



When Markets Collide

Investment Strategies for the Age of Global Economic Change

THE SUMMARY IN BRIEF

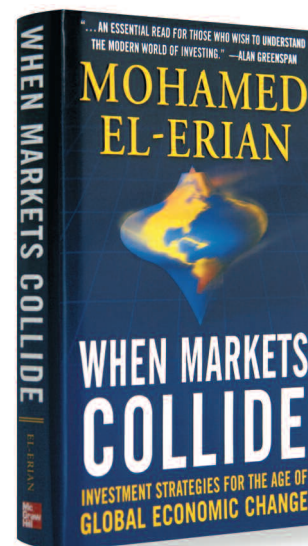
This summary provides a timely alert to the fundamental changes taking place in today's global economic and financial systems — and a call to action for investors who may fall victim to misinterpreting important signals. While some have tended to view asset class mispricings as mere “noise,” Mohamed El-Erian shows why they are important signals of opportunities and risks that will shape the market for years to come. He also puts recent events in their proper context, giving you tools that can help you interpret the markets, benefit from global economic change and navigate the risks.

The world economy is in the midst of a series of handoffs. Global growth is now being heavily influenced by nations that previously had little or no systemic influence. Former debtor nations have built unforeseen wealth and, thus, are enjoying unprecedented influence and facing unusual challenges. And new derivative products have changed the behavior of many market segments and players. Yet, despite all these changes, the system's infrastructure has not been upgraded to reflect the realities of today's and tomorrow's world. Market accidents and policy mistakes are therefore inevitable.

Investigating the underlying drivers of global change, *When Markets Collide* provides a detailed map for navigating the way through an otherwise perplexing new economic landscape.

IN THIS SUMMARY, YOU WILL LEARN:

- How to recognize new opportunities and risks.
- How to construct an appropriately diversified and internationalized portfolio.
- How to protect your portfolio against new sources of systemic risk.
- Ways to rethink the impact of central banks and financial policies around the world.



by Mohamed A. El-Erian

CONTENTS

Finding Signals Within the Noise

Page 2

Aberrations, Conundrums and Puzzles

Page 3

How Traditional Resources Failed Us

Page 4

Understanding the New Destination

Page 5

Prospects for the Journey

Page 6

Improved Risk Management

Page 7

Conclusion

Page 8

THE COMPLETE SUMMARY: WHEN MARKETS COLLIDE

by Mohamed A. El-Erian

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Introduction: Finding Signals Within the Noise

We are witnessing a slow but steady transformation of the global economic and financial landscape.

At first, the changes impacted relatively small areas of the investment and policy world — essentially, the specialized segment of emerging market investing and the even more specialized and arcane world of derivative instruments and risk transference. But the phenomena — and the related good, bad and ugly that came with them — gathered momentum, and they are now critically relevant to a broad spectrum of investors, policy-makers and international institutions.

Ongoing economic and technical shifts or "transformations" are impacting the world we live in — present and future.

Transformations

Transformations are not easy to recognize or navigate, especially when they are initially unanticipated and evolve rapidly. By challenging conventional wisdom and historic entitlements, transformations feed a dynamic that is inevitably uneven and, at times, unpredictable.

As transformations in individual markets are gathering momentum, it becomes evident that the market and policy infrastructures cannot yet adequately support the emerging realities — at either the national or international levels. Activities that have been newly enabled by the transformations tend to outrun the ability of the system to accommodate and sustain them. The result is a series of blockages and other "plumbing problems" whose prevalence gives rise to an initial bewilderment, turmoil, a blame game and a subsequent realization that some type of change is needed.

Uncertainty

When the needed refinements are being undertaken, market participants — investors and national and multilateral policymakers — face uncertainty and worry about the prospect of further turbulence. The market turmoil that started in the summer of 2007 illustrates the type of overshoots and dislocations that are likely to continue to occur.

The turmoil will shake the foundation of our global financial system. What started as a problem peculiar to the subprime segment of the U.S. mortgage market has morphed into a series of collapses whose impacts are being felt on both Wall Street and Main Street.

This reflects the secular transformation of the global economy. There are now economic and financial forces in play whose impacts are of great consequence but that cannot as yet be adequately sustained by the world's current policy and market infrastructures. As such, the efficiency gains that they bring are associated with higher risks of short-term disruptions. Indeed, the *present turmoil is neither the beginning nor the end of the transformation phase*.

