Roundtable on Leadership and Administration

Center for Public Administration and Policy

Virginia Polytechnic Institute & State University

Alexandria, Virginia

November 2008

CPAP Faculty
Brian Cook, Professor
Sang Ok Choi, Assistant Professor
Larkin Dudley, Associate Professor
Matthew Dull, Assistant Professor
Laura Jensen, Associate Professor and Chair, CPAP
Anne Khademian, Associate Professor and CPAP NOVA Program Director
Joe Rees, Associate Professor
Patrick Roberts, Assistant Professor
James Wolf, Professor and Facutly Liaison for CPAP Richmond

Associated CPAP Faculty
David Brunori, Adunct Professor
Suzette Denslow, Adjunct Professor
Jason Fichtner, Adjunct Professor
Jack Harrald, Visiting Professor
Tom Hickok, Adjunct Professor
Karen Hult , Professor of Political Science and CPAP
Theresa Jefferson, Visiting Associate Professor
Phyllis Katz, Adjunct Professor
Bruce Lawlor, Professor of Practice and Director of CTSP
Minnis Ridenour, Senior Fellow for Resource Development
Randall Murch, Adjunct Professor
William Murray, Adjunct Professor
Aaron Schroeder, Adjunct Professor
Bob Stripling, Adjunct Professor
Jack Tuttle, Adjunct Professor
Colleen Woodard, Visiting Assistant Professor and Roundtable Co-Chair

Faculty Emeriti
John Dickey, Professor Emeritus
Charles Goodsell, Professor Emeritus
Philip Kronenberg, Professor Emeritus
Renee Loeffler, Director, Institute for Public Policy Research
John Rohr, Professor Emeritus
Gary Walmsley, Professor Emeritus
Orion White, Professor Emeritus

CPAP Staff
Irene Jung, Office Manager, CPAP Alexandria and Richmond
Laura French, Office Manager, CPAP Blacksburg

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Report Cover and Report Layout by ***Beth Offenbacker***
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Virginia Polytechnic Institute and State University
CPAP– Alexandria, 1021 Prince Street, Alexandria, VA 22314
703.706.8123, www.cpap.vt.edu, www.roundtable.cpap.vt.edu

Roundtable on Leadership & Administration

Public Leadership:
Understanding and Responding to the FinancialCrisis

A Conversation with
Roger Leeds
Research Professor of International Finance and Director,
Center for International Business and Public Policy,
Johns Hopkins University

Center for Public Administration & Policy
Virginia Polytechnic Institute and State University

SUMMARY REPORT

November 2008

Purpose of the Roundtable Series

The Virginia Tech Center for Public Administration and Policy Roundtable Series on Leadership and Administration:

- Brings together leading scholars, practitioners, students, members of academia, public managers, and participants from the nonprofit and private sectors;
- Stimulates insightful and thoughtful conversation with
- Focuses on the exchange of ideas;
- Advances our knowledge and understanding of leadership in public administration through the sharing of research and experiences.

Participants have the opportunity to explore the links between theory and practice in an intimate setting of conversation.

www.LeadershipandAdministration.blogspot.com

Public Leadership: Understanding and Responding to Crisis

Saturday, November 1, 2008

The subject of this Roundtable session was "*Public Leadership: Understanding and Responding to the Financial Crisis.*" At the table: Professor Roger Leeds, Research Professor of International Finance and Director of the Center for International Business and Public Policy at Johns Hopkins University. The following is an excerpt from his Roundtable presentation.

Roger Leeds

Research Professor of International Finance and Director, Center for International Business and Public Policy, Johns Hopkins University

I teach a course called Global Financial Markets, among other things, and it's not surprising this semester it's unusually popular, much more popular than it usually is because of what's happening around the world.

But I always tell my students -- many of my students who are not finance specialists are going to go into the foreign service -- are going to become journalists. Some of them are going to work on Capitol Hill and in different parts of the government. And I try to make the first in my very first class, I won't bore you with it now, but I try to make the case that regardless of what your professional objectives are, I think it's fundamentally important for you to have some understanding of how the financial markets work, how the financial system works, because it affects, as you'll see this morning, as I'm going to say, literally everything and everybody.

And if you're going to be a public official, you have to have some understanding of how markets work in the financial world. Just to cite one example, the biggest user of financial markets in every single country around the world are governments. They borrow money in larger volumes more consistently around the world than any other user, consumers, businesses, banks, governments. And yet if you talk to public officials in any country, including the United States, at any level, most people don't know how that happened. They don't know how the government accesses capital in the financial markets and what the issues are and so forth.

So that's one of the reasons I wanted to come here because I think it's very, very important that folks like you, I don't expect you to be finance experts; most of the people I teach are not going to be finance experts, but I do think it's clearly important that you, especially in the public sector, have some understanding of how markets work and how important finance is to everybody regardless of where you sit or stand in your career. So that's my motivation for wanting to spend, or one of my motivations for wanting to spend, some time with you this morning.

Let me just make a couple of introductory comments and then tell you what I'd like to do. The first observation is you should keep in mind that everyone is an expert after the fact, and it's much easier to be a critic than to come up with constructive alternatives. And we are overwhelmed at this time with pundits who are telling us what happened after the fact and being very critical of people. And I want to avoid that if I can. It's very, very easy to be critical, but I want to try and understand what you'd understand from my perspective, a little bit about what's been happening over the last few months, without necessarily being critical of those who have been engaged, although to some extent it's a little bit inevitable.

I think that the first observation, before I get into the causes of our crisis, what happened and why it happened, and then possibly later what we might see in the future, I think you have to have an appreciation that the scope, the complexity, the speed with which events are unfolding in the global financial markets is historically unprecedented over the last few months. It's been breathtaking by any standard. And no matter how expert you are, I wake up every morning with a new surprise. So we have to put it in that content.

And I would submit, speaking of the pundits, that no one can claim to fully understand what's going on in the global financial markets; it's simply too complex for anyone to grasp it in its entirety. This is a terribly difficult and complex a situation. And no one could have imagined, even a very short time ago, that this would be unfolding in the way it has unfolded. This is stunning to the most experts, and it continues to be stunning to the most expert mind.

Think back a mere six or eight months ago. Who would have thought, who could have predicted, that a Republican administration would be leading the charge for massive public investments in private companies. Who would have predicted that? And you know nobody would have. Who would have predicted a few months ago that the prime minister of China would stand before an international audience, as Wen Jiabao did last week in a summit with the European Union leaders, and lecture the United States on financial markets by saying, and I quote, "We need financial innovation, but we need financial oversight more." And people listened and it was a credible statement. Who would have thought a few months that we would be listening to a Chinese prime minister talk this way and listen and consider it credible? Who would have thought that the Dow Jones would experience swings in one day of 1,000 points? The volatility is staggering to every expert in the marketplace. People who have been there 20-30 years cannot believe the amount of volatility. In the month of October we had the largest single decline in the Dow Jones Industrial Average in the last 21 years, and in the same month, last week, we had the largest increase in 30 years, in one week. Who would have thought? Who would have thought that the largest insurance company in the world, AIG, would require a bailout a few months ago? And I could go on and on and on. Or that the Congress would approve in one week $700 billion of expenditure of taxpayer money? Who would have thought? It was inconceivable just a few months ago.

So we are in an unprecedented period that no one predicted. And even if you take into account what's been happening, especially over the last 45 to 60 days, and I want at the outset give a slight hint of optimism because I'm reminded of what Herbert Stein -- Herbert Stein was an economist and chairman of the Council of Economic Advisors I think two or three decades ago. He was a very funny guy and a very highly respected economist. He made the very astute observation about 20 years ago, he said things that can't go on forever won't. And he was talking about the markets; he was talking about the markets. And so he was talking about the markets when they were going up, saying this can't go on forever, and we're hearing that. But it also is true of the down side. So there is going to be light at the end of the tunnel. I'm not going to tell you where it is or when it is, but I'm a great believer that everything in life is cyclical and you should keep that in mind in your moments of greatest despair.

So a couple of reminders. But, first, let me just give you the three premises that I'd like to talk about this morning very, very briefly because this is a complicated subject and I want to leave lots and lots of time for questions and discussion. But I do have three premises. The first is sort of a reminder, and that is that I'm going to submit to you that the financial sector is different and more important from a public welfare perspective than virtually any other part of the private sector, any other part of the market economy. And I want to try and demonstrate that. And that because it's different and more important this gives you the rationale, the justification, for heavy government involvement in the financial sector even in good times, not to mention now. So it's not like the rest of the private sector, and I think there's some identifiable reasons that are worth talking about for just a few minutes so we can put this in perspective.

Secondly, what happened? In the simplest terms, and this is what we'll talk about, it is a result of massive market failure and government failure, a combination of the two. And I think you have to understand it in this context. There's no single culprit here, and it's a breakdown in the markets and the people that are in the markets, but it's also a breakdown in how we oversee and supervise those markets. And so I think there's plenty of blame to go around, again, after the fact I acknowledge.

And finally, and this probably is most interesting to you or maybe interesting to you, I'm going to submit that this crisis has exposed flaws in financial sector regulation obviously, and I think it's going to probably serve as a catalyst for very far-reaching changes in the way we oversee and supervise financial markets. And I also think it's going to be a catalyst for a very significant change which has already begun in the competitive landscape of finance both in this country and around the world. So it's a very significant event in my view, and I think that I can demonstrate that.

Just a few caveats before I get into the substance, other caveats. One is I'm going to focus mainly on finance and the financial crisis, but as you all know, as you just acknowledged, anybody who has a 401(k) knows, this financial crisis has now spilled over into being a very significant economic crisis. And I distinguish between the two; they're closely related. But I'm not going to focus, although we can in the discussion if you want, on the economic crisis, which I submit is going to aggravate and put further pressure on the financial sector going forward. The financial crisis is well along its way. The economic crisis is just in its early stages. But I'm not going to really focus on that too much.

Secondly, I'm going to focus primarily, but not exclusively, on the United States. But as you all know, this is a global crisis and it's becoming more of a global crisis every day. Just this last week, Japan announced a $50 billion bailout package in its country, and it's hard to identify a single country anywhere in the industrialized world as well as many emerging markets that's not already spending huge amounts of public money in response to this financial crisis. But I think it started here, it's a good place to understand it, but obviously it's global, but I'm not going to focus too much on that.

Finally, to state the obvious, we are still in the eye of the storm, so anything I say today will probably be obsolete or could be obsolete very, very quickly. Don't think that this is over. This is the beginning and not the middle or the end. And so I'm being asked to talk about something that is unfolding before our very eyes, and we have to keep that in mind. And it's very humbling because we are very much at the beginning. And so I think that's an important thing to keep in mind.

So I think that if you wanted to encapsulate what's been happening, there were a couple of seminal moments in the last couple of months that, for me anyway, captured what's been going on here and how dramatic it is. Two of the most unabashed and credible advocates in our country in supporting free markets and a minimalist approach at regulation have made statements that sort of capture what's been going on here. In late September, the Secretary of the Treasury, Hank Paulson, former Goldman Sachs managing partner, acknowledged in congressional testimony, and I'm quoting, "There's no way to stabilize the markets other than through government intervention." Now today that may seem pretty obvious and not very controversial, but to come from a gentleman like that and he's saying basically, in other words, that markets in the private sector cannot be left any longer to their own devices to solve this crisis, and that's a startling admission by someone from Wall Street.

But the ultimate comment came a couple of weeks ago, and I'm sure you all read it, in another congressional testimony by none other than Alan Greenspan, when he acknowledged that he was, and I quote, "in a state of shocked disbelief about the breakdown of the ability of banks to regulate themselves." Shocked disbelief. This is a gentleman who is the icon of deregulation and minimal government intervention in the way financial markets work. And he publicly confessed, he said, and I quote, "I made a mistake in presuming that the self interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms." So he had lost faith, he said, in the ability of these private firms to regulate themselves to protect the shareholders. This is an extraordinary admission by a man who for 30 years had been the most articulate spokesman for minimal regulation of the markets. In referring to his free market ideology, Mr. Greenspan said, "I have found a flaw in my own belief in free markets subjected to minimum regulation. I don't know how significant or permanent it is, but I have been very distressed by that fact."

So this is troubling even to those who are the largest, most articulate proponents of the minimalist approach to regulating financial markets. And I think that these two statements by two icons of free market capitalism are indicators, good indicators, of how serious this is and how it's changing the way all of us think about the correct balance between government and the private sector in regulating market behavior. And so we're all having to rethink how we think about these things.

So let's just look for a minute, if we could, about why, as I said, I think finance is different and why I think you should pay attention to finance and understand a little bit about it. And it's different everywhere, not just in the United States, and it's different for reasons which we can identify. And when I say "different," I mean different than any other part of the private sector in a market economy.

First is that the systemic consequences are different. There's no other sector of the economy where if one large institution fails it threatens the solvency, not just the liquidity, the solvency of many others because financial institutions, unlike any other part of the private sector, they're constantly borrowing and lending to one another, so they always have financial exposure to one another. And this is the explanation for why we talk about a systemic crisis. So when the government comes in to rescue a bank, and it makes this point every time it happens, it's not the institution they're concerned about rescuing, it's the system. But if a CitiBank or a Bank of America or a JP Morgan Chase fails, it threatens the stability of all the financial system because of its cross financial exposure. So the systemic consequences are huge.

And also banks have public welfare consequences for literally everybody. Everyone in a country, every citizen has a stake in the stability of financial institutions. You can't think of any other part of the private sector where that's true. So, for example, banks are the fiduciaries for the nation's savings. Every single person has some portion of their savings, their money that they've earned, in banks. Almost everybody. Unless it's under the mattress, some of it goes through banks. And, therefore, if a bank fails, the public welfare consequences are very broad based. So serving as the fiduciary, guardians of a nation's savings as it were, makes them a little bit more important than most other parts of the private sector.

They also are the executors of monetary policy. The Central Bank sets monetary policy, but who delivers that policy? Who executes it? It's the banks. So if they want to raise interest rates or lower interest rates, they do it through the banks. So private sector institutions are exercising a major part of our public policy. There's no other part of the private sector that is like that, so, again, it's different and more important from a public welfare point of view.

And because of these differences, there's some other things that make it unique. It has access to the safety net which we're seeing in spades right now. The fact that we are willing to give protection to banks on a level that we don't to any other part of the private sector because they are so important, that's the quid pro quo, the rationale for why there should be and is relatively heavy oversight and supervision of the banks. We the taxpayers are standing behind them inevitably, and so that's very, very important.

And finally I would say that there's no other product quite like money. To put it mildly, and very, very mildly, it's opaque. It's not real. You can't kick it. You can't feel it. You don't transport it in a truck. You don't put it out for display in a store. It's literally all electronic now. There's no physical money around except what's in your pocket. So these huge transfers are done electronically, so it's a very opaque business. The assets and liabilities are what we call in the business intangible, unlike any other product that you can think of except services. There are other services that are intangible also. But it is so easy to move this around that it lends itself to all kinds of shenanigans, whether it's financing of terrorism, or whether it's drug money, or whether it's white collar crime. It's tremendously challenging for the regulators to oversee and supervise the financial industry for this reason, among others. And with the extraordinary changes in technology that have occurred over the last 15 or 20 years, the challenge for the regulator has gotten more and more and more difficult. Money moves around the world effortlessly and can be undetected effortlessly as well. And so this is a very, very tough business to regulate.

And so these are the reasons that I would point out that explain why finance and the financial sector are different. And they're different from the point of view of public policy, and I think you should have this in mind when you think about this.

So let's talk a little bit about what's happening. How did this happen? In some respects, although I just said that it's staggering in the way it's unfolded, and no one could have predicted it, and no one did predict it, in some respects it's not that new, and when I talk about the causes of this crisis, you're going to see that there are a lot of things that have happened that we've known about and that have happened before.

One example, some of you remember that exactly 10 years ago we had the downfall of a small hedge fund in Greenwich, Connecticut called Long Term Capital Management. Two hundred people and the Fed had to intervene to save it. And many of the things that went on then are similar to what's been going on in the last few months. And after that event, which was cataclysmic, believe it or not, or we thought it was cataclysmic 10 years ago, there was congressional hearing after congressional hearing after congressional hearing to correct some of the things that had happened that had created this systemic crisis or potentially systemic crisis of Long Term Capital Management, the hedge fund. And nothing, I mean nothing, happened. We went back to business as usual. And as you'll see, a lot of the things that happened are the same things that are happening now.

So although it's unfolding in a way we never could have expected, a lot of the causes, as you'll see, are not particularly unique. To start with, virtually every financial crisis starts in the same way. It starts with a loss of confidence in an institution, a company, a bank, even a country because of performance failure. So if for some reason, the performance of the company, the bank, or the country under performs, that causes a loss of confidence amongst those who provide capital to that particular country, company, bank. And the first thing that happens, and it happens every time, is the inability to gain access to not long-term or medium-term capital, but very short-term capital. And short-term capital, whether you're a country or a company, is the lifeblood of every institution. You cannot do business for very long if you can't borrow money over the short term, in the short term. And I'm talking days or weeks; I'm not talking years.

And so I think that once you lose that access to capital in the short term, you're in trouble, and it's the same pattern over and over again. This problem, however, in the financial sector is compounded by this, what I call, the systemic factor, so that if you have under performance of one bank, it quickly spills over to other banks because they are all interconnected. That's one of the problems.

But it's also compounded in this crisis because many of the culprits, the under performing financial institutions, were outside the scope of the regulator. So the Federal Reserve, for example, regulates the banks, doesn't regulate investment banks, doesn't regulate hedge funds. It doesn't regulate insurance companies. And they were a large part of this problem, and they're all interrelated. And so you have this systemic interconnection that when one part of the system begins to fall apart, the others quickly follow.

And so what happened here in the very beginning was, and I'm sure you read about this, not a credit crunch, a credit freeze. A freeze, which means that there was so much loss of commerce, nobody knew, and still doesn't know, who's solvent, who's not, who they should lend to, who they shouldn't. And so everybody's pulling back. And so even the most reputable companies and banks are having trouble gaining access, and I stress we're not talking long-term capital, we're talking weeks or a couple of months. And when you have that kind of a freeze, everything comes to a grinding halt.

So how did this freeze, which has spilled over into the real economy, get started? What are the root causes? Well, I want to stress that one thing that everybody talks about that I would argue is not particularly unique or really the cause, and every politician talks about this, Republicans and Democrats, is greed. I'm not saying that greed is not present, but it's not unique to this particular crisis. It's not unique to the financial sector. It's not unique to the United States. It's a constant phenomenon in human nature, and just to remind you of this, it's been going on since time immemorial. This is a quote, and we'll see if you can recognize who said it. "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard for their own self interests." Anybody know where that came from? [Female Voice: Adam Smith.] Adam Smith, <u>The Wealth of Nations</u>, and that – [Male Voice: 1776.] -- 1776, exactly. Self interest is not new. And then I hate to quote Alan Greenspan again, who happens to agree with Adam Smith, but he had a similar observation on human nature. "In bred human propensities is to swing from euphoria to fear and back again seem permanent. Generations of experience do not appear to have tempered these propensities." The idea that this time is different syndrome is with us all the time. It's endemic to human nature it seems to me. So I don't think it does us much good to focus on the greed factor. It's not that it isn't there; it is. It's always there, but it's a given. And I don't think it's going to go away any time soon no matter who becomes president, and so we might as well learn to live with it.

So let's focus on what I said at the beginning with the two interrelated sets of causes, government failure and market failure. On the market failure I'd focus on four specific factors that were causes of this crisis, and they are somewhat unique to the financial sector. All are well known to regulators and practitioners, and, as I said earlier, some of them have been present for a very, very long time.

The first is what we call leverage or debt. And the combination of high debt and lack of disclosure, and which is very easy to do because of the opaque nature of finance, it's easy not to disclose, and, therefore, makes it very difficult not only for regulators to know what's happening, but investors to know what's happening. The marketplace can't work very well if you don't have good information. But in the finance sector, this problem is greater than it is in other parts of the economy. First of all, banks and other financial institutions tend to be more highly leveraged than other types of companies. So you read about banks having leverage of

10, 12, 15 to one; that's $15 of debt to every dollar of capital underlying that debt. That's very, very high by most private company standards. And then you get into the investment and hedge funds; it's 25, 30, 35 to one. So these institutions are very, very highly leveraged, and this is a very important explanation for why it happened, but it's worse than that. Not only do they borrow a lot, but they borrow and put up as collateral securities.

So one way to look at this whole crisis is that we are undergoing what I would call a massive nationwide, global, if you will, margin call because when you borrow money, which banks, and hedge funds, and investment banks do as a matter of course more than any other part of the private sector, they're always putting up collateral, and that collateral is other securities. And if they get into trouble they get a margin call, and somebody calls up and says, give me back my securities or put up more money against those securities. Your collateral is not adequate for the amount you borrowed, and that creates what we call in the business a negative feedback loop.

And what you have seen going on for the last 60 days or more is all these institutions who performed so badly and have borrowed so much money, the phone has been ringing all day every day for margin calls. Put up more collateral or sell what you have and give me my money back. And that feeds on itself. It's fueling the market's downturn, so they're having to sell into a declining market. And so all this volatility and all this downturn is in large measure due to these margin calls.

And a lot of it is happening with institutions that are not banks, that are regulated by the Federal Reserve. They're the non-bank financial institutions, the hedge funds and the insurance companies, that are outside the purview of the Fed, and they're the ones that are the most highly leveraged up until now. And so that is a real problem. So that's problem number one and it's a big one.

The second one is what you've heard and may or may not understand is the phenomenon of securitization, which is a relatively new part of the financial industry. It goes maybe 20-25 years, and there's some good and bad things about securitization. Securitization is basically taking assets that are illiquid, like mortgages, and packaging them, liquid mortgages, and selling them as a liquid security. You can do it with mortgages, you can do it with receivables, you can do it with lots of different stuff, and it's become very commonplace in the financial world, around the world, over the last 20 years. And it's very, very good. We thought it was very, very good because it spreads risk. Rather than the bank holding those mortgages or other assets on its balance sheet for, say, 25 or 30 years, they package these things, sell them to the investing public around the world, and so they're effectively spreading the risk around, and that's a good thing.

But you can imagine if you're a banker and rather than hold that mortgage or that group of mortgages for 20 or 30 years, you're getting rid of it almost immediately. Your whole incentive to do due diligence, careful due diligence, knowing that you will at risk with that borrow for a very long period of time, evaporates. And that's exactly what's been happening. Think of the subprime mortgage crisis. Why would a banker care who he's lending to or the credit worthiness of that borrower if they know that they're not going to be holding that asset for very long? And that's the down side of securitization is that it takes away the incentive for the lender to be careful and prudent about who they are going to lend to. And we've seen that happen in such massive amounts, and we are suffering the consequences of that.

And it also led to, because you aren't going to hold that asset, you have a tendency to mis-price the risk incorporated in that asset. So they underpriced the risk, and they assumed they could sell these assets and they couldn't. And so when the liquidity dried up and they were holding these assets that they thought they could sell, and you may have learned this in some of your courses, the market breaks down. There's no price discovery mechanism working once there's no liquidity, and that's been happening massively with these securitized assets. So that's the second cause in the market, and that's a market failure of sorts as well.

The third is we put enormous faith, and again I think of Alan Greenspan and his colleagues, in internal risk management systems. We said that we don't need as much government oversight because large, highly sophisticated financial institutions have increasingly well-functioning internal risk management systems, and so they can manage themselves. They can regulate themselves because they have incentives to not under perform, and they have these hugely sophisticated models that make certain assumptions, the "what if" scenarios, and they protect themselves. And what we've discovered time and again, we learned this with Long Term Capital Management, we're learning it again today, those risk management systems work great until the 100-year storm happens every year, every two years, every five years. These 100-year storms happen more often than we thought, and these risk management systems crumble immediately when you have these unexpected events, and that's happened again this time.

So these highly sophisticated models were very, very good until the unexpected happened, and then none of the assumptions underlying these models were valid, and they were caught unawares because their models broke down and they had too much faith in these models. Exactly, exactly what happened with Long Term Capital Management and other financial crisis of a long time ago. So I think that that's another one of the causes of this that we should keep in mind.

And finally, and you've heard a lot about this and I won't dwell on it, and it's a very, very difficult problem to solve, is we have distorted incentive systems in the private sector, especially in finance. You've read about these outsized compensation packages. It's all based on short-term performance if based on performance at all. Some would argue that it's not even based on performance, but if you can buy into the fact that the compensation is somehow linked to performance, it's very short term, not long term, not medium term. And we're seeing the consequences of incentive systems for financial institutions that place all the premium on what you do...

At the Table

Roger Leeds, Professor, Johns Hopkins University

Roger Leeds spent 25 years as a practitioner in international finance. He was an investment banker at Salomon Brothers, a senior staff member of the International Finance Corporation (World Bank), a partner at KPMG in charge of its global privatization practice and a managing director of a major private equity firm in New York.

Leeds serves as chairman of the Emerging Markets Private Equity Association. In addition to Johns Hopkins, he has taught at the Wharton School at the University of Pennsylvania and Harvard University's John F. Kennedy School of Government. He has served as a guest commentator on CBS, CNBC News, CNN and NPR and has served on various boards and advisory committees. He earned his Ph.D. in international relations from Johns Hopkins.

His publications include *Financing Small Enterprises in Developing Countries: Lessons Learned From Experience* (2003). He is the author of more than 30 articles and book chapters on international financial and economic issues in developing countries. Leeds is currently writing a book on private equity in emerging markets.