WALL STREET AND WASHINGTON: MARKETS, POLICY, POLITICS

SPRING 2012
GOALS OF THE COURSE

- UNDERSTAND THE INSTITUTIONS AND THE PLAYERS
- UNDERSTAND THE IMPORTANCE THEY PLAY IN SOCIETY
  - WHAT WALL STREET DOES
  - WHAT VARIOUS PARTS OF GOVERNMENT DO
- UNDERSTAND HOW WALL STREET AND WASHINGTON INTERACT
- UNDERSTAND THE SYMBIOSIS OF MARKETS, POLICY AND POLITICS
GOALS OF THE COURSE

- UNDERSTAND THE CONSTRAINTS AND LIMITATIONS ON THE PARTICIPANTS –TO BE ABLE TO ARGUE BOTH SIDES
- UNDERSTAND THE CHANGING GLOBAL ENVIRONMENT FOR FINANCE AND REGULATION
FORMAT

• READINGS – CAITLIN’S BOOKS; OTHERS (HENRY PAULSON, ANDREW ROSS SORKIN)

• LECTURES/DISCUSSIONS: CLASS TOPICS (AND NOTE WHEN NO CLASSES)

• GROUP STUDENT PROJECTS

• PAPERS (AND PRELIMINARY OUTLINES DUE FRIDAY, FEBRUARY 10)
FORMAT

• TRIPS TO NYC AND WASHINGTON DC (INFORMATION, ATTIRE, TIMELINESS)
• IMPORTANCE OF CLASS PARTICIPATION
• ATTENDANCE POLICY
SOME OF THE FUNDAMENTAL ISSUES

- HISTORICAL DRIVERS OF WS/WASH INTERACTION
- CAUSES OF THE 2007-2009 FINANCIAL CRISIS
- REGULATORY REACTION AND EFFECTIVENESS—HAVE THE FUNDAMENTALS BEEN ADDRESSED?
SOME OF THE FUNDAMENTAL ISSUES

• POST CRISIS ENVIRONMENT FOR FINANCIAL INSTITUTIONS, POLICY MAKERS, AND REGULATORS
   FUTURE CHALLENGES FOR BANKS AND OTHER FINANCIAL INSTITUTIONS
   FUTURE CHALLENGES FOR THE FEDERAL RESERVE
   FUTURE CHALLENGES FOR REGULATORS SUCH AS THE SEC, CFTC, FDIC, BIS, ETC.
   GLOBAL CHALLENGES
    • EURO
    • CHINA
    • THE DOLLAR
SOME OF THE FUNDAMENTAL ISSUES

- TENSIONS BETWEEN WALL STREET, WASHINGTON AND MAIN STREET
- INTERNATIONAL SUPERVISION AND REGULATION – ISSUES AND INSTITUTIONS
- LEADERSHIP ACROSS SECTORS
- VALUES AND ETHICS
SOME OF THE FUNDAMENTAL ISSUES

• OTHER SPECIFIC ISSUES
  ➢ SYSTEMIC RISKS
  ➢ TOO BIG TO FAIL
  ➢ RISKS AND REWARDS OF FINANCIAL INNOVATION
  ➢ CONSUMER PROTECTION
SOME PHILOSOPHICAL QUESTIONS

• WHAT ARE THE SHIFTING CONTOURS OF CAPITALISM – THE INTERPLAY BETWEEN MARKETS AND GOVERNMENTS – IN THIS SECOND DECADE OF THE 21ST CENTURY?

• ROLE OF FINANCE IN SOCIETY: WHAT ROLE SHOULD FINANCIAL SERVICES PLAY IN NATIONAL ECONOMIES? WHAT PROPORTION OF GDP IS “TOO MUCH”?

• BALANCING RISK AND STABILITY

• GOVERNMENT AS INVESTMENT BANKER
SOME PHILOSOPHICAL QUESTIONS

• WHAT ARE THE MOST CRITICAL ECONOMIC AND SOCIAL CHALLENGES THAT MARKETS AND GOVERNMENTS MUST TACKLE TOGETHER?

• HOW TO THINK ABOUT RESPONSIBILITY AND ACCOUNTABILITY WHEN MARKETS AND REGULATORY POWER IS SO MULTIFACETED, SO INTERCONNECTED AND SO GLOBAL?

• WHAT CAN BE DONE TO IMPROVE EFFECTIVE COOPERATION BETWEEN PRIVATE AND PUBLIC INTERESTS?
WHAT IS WALL STREET?
WHAT IS WASHINGTON?
WALL STREET = FINANCIAL SYSTEM

- Banks that take deposits
- Investment banks
- Investment advisors
- Brokers
- Private Equity
- Venture Capital
- Hedge Funds
- Mutual Funds
- Energy and Commodity Trading
- Insurance Companies
- Stock Exchanges
- Clearance and Settlement Firms
- Rating Agencies
- Financial Engineers
- Financial Research
- Industry Trade Associations
- International Financial Institutions
- Financial Press

CONNECTIONS AMONG THEM
WALL STREET = GOVERNMENT AND REGULATION

- Treasury
- Federal Reserve
- Securities and Exchange Commission
- Commodities Futures Trading Commission
- Federal Deposit Insurance Corp.
- Justice Department (several agencies)
- Congressional Committees on Banking Finance
- State Regulators
- Foreign Counterparts
- International Regulators

OVERLAPPING MANDATES GAPS
HOW DO WALL STREET AND WASHINGTON RELATE TO ONE ANOTHER?
HOW DO WALL STREET AND WASHINGTON INTERACT?

- Financial regulation – Fed, SEC, CFTC, etc.
- Congressional oversight
- Interest rates
- Currency
- Fiscal – tax, subsidies
HOW DO WALL STREET AND WASHINGTON INTERACT?

• Sale and purchase government securities
• Trade negotiations for financial services
• GSEs and hybrid institutions
• Law enforcement
• Industry associations
HOW DO WALL STREET AND WASHINGTON INTERACT?

• Lobbyists
• Research and financial intelligence
• Campaign contributions
• Banks and sovereign debt deeply intertwined
• Journalists
• Movement of people back and forth
WALL STREET AND WASHINGTON

WALL STREET
- COMMERCIAL BANKS
- INVESTMENT BANKS
- PRIVATE EQUITY
- HEDGE FUNDS
- INVESTMENT MGRS
- RESEARCH ECONOMISTS
- EXCHANGES

MARKETS
- GLOBAL INSTITUTIONS
- LOBBYISTS
- INDUSTRY ASSOCIATIONS
- LAWYERS
- ACCOUNTANTS
- RATING AGENCIES
- JOURNALISTS

WASHINGTON
- EXEC BRANCH
- CONGRESS
- FEDERAL RESERVE
- REGULATORS
WALL STREET AND WASHINGTON
SEESAW OF POWER

WS 1950s/1960s W

W 1980s - 2007 W

WS 2010 - ? WS
WHAT ARE SOME OF THE KEY “ENVIRONMENTAL” FACTORS AGAINST WHICH THE COURSE WILL UNFOLD?
ENVIRONMENT FOR COURSE

• Wake of massive financial crisis
• Wave of massive financial regulation
• Fundamental global economic problems
  ➢ Major deleveraging in US, Europe, Japan and collective austerity
  ➢ Resolution of global imbalances
  ➢ Emergence of China in financial system, also other large emerging markets
  ➢ Future of Eurozone
  ➢ US fiscal outlook and US financial leadership
• Major changes in structure and business model of banking, including size, scope, profitability
ENVIRONMENT FOR COURSE
CRISES, UNCERTAINTY, POLITICAL DYSFUNCTION

• Substantial increase in international regulation
• Shrinkage of Wall Street (jobs)
• Big “doctrinal” debates
  ➢ Future of capitalism itself
  ➢ Growth strategy
  ➢ Competitiveness strategy
  ➢ Jobs strategy
  ➢ Central banking
  ➢ Law enforcement
  ➢ Executive remuneration
• High corporate profits, soaring CEO compensation, stagnant labor situation – politically explosive?
• Deep-seated political polarization
  ➢ Tea Party vs. Occupy Wall Street
  ➢ Free market vs. Managed capitalism
ENVIRONMENT FOR COURSE

- Massive role of Wall Street money influencing politics
- Potential generational polarization
- Fear of contagion, but inadequate understanding
- Controversy over financial “innovation” and when it is just another kind of speculative trade for profit
- Who makes policy? Finance bigger than finance per se. Finance (deleveraging, austerity) driving politics (nationalism, xenophobia)
- Lending and IPOs less than robust, with consequences for economic growth and restructuring
- Enormous uncertainty over investment climate, investment strategy
- Divergent global growth paths
WALL STREET AND WASHINGTON

BRIEF HISTORY

BEFORE 1950
• HAMILTON VS. JEFFERSON
• JACKSON VS. BIDDLE
• J.P. MORGAN’S BAILOUTS OF US TREASURY AND US BANKING SYSTEM
• 1920’S BOOM
• 1930S BUST AND REGULATORY SURGE
• 1940S BRETTON WOODS DEBATE

[TRANSCRIPT TO BE POSTED]
Washington, Wall Street, and the Policy Trap

Washington and Wall Street
Stephen S. Roach

MGT585, INRL711

January 10, 2012
The Policy Debate

- Stability vs. Sustainability
- Crises and Tipping Points
- Shifting Policy Mandates
- Political constraints
- Balancing Act: Washington vs. Wall Street
## Shifting Mix of Global GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Western Europe</th>
<th>FSU</th>
<th>United States</th>
<th>Japan</th>
<th>China</th>
<th>India</th>
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<tbody>
<tr>
<td>1500</td>
<td>17.9%</td>
<td>3.4%</td>
<td>0.3%</td>
<td>3.1%</td>
<td>25.0%</td>
<td>24.5%</td>
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<tr>
<td>1600</td>
<td>20.0</td>
<td>3.5</td>
<td>0.2</td>
<td>2.9</td>
<td>29.1</td>
<td>22.5</td>
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<td>1700</td>
<td>22.5</td>
<td>4.4</td>
<td>0.1</td>
<td>4.1</td>
<td>22.3</td>
<td>24.4</td>
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<td>1820</td>
<td><strong>23.6</strong></td>
<td>5.4</td>
<td><strong>1.8</strong></td>
<td><strong>3.0</strong></td>
<td>32.9</td>
<td><strong>16.0</strong></td>
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<tr>
<td>1870</td>
<td>33.6</td>
<td>7.6</td>
<td>8.9</td>
<td>2.3</td>
<td>17.2</td>
<td>12.2</td>
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<tr>
<td>1913</td>
<td>33.5</td>
<td>8.6</td>
<td>19.1</td>
<td>2.6</td>
<td>8.9</td>
<td>7.6</td>
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<tr>
<td>1950</td>
<td>26.3</td>
<td>9.6</td>
<td>27.3</td>
<td>3.0</td>
<td>4.5</td>
<td>4.1</td>
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<td>1973</td>
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<td>9.4</td>
<td><strong>22.0</strong></td>
<td>7.7</td>
<td>4.6</td>
<td>3.1</td>
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<tr>
<td>1998</td>
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<td>3.4</td>
<td>21.9</td>
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<td>11.5</td>
<td>5.0</td>
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<tr>
<td>2008</td>
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<td><strong>18.6</strong></td>
<td>5.7</td>
<td>17.5</td>
<td>6.7</td>
</tr>
<tr>
<td>2015e</td>
<td><strong>15.9</strong></td>
<td>4.0</td>
<td>18.3</td>
<td>5.5</td>
<td>18.0</td>
<td><strong>7.6</strong></td>
</tr>
</tbody>
</table>

*Note: Based on 1990 International (PPP) Dollars; FSU is Former Soviet Union.*

*Source: Angus Maddison, The World Economy: A Millennial Perspective, OECD (2001); IMF, Morgan Stanley*
## Shifting Policy Mandates: Tipping Points for Wall Street

<table>
<thead>
<tr>
<th>PROBLEM</th>
<th>RESPONSE</th>
<th>POLICY TARGET</th>
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<tbody>
<tr>
<td>GREAT DEPRESSION: 1930s</td>
<td>GLASS STEAGALL ACT OF 1933</td>
<td>FINANCIAL STABILITY</td>
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<td>POST WORLD WAR II: 1940s</td>
<td>EMPLOYMENT ACT OF 1946</td>
<td>FULL EMPLOYMENT</td>
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<tr>
<td>GREAT INFLATION: 1970s</td>
<td>HUMPHREY HAWKINS ACT OF 1978</td>
<td>PRICE STABILITY</td>
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</table>
Policy Pitfalls: Implications for Wall Street

- Winning the Battle Against Inflation
- The Hubris of Victory: The Great Moderation
- Globalization, Technology, and Inequalities
- Bubbles, Imbalances, and Crises
- Ideology: De-regulation to Self-regulation
Central Banks: Out of Basis Points

Calculations:
- US: Effective Federal Funds Rate less trailing 12-month average CPI growth (including energy and food)
- Japan: Official/Basic Discount Rate less trailing 12-month average CPI growth

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Fiscal Authorities: Opening the Spigot

Gross Government Debt as a Share of GDP

Source: IMF

Advanced Economies
Japan
United States
Euro Area

IMF Forecast

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The Lessons of Japan: A Tale of Two Zombies

Bubble-Impacted Real Sectors As a % of GDP

US- Consumption +Residential Investment

Japan-Private Non-Residential Investment

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The Political Economy of Growth

- The Siren Song of the Boom
- True vs. False Prosperity
- The Growth Sacrifice
- Short-term Political Constraints
The Ultimate Trap for Washington and Wall Street

Re-election Rates: U.S. House of Representatives

Source: Center for Responsive Politics