Is Past Prologue?

Stephen S. Roach
MGT585, INRL711
April 24, 2012
Peering into the Future: Key Macro Themes

- Anemic Global Recovery
- Japanese-like Developed World
- Decoupling Challenges in the Developing World
- Persistent Global Imbalances
- The Next Crisis
- Whither Wall Street and Washington?
Macro Baseline: Anemic Global Recovery

Global Output Gap

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012&lt;sup&gt;e&lt;/sup&gt;</th>
<th>2013&lt;sup&gt;e&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>World GDP Growth</td>
<td>2.8%</td>
<td>-0.6%</td>
<td>5.3%</td>
<td>3.9%</td>
<td>3.5%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Trend Growth</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Deviations from Trend</td>
<td>-0.9</td>
<td>-4.3</td>
<td>1.6</td>
<td>0.2</td>
<td>-0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>Crisis-Related Shortfall in 2008-09:</td>
<td>-5.2 ppts</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Post-crisis Recovery in 2010-13:</td>
<td>2.0 ppts</td>
<td></td>
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</tr>
<tr>
<td>Net Shortfall by the end of 2013:</td>
<td>-3.2 ppts</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: IMF April 2012 WEO
Achilles’ Heel of a Two-Speed World

GDP Shares: Developing Asia

as % of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>World GDP Growth</th>
<th>Advanced Economies</th>
<th>Emerging and Developing Economies</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>2.8%</td>
<td>0.0</td>
<td>6.0</td>
</tr>
<tr>
<td>2009</td>
<td>-0.6%</td>
<td>-3.6</td>
<td>2.8</td>
</tr>
<tr>
<td>2010</td>
<td>5.3%</td>
<td>3.2</td>
<td>7.5</td>
</tr>
<tr>
<td>2011</td>
<td>3.9%</td>
<td>1.6</td>
<td>6.2</td>
</tr>
<tr>
<td>2012e</td>
<td>3.5%</td>
<td>1.4</td>
<td>5.7</td>
</tr>
<tr>
<td>2013e</td>
<td>4.1%</td>
<td>2.0</td>
<td>6.0</td>
</tr>
</tbody>
</table>

Source: IMF, Morgan Stanley Research
Current Account Imbalances
(as % of World GDP)

Surpluses
- Oil Producers
- Germany and Japan
- China and EMA

Deficits
- United States
- OCADC
- ROW

Source: IMF
Imbalances Beget Crises

11 Crises in the Past 30 years

- 1982: Latin American Debt Crisis
- 1987: Stock Market Crash
- 1990: US Savings and Loan Crisis
- 1990: Japan
- 1995: Mexico
- 1997: Asia
- 1998: LTCM
- 2000: Dotcom
- 2001: Enron-Led Accounting Scandals
- 2007: Subprime
- 2010: Europe
## Modern US Policy Mandates: Born in Crisis

<table>
<thead>
<tr>
<th>PROBLEM</th>
<th>RESPONSE</th>
<th>POLICY MANDATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>GREAT DEPRESSION: 1930s</td>
<td>GLASS STEAGALL ACT OF 1933</td>
<td>FINANCIAL STABILITY</td>
</tr>
<tr>
<td>POST WORLD WAR II: 1940s</td>
<td>EMPLOYMENT ACT OF 1946</td>
<td>FULL EMPLOYMENT</td>
</tr>
<tr>
<td>GREAT INFLATION: 1970s</td>
<td>HUMPHREY HAWKINS ACT OF 1978</td>
<td>PRICE STABILITY</td>
</tr>
</tbody>
</table>
The Great Depression

U.S. Stock Market: Dow Jones Industrial Average

Glass-Steagall II: Banking Act of 1933

- FDIC: Deposit insurance
- Separation of commercial and investment banking
- Limits on bank speculation
- Focus: Financial stability
- Volcker Rule: Glass Steagall redux?
Post-World War II

**U.S. Unemployment Rate: 1929-42**

**Employment Act of 1946**
- Created the Council of Economic Advisors: Annual Report
- Created the Joint Economic Committee in Congress
- Original Bill: Full Employment Act of 1945 was defeated
- General goals of full employment and price stability
The Great Inflation

Humphrey-Hawkins Act of 1978
- Full Employment and Balanced Growth Act
- Amendment to Employment Act of 1946
- Requires Fed to produce a biannual Monetary Policy Report to Congress
- Mandates Fed to maintain long-term economic growth and seek price stability
- Volcker’s political cover in 1979-81
The Great Crisis

Dodd-Frank Act of 2010
- Wall Street Reform and Consumer Protection Act of 2010
- Financial Stability Oversight Council (FSCOC)
- New “soft mandate” on financial stability
- Worrisome distinction between monetary and macroprudential policies

“Going forward, for the Federal Reserve, as well as for other central banks, the promotion of financial stability must be on an equal footing with the management of monetary policy as the most critical policy priorities.” -- Ben Bernanke, April 13, 2012
The Essence of a Major Crisis

The Political Economy of False Prosperity

• The Angst of Labor
• Globalization 2.0
• Bubbles and their Aftermath
• The Policy Trap
• The Next Crisis
### Advanced Economies: Government Finances

<table>
<thead>
<tr>
<th>Year</th>
<th>Fiscal Balance</th>
<th>Debt/GDP</th>
<th>Debt Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>-0.9%</td>
<td>68.4%</td>
<td>3.0%e</td>
</tr>
<tr>
<td>2005</td>
<td>-2.4%</td>
<td>74.4%</td>
<td>3.0%e</td>
</tr>
<tr>
<td>2009</td>
<td>-8.7%</td>
<td>95.8%</td>
<td>2.75%</td>
</tr>
<tr>
<td>2010</td>
<td>-7.6%</td>
<td>100.4%</td>
<td>2.75%</td>
</tr>
<tr>
<td>2011e</td>
<td>-7.0%</td>
<td>102.3%</td>
<td>?</td>
</tr>
<tr>
<td>2012e</td>
<td>-5.1%</td>
<td>103.4%</td>
<td>?</td>
</tr>
<tr>
<td>2013e</td>
<td>-4.0%</td>
<td>104.0%</td>
<td>?</td>
</tr>
</tbody>
</table>

### United States: Government Finances

<table>
<thead>
<tr>
<th>Year</th>
<th>Fiscal Balance</th>
<th>Debt/ GDP</th>
<th>Debt Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>+2.4%</td>
<td>34.7%</td>
<td>2.3%</td>
</tr>
<tr>
<td>2005</td>
<td>-2.6%</td>
<td>36.9%</td>
<td>1.4%</td>
</tr>
<tr>
<td>2009</td>
<td>-10.0%</td>
<td>53.5%</td>
<td>1.3%</td>
</tr>
<tr>
<td>2010</td>
<td>-8.9%</td>
<td>62.1%</td>
<td>1.4%</td>
</tr>
<tr>
<td>2011e</td>
<td>-9.8%</td>
<td>69.4%</td>
<td>1.5%</td>
</tr>
<tr>
<td>2012e</td>
<td>-7.0%</td>
<td>73.9%</td>
<td>1.7%</td>
</tr>
<tr>
<td>2013e</td>
<td>-4.3%</td>
<td>75.5%</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

*Source: IMF, US Congressional Budget Office*
Whither Wall Street and Washington?

Who Knows Best?

- Man: J.M. Keynes
- Markets: F.A. Hayek

http://www.youtube.com/watch?v=GTQnarzmTOc

Financials Share of Top 500 US Stocks Net Income

- Latest data: 12/31/11: 16%
- Peak: 12/31/02: 48%
FINAL CLASS
WALL STREET AND WASHINGTON:

Jeffrey Garten
OVERVIEW

• WHAT WE COVERED

• A FEW PERSONAL OBSERVATIONS

  ➢ MEGA FORCES
  ➢ POLICY IMPERATIVES
  ➢ UNEXPLORED ISSUES
COURSE COVERAGE

• History of WS-W since Hamilton-Jefferson debates, emphasis on post-WWII era
• Financial Crisis in multiple dimensions
• Regulatory response
• Global dimensions of finance and regulation
• Wall Street-Washington connections
• Leadership in private and public sectors
• Macroeconomic issues
• Broader public policy issues
MET A LOT OF PEOPLE

NEW YORK CITY

Day #1

- Roger Altman, Chairman Evercore, former Deputy Secretary of the Treasury
- Jamie Dimon, Chairman and CEO, JP Morgan
- Kenneth Jacobs, Chairman and CEO, Lazard
- Paul Volcker, former Chairman, Federal Reserve
- Roger Ferguson, Chairman and CEO of TIAA-CREF, former Vice-Chairman, Federal Reserve
- Robert Rubin, former Secretary of the Treasury, former Chairman and CEO, Goldman Sachs
MET A LOT OF PEOPLE

NEW YORK CITY

Day #2

• Henry Paulson, former Secretary of the Treasury, former Chairman and CEO, Goldman Sachs
• Duncan Niederaurer, Chairman and CEO, NYSE & Euronext
• Rodgin Cohen, Senior Partner, Sullivan and Cromwell
• Christine Cumming, First Vice President (#2 position), New York Federal Reserve
• Andrew Ross Sorkin, author Too Big To Fail
MET A LOT OF PEOPLE

WASHINGTON D.C.

DAY #1

• DIANA FARRELL, Director, McKinsey Center for Government, and former Deputy Director, National Economic Council for President Obama
• CHARLES DALLARA, President and CEO International Institute of Finance
• GENE LUDWIG, Chairman & CEO, Promontory Group, former Comptroller of the Currency
• ED LUCE, Columnist, Financial Times
• KEN BENTSEN, Executive Vice President, Public Policy & Advocacy, Securities Industry and Financial Markets Association (SIFMA)
• REEMA DODIN, Floor Manager for Senator Durbin
MET A LOT OF PEOPLE

WASHINGTON D.C.

DAY #2

- SARAH BLOOM RASKIN, Governor Federal Reserve
- ELISSE WALTER, Commissioner, SEC
- JOHN CASTELLANI, former CEO Business Roundtable, CEO, PhRMA
- ROB NICHOLS, President, Financial Services Roundtable
- LAEL BRAINARD, Undersecretary of Treasury for International Affairs
- ALAN KRUEGER, Chairman, Council of Economic Advisors
MET A LOT OF PEOPLE

WASHINGTON D.C.

DAY #3

• RICHARD (DICK) BERNER, Counselor to the Secretary, Department of the Treasury
• GERALD SEIB, Washington Bureau Chief, Wall Street Journal
• MARY SCHAPIRO, Chairman, SEC
• JANET YELLEN, Vice Chairman, Federal Reserve
MET A LOT OF PEOPLE

WASHINGTON D.C.

DAY #4

- JEANNE ROSLANOWICK AND MICHAEL BERESIK, Chief of Staff, House Minority Financial Services, Financial Services Committee,
- GARY GENSLER, Chairman, Commodity Futures Trading Corporation (CFTC)
- PAUL STEVENS, President, Investment Company Institute
- MARTIN GRUENBERG, Chairman, FDIC
- DAVID SMICK, Editor and Publisher, The International Economy, Prominent Washington consultant to global financial institutions
- THE HONORABLE SHELDON WHITEHOUSE, United States Senator, Rhode Island (D)
MET A LOT OF PEOPLE

WASHINGTON D.C.

DAY #5

• MICHAEL BORDEN, Senior Counsel to the Majority, House Financial Services Committee
• DAVID LIPTON, Deputy Managing Director and First VP, IMF
WIDE RANGE OF STUDENT PRESENTATIONS

- CAUSES OF FINANCIAL CRISIS
- DODD-FRANK LEGISLATION
- INTERNATIONAL REGULATION
- CHANGING NATURE OF EXCHANGES
- FEDERAL RESERVE
- SECURITIES AND EXCHANGE COMMISSION
- POLITICAL ENVIRONMENT IN WASHINGTON
- WASHINGTON TRIP
- EUROPEAN SITUATION
- CHINA
DISCUSSED SOME VEXING PHILOSOPHICAL QUESTIONS

• