.

The City Team lobbied the European Central Bank (ECB) and the Bank of England (BOE) to inject economic stimulus and introduce significant rate cuts, which they felt were long overdue. They also negotiated with the European central banks for possible financial rescue packages and discussed potential reserves, expected severe layoffs, and business cutbacks. The central banks responded by telling the City Team to better regulate themselves through improved business policies, risk management, and loss assessment.

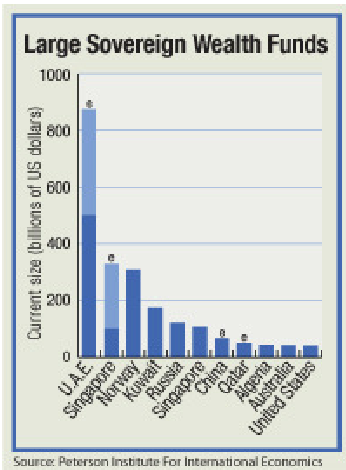
Separately, the City Team pressured the US Government to review policies towards supporting the US monoline insurance companies and voice concerns to the Chinese government about possible Chinese military action against Taiwan. In general the City Team did not find that politics heavily influenced their views of the unfolding crisis, but they did wonder about the repercussions should foreign sovereign wealth funds accumulate ownership in major European financial companies.

Following the decline of the dollar, private European investors began to slowly invest in US assets. The news that GM and Ford were about to receive strategic investments from the China Investment Corporation (CIC) and Morgan Stanley provided a glimmer of hope that buyers were still around and willing to provide bail-outs. The Federal Reserve's rate cut also created buying opportunities for European investors. The City Team talked to the sovereign wealth funds of the Oil and Cash Team, who were generally supportive of negotiating deals with the strongest of the financial institutions. However, the City Team was concerned about the political repercussions of foreign sovereign wealth funds accumulating ownership in European banks and insurance companies. They welcomed and supported the Newport Beach Team's announcement of an RTC-like fund that would take distressed debt from the mortgage marketplace.

THE OIL AND CASH TEAM

Two acronyms—NOC and SWF (for National Oil Company and Sovereign Wealth Fund)—describe the set of interests bound up in the large emerging market countries that are building national wealth rapidly through the export of energy or manufactured goods. Team members will, in seminar-style, game the investment and portfolio decisions of state-owned national oil and gas companies, high net worth individuals, royal families, and SWFs of the oil exporting countries and large trade surplus countries, along with the governments and monetary authorities with which they are connected. Examples of such entities would be oil and gas companies like Saudi Aramco, CNOOC, Gazprom, Petrobras, Rosneft, and Sinopec; and investors such as CIC (China), Temasek, ADIA (UAE), GIC (Singapore), Istithmar (Dubai), and the Kuwaiti and Saudi Royal Families.

While initial news reports indicated that the recession in the United States was worse than expected; subsequent news reports may have caused the Oil and Cash Team to worry more or less about specific mounting problems but did not affect their overall strategy, which was to wait and evaluate the market for opportunities to buy assets that became undervalued in reaction to the US recession.



The Oil and Cash Team's biggest concerns included: competition among each other for underpriced assets, protectionist caps on foreign ownership, and the stability of global oil consumption. They were also quite concerned about the social unrest in mainland China. Politics did factor into their decision making process, and they cautiously waited to see what the US Congress' reaction to an infusion of foreign "state-controlled cash" in the US market would be before they made any aggressive moves.

Initially, the sovereign wealth funds shifted their exposure into currency markets, purchasing Canadian, Swiss, and Russian currencies that would benefit from stable commodity prices. National Oil Companies on the team bought reserves and some small energy companies that would not be seen as politically sensitive. The Oil and Cash Team also made investments in financial services firms that they viewed as oversold by the market. The Chairman of the Federal Reserve's statement encouraged the Oil and Cash Team to increase their investments and move into markets more aggressively. They began by making selective investments in commercial real estate and manufacturing. The sovereign wealth funds were active players; they provided a capital infusion for The City Team's HSBC, supported the Newport Beach Team's "Save America Fund", and signed a joint statement by the US Secretary of the Treasury on maintaining open cross-border investment policies.