Inconsistencies and Anomalies

A series of inconsistencies and anomalies acted as early signals of the growing tension between what participants or actors on the global finance stage were pressing for and what could be reasonably and safely accommodated by the existing systems in order to minimize the risk of turmoil. The signals also indicated the extent to which cross-border wealth handoffs were empowering a new set of actors and products when it came to global influence.

It is important to realize that the forces behind the recent financial crises have not gone away. Instead, underlying global transformations will play a major role



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Summary: WHEN MARKETS COLLIDE

in defining and influencing the investment and policy landscape for years to come. ●

Aberrations, Conundrums and Puzzles

Over the last few years, economic and financial issues have arisen that could not be explained using existing models, mindsets or prior experiences. As a result, they came to be called “aberrations,” “conundrums” and “puzzles” and many in the marketplace dismissed them as being just “noise” and, as such, devoid of meaningful information. But these issues were, in fact, signals of underlying shifts or transformations that have proven to be of great consequence — in particular, as illustrated in the crisis that shook the foundation of the international financial system. These signals remain significant to investors now and will continue to be so in the future.

Investor Reaction

The biggest puzzle centered on the reaction of investors — particularly the ability and willingness of the financial system to overconsume and overproduce risky products in the context of large systemic uncertainty. It is striking how two phenomena that you would expect to be negatively correlated ended up being positively correlated for so long — namely, on the one hand, the significant fall in the premiums that investors were paid to assume risk and, on the other hand, the investors’ desire to assume even more of this mispriced risk.

The dynamics behind this positive correlation went something like this: Some investors were hesitant to accept the lower expected returns associated with the generalized decline in risk premiums. Accordingly, they tried hard to squeeze out additional returns. Leverage served as the best way to do so: By borrowing, they could put more money to work in their best investment idea; this seemingly made sense as long as the expected return was higher than the cost of borrowing. In turn, the leveraged positions pushed risk premiums even lower, encouraging another round of leverage.

The Punch Bowl

That cycle is just one illustration of the amazing sense of calm and self-confidence that prevailed despite the abundance of things that could not be explained. Rather than stay on the sidelines until proper explanations emerged, many investors rushed into ever-riskier trades and even higher leverage. Wall Street responded by putting the production of ever-more-complex products into overdrive. And while national and multilateral policy makers

expressed a mix of concerns and bewilderment, no meaningful actions were taken to “take the punch bowl away.”

A few months later, the world economy found itself in the grip of significant market turmoil. Unlike the majority of the global financial crises of the preceding 25 years, this one was triggered by events in the world’s most sophisticated economy, the United States. It impacted segments closest to the monetary authorities — namely, the interactions among banks.

The U.S. Stock and Bond Market

Consider this: The U.S. bond and stock markets are the two most liquid markets in the world. As such, economists regard them as also being the most efficient markets in the manner in which they process and price information. Yet these markets had sent conflicting signals about the prospects for the largest economy in the world. And these conflicting signals were occurring *at the same time*.

Again, several explanations were offered, but none garnered a meaningful consensus. Some cited the strength of the equity market as signaling the robust state of companies’ balance sheets. With companies holding so much cash, there is always the possibility of higher dividend payments and share buyback programs. Others pointed to the health of the global economy *as a whole* and the growing extent to which U.S. corporations were booking earnings from foreign sales.

‘Private Equity Put’

A third view stressed the “private equity put.” This notion was based on the correct observation that private equity firms were attracting a ton of cash and had access to extremely accommodating debt financing (in terms of both interest rates and covenants). As such, they were able to step in at the slightest sign of a price downturn and buy public companies in a “public-to-private” transaction. As this behavior became noticed and understood by investors, some rushed in to front-run the private equity bids and others repriced whole market sectors on the basis of private equity funds’ interest in a particular company.

We will never be able to determine with certainty what caused the U.S. equity market to behave so differ-

Secular Transformations

Long-term changes, what analysts refer to as “secular transformations,” are inherently challenging. They involve significant realignments in economic power and tricky handoffs in what determines economic growth, wealth, inflation and investment returns.

Alan Greenspan's Conundrum

Perhaps the most famous reaction to the phenomena of anomalies and inconsistencies was contained in then-Fed Chairman Alan Greenspan's semiannual monetary report to the U.S. Senate. In the February 2005 report, he noted that "for the moment, the broadly unanticipated behavior of world bond markets remains a conundrum."

ently from the bond market, and for such a prolonged period of time. However, what is clear is the importance of not dismissing the phenomena as simply "market noise" — especially when these aberrations were accompanied by other puzzling events.

Sea Change

Fortunately, all these previously unthinkable developments are now finally being recognized for what they really were — indications of a sea change. Indeed, what began as noise for many investors and policymakers became a signal of a major redefining of the global financial system. And it quickly became clear that certain parts of the international monetary system and market infrastructure were particularly ill-prepared for this change, which had costly consequences. ●

How Traditional Resources Failed Us

Institutions that are one step removed from the immediate action and that are staffed by professionals charged with "surveillance" of the international system are particularly placed to correctly identify when signals are something more than noise, perhaps even to predict them. Moreover, due to a universal membership and the power granted to them by their articles of agreement, they should play a role in facilitating welfare-enhancing changes in the global landscape. After all, they are built to reconcile domestic and international considerations. In actuality, however, these institutions have often found themselves better equipped to deal with the challenges of yesterday rather than with those of today and tomorrow.

International Monetary Fund

The International Monetary Fund (IMF) has traditionally been considered the most influential of the existing multilateral institutions that are operating at both the country and cross-border levels.

With many positive attributes, you would expect the IMF to flourish in the scenarios that have played out

among nations in the last few years — namely, lots of national policy uncertainties, new and unusual forms of cross-border flows, and the inability of any one country to deliver an *orderly* global outcome. Instead, it has languished.

Like many other entities and activities in both the public and private sectors, the business model of the IMF is ill-equipped to deal with the changes that are occurring in the global economy.

Four Considerations

Four important observations warrant further investigation and shed light on the future opportunities and risks confronting investors.

First, we are coming from a period of significant and simultaneous historical aberrations. They have been widespread and have posed quite a puzzle for long-standing models, strategies and conventional wisdom.

Second, too many investors rushed to dismiss these aberrations as noise rather than considering whether they were signaling something consequential about underlying forces. As a result, and despite the deep and wide market inconsistencies that were prevailing, many investors' initial reactions were to assume greater risk, consistent with the decline in implied volatility. At the same time, policymakers ended up taking a rather *laissez-faire* attitude in reaction to the migration of risk away from official and private supervisory bodies that had the expertise to conduct the necessary oversight.

Third, the systemic failure to distinguish signals from noise undercut the ability of both investors and policymakers to understand the nature and implications of the underlying transformations — transformations that were not only changing the secular destination for the global economy but also making for a rather bumpy journey.

Finally, when the inevitable adjustment came, it caught many off guard. The result was a major shock to the traditional parameters that underpin the smooth functioning of the market system. Yet industrial countries, rather than emerging economies, experienced the bulk of the collateral damage. ●

Separating What Matters From What Doesn't

Nobel Prize-winning economist Milton Friedman argued that the actions of a pool player may be largely predicted by a model constructed on the assumption that the player possesses high-level mathematical and other skills. These skills enable the player to compute quickly and accurately the angles and deflections that determine the best shot at any specific time.

‘Black Box’ Models

Friedman argued that the best test of a model is to compare its predictions with actual outcomes. To this end, it was defensible to construct the model on the basis of simplifying assumptions (as in the case of the approach used for the pool player). While one may bicker with this approach — it is nevertheless useful for thinking about how to reverse engineer a type of behavior that leads to specific outcomes. And whether they know it or not, many of today’s hedge funds that use “black box” models are effectively applying Friedman’s approach.

Today, the question is whether we could reverse engineer the reaction of a successful market trader by assuming that, as a starting point, he was anchored by a systematic approach to analyzing market noise and reacting accordingly. It is an attempt to reverse engineer his behavior on the basis of an analytical model.

Such an exercise would yield the following six key steps:

1. **Identify the source of the noise that creates an unusual market dislocation.** Observe the mass of market data with a view to picking out anomalies.
2. **Be disciplined in treating each episode of such noise as potentially containing important signals.**
3. **Assess the actual signal content through an evaluation based on the a priori modeling of the economic or market phenomenon.**
4. **Differentiate between factors that influence the destination and those that influence the journey when assessing the content.**
5. **After you have gone through this process, and not until then, you should actively pursue the views of the experts and the talking heads.**
6. **Be open to finding not only cyclical influences but also secular ones.**

Signals in the Noise

When you are trying to identify signals within the noise of the marketplace, you need to consider that there are many reasons why our natural inclination will be to resist notions of change. Moreover, once you overcome the recognition delay, you cannot assume that the system will simply reset itself (that is, return to the state it would have been in, absent the initial shock). There is a significant chance that the delay itself will give rise to new dynamics.

It is this type of thinking that has led experts to be sensitive not only to the emergence of a new secular destination for the global economy but also to the recognition that the journey warrants careful analysis. By

understanding the key components of the journey and destination, investors will be in a better position to exploit the benefits of our changing world while also minimizing their risks. ●

Understanding the New Destination

Analysis suggests that the markets are heading toward a secular destination involving consequential changes for investors:

- First, the engine of economic growth worldwide will no longer be so highly dependent on the United States; instead, emerging markets will increasingly constitute a consequential and independent driver for growth.

- Second, the nature of this new growth driver will evolve away from a high reliance on exports and toward domestic components of demand (namely, internal consumption).

- Third, this evolution has the potential to facilitate the much-needed and long-delayed adjustment in a U.S. economy that has been overly dependent on debt-financed consumption. In the process, the global economy will regain greater balance and reduce its financial vulnerability caused by an overly skewed distribution of global trade imbalances.

- Fourth, global inflation trends will be negatively impacted by continued pressures on natural resources. Moreover, they will be influenced by the gradual dissipation of the disinflationary impact previously associated with large chunks of efficient and cost-effective labor entering the global economy. This will complicate the policy challenge facing central banks, which are already operating in an unusually fluid world.

- Fifth, the global allocation of capital and related moves in asset prices will increasingly be influenced by the activities of sovereign wealth funds (SWFs) that take into account the interest of future generations. These SWFs are likely to gradually shift away from fixed-income investments and go toward higher-risk instruments and those that are deemed to offer stronger protection against inflation.

- Finally, these economic and financial changes will be accompanied by further technical developments centered on a highly nonlinear path for structured finance and other activities that depend on the continued proliferation of derivative products.

Risks and Returns

For investors, these changes alter the configuration of risk and returns. They call for changes in institutional and strategic approaches, and they realign the patterns of comparative advantages. They also modify the effectiveness of national and multilateral policy responses.

Summary: WHEN MARKETS COLLIDE

Market participants need to adjust if they wish to remain successful in this new age. Specifically, they have to develop an appropriate action plan that speaks to the characteristics of the new secular destination. But this is only a *necessary condition*; it is not *sufficient* to ensure success. Market participants also need to be able to navigate the journey. ●

Prospects for the Journey

As is typical of disruptive innovation, structural transformations have enabled — and will continue to do so — new activities that cannot as yet be adequately supported. As a result, it is inevitable that there will be a series of collisions between the world of yesterday and that of tomorrow.

The world of tomorrow will see a proliferation of new activities and instruments of finance, as well as a growing influence of new actors on the global stage. Meanwhile, the world of yesterday is embedded in the infrastructure and plumbing systems that seek to support these new activities, and we have already seen that they have limited and declining success in rendering that necessary support.

Yesterday's supporting structures and institutions are also reflected in the growing displacement pressure on hitherto dominant actors at the national and international levels, as well as the decline in the market share of traditional instruments and products.

Adjusting to Change

In the recent past, the world has seen the types of effects that inevitably result from the move from old to new. So we already know that we need to anticipate that different parts of the system will find it difficult to adjust quickly to the new realities. These difficulties will be experienced at individual firm and country levels, as well as at multilateral levels, and blunting these difficulties will require fundamental changes in mindsets and infrastructures.

This point is best illustrated by looking in turn at the experiences and challenges facing private sector organizations, national governments and multilateral institutions. Indeed, investors will get their arms fully around the challenges they face only if they also understand what difficulties lay ahead for national and multilateral policymakers. After all, the three parties are engaged in the equivalent of a complicated game of multidimensional chess. The game inevitably involves interdependency among players with diverse objectives, tools and constraints.

Global Change

Analysis suggests that the international economy has embarked on a major course of global change with an outmoded infrastructure. And there are distinct differences

among and within the three groups of market participants when it comes to ability and willingness to adjust.

There are therefore many reasons to expect that the journey will be inevitably bumpy. The risk is best captured in the concept of potentially compounding market accidents and policy mistakes. ●

Benefiting From Global Economic and Financial Change: An Action Plan for Investors

Having specified their expected return target and their risk tolerance, investors must adequately design and execute the three basic steps of portfolio management: choosing the right asset allocation, finding the best implementation vehicle and conducting the appropriate risk management. Specifically, investors need to design and implement a portfolio management approach that:

1. **Targets a new secular destination.**
2. **Utilizes the right instruments.**

And they must do so in a manner that also enhances their ability to navigate what is likely to be a rather bumpy journey.

Science and Art

Anyone who traffics frequently in this world will tell you that the specification of appropriate asset allocations inevitably involves a mix of science and art. Those who get into the details of these exercises will tell you that the balance has shifted significantly in the last few years away from science and toward art (also known as “judgment” and “gut feeling” or, if you wish to be less charitable, “guesstimates”). This is due to several factors: Traditional boundaries between asset classes are blurring; correlations are increasing; and when not linked by fundamentals, asset classes get connected by technical factors, including the “common ownership” of investors.

So why has the industry persisted in using an approach that has become less robust over time? It has done so for negative rather than positive reasons. Specifically, we have yet to come up with a better alternative.

Risk Factors

Rather than look at asset classes, the most promising approach starts with the risk factors that give rise to investment returns over time. Put another way, it looks at why investors are paid for allocating their capital in a certain way.

The ideal situation is to come up with a small set (three to five) of distinct factors that command a risk premium. The next step is to assess the stability of the

Summary: WHEN MARKETS COLLIDE

factors and how they can be best captured through the use of tradable instruments. This provides for a portfolio optimization process whereby the factors are combined in a manner that speaks directly to the investors' return objective and risk tolerance. The end product is a more robust and time-consistent combination of asset classes that map clearly to the underlying factors.

Hard Work

Conceptualizing the approach is one thing; coming up with answers is a completely different thing! Yet it's a very worthwhile effort, as even partial progress is valuable.

Success here involves coming up with a new method that bypasses many of the limitations of the traditional approach. This would shift the balance back toward more robust science, and it would allow investors to better capture risk premiums in a more efficient and sustainable manner. Partial success is coming up with a methodology that enables an investor to better check the consistency of his or her current approach, including whether the selected asset classes provide an efficient mix of risk premiums. ●

An Action Plan for National Policymakers and Global Institutions

Governments will need to develop a better understanding of the new realities of the financial system and respond accordingly.

In order to gain this insight, financial authorities need to be better plugged into day-to-day market developments. The Federal Reserve Bank of New York is the leader in this regard, maintaining close contacts with markets. The ability of other countries to do the same has been inadvertently hindered by the move to separate bank supervisory activities from the institutions that are conducting monetary policy.

The financial authorities will also have to improve their ability to conduct appropriate oversight on activities that have migrated outside sophisticated jurisdictions. In the case of national supervisory and regulatory bodies, this involves gaining a better handle on off-balance-sheet activities and other forms of financial alchemy and regulatory arbitrage. It will also entail retooling the bodies overseeing areas that have assumed either quasi- or full-capital market characteristics yet are still subject to backward-looking regulatory and supervisory approaches (for example, the insurance and mortgage areas). Finally, either through moral suasion or more direct methods, the fiduciaries of various investment vehicles will have

to develop stronger expertise and more robust oversight modalities. This is particularly the case for vehicles that may involve some type of contingent liability for public finances (such as pension funds).

IMF

The need for adjustments is most extreme in the case of the International Monetary Fund, an institution that has gone from being seen as the lynchpin in the complex of multilateral institutions to being questioned almost on a daily basis about its relevance, effectiveness and standing.

There is little disagreement on the needed enhancement of the IMF. Indeed, a common set of issues has emerged from the work done by the institution itself, the reports of committees, and the views of observers and practitioners. These include the need to accomplish the following:

- Retool the internal staff expertise to ensure that the traditional focus on economic issues is adequately complemented by a good understanding of the manner in which increasingly complex financial markets behave and influence the real economy.
- Alter internal modalities so that the IMF's country missions respond to the actual challenges facing member countries as opposed to imposing a discussion agenda that is driven by more narrow and inevitably dogmatic headquarter-based views.
- Strengthen the analytical standing of the institution so that it is able to engage credibly in sensitive national policy issues that require reconciliation at the global level, such as the surveillance of exchange rate policies.
- Develop a more robust internal income model that diversifies the sources of revenues and links them to the range of activities of the institution.
- Adequately budget and price where appropriate the services that the IMF is providing, and do so within the context of a more transparent system of cross-taxation and subsidization.
- Remove feudal practices that reserve key management and staff positions for certain industrial country nationalities.
- Allocate voting power and board representation on the basis of today's realities rather than those of the outmoded past. ●

Improved Risk Management

Great portfolio managers have a knack for scaling their trades. In doing so, they combine the right degree of insurance with a manageable cost.

Summary: WHEN MARKETS COLLIDE

An important consideration here relates to the effectiveness of the circuit breakers that come with today's global economic and financial conditions. Indeed, analysis sheds light on the way in which certain aspects can help ensure that the inevitable bumps (including those that pertain to the potential policy mistakes and market accidents) do not completely derail the journey.

Three Circuit Breakers

The global economy is fortunate at this time to benefit from three circuit breakers that reduce, but not eliminate, the probability of individual dislocations contaminating the long-term economic well-being:

1. Policymakers seem willing to intervene in an attempt to safeguard the smooth functioning of their international financial system and the robustness of economic growth; in the process, they are willing to underwrite the inevitable risk of moral hazard (the notion that insurance arrangements can, in themselves, change people's behavior).

2. There is considerable fresh capital on the sideline able and willing to step in; in the case of the funds held by the SWFs, this is starting from a position of significant absolute and relative underexposure to risk assets.

3. The breakout phase of economic growth in key emerging economies provides the global economy with a degree of resilience that it has generally lacked in the past.

Investors would be well-advised to maintain a careful check on the strength and lag structure of these three circuit breakers, whose effectiveness also depends on the potential duration of the technical dislocation (itself a function of the degree to which existing institutions have gotten themselves offside and, therefore, need to de-lever and reduce balance sheet). ●

Conclusion

As an aggregate, the global economy is navigating structural changes at a time of considerable fragility. Certain balance sheets are stretched, particularly in the United States; not all segments of the population benefit from the new global realities; the challenge of global climate change is real and as yet unaddressed; and political cycles are increasingly deviating from economic ones, raising the risk of disruptive protectionism and "beggar-thy-neighbor" policies.

Indeed, the global economy is in the midst of a tug-of-war. On the one side, we have pockets of financial excesses, overleverage, resource pressures and inequalities — all of which serve to undermine the sustainability and beneficial impact of globalization and integration. On the other side, the coming onstream of more balanced growth led by emerging economies and the development of their

excess savings act as stabilizers and provide a meaningful potential for a new welfare-enhancing phase for globalization, economic growth and poverty alleviation.

Coordination and Interdependency

There is a lot at stake, and the challenges are considerable and multifaceted. There are also critical coordination and interdependency issues.

Even if it were feasible and desirable, the official sector is in no position to lead the private sector to an orderly adjustment path. The private sector must assume this responsibility. The best that the official sector can do is to help encourage a potentially more orderly process by making much-needed progress on its own set of urgent reform priorities. Indeed, for the private sector to get it right, it needs support in the form of concurrent adjustments in the parameters that govern important aspects of market behavior, including those in the regulatory and policy channels at both the national and multinational levels.

Enhanced Global Welfare

The hope is that, in classic Adam Smith manner, global welfare will be enhanced by each group of market participants simultaneously pursuing its self-interest in response to the ongoing structural transformations — thereby reinforcing the potential incentive alignments and feeding the virtuous elements of the adjustment process. The danger is that differences in the willingness and ability to adapt will further complicate the journey and make the global economy more vulnerable to growth slowdowns, protectionist forces, liquidity sudden stops and financial market dislocations.

It is time for investors and policymakers to take measures. By acting in a decisive manner, they will shift the balance away from the dynamics of a vicious cycle toward those of a virtuous cycle. The resulting gains will go well beyond superior investment performance and good policy implementation. They will also be reflected in the ability to make this age of global economic change consistent with high global growth, declining poverty and relative financial stability. ●

RECOMMENDED READING LIST

If you liked *When Markets Collide*, you'll also like:

1. ***Intelligent M&A* by Scott Moeller and Chris Brady.** Moeller and Brady set forth a solid strategy for thriving in the high-stakes, high-stress environment of corporate mergers and acquisitions.
2. ***Judgment* by Noel M. Tichy and Warren G. Bennis.** Leaders are remembered for their best and worst judgment calls, and their judgment can determine the fate of an entire organization.
3. ***Crisis Leadership Now* by Laurence Barton.** Learn how to form a framework for building crisis management thinking into your company's strategic toolbox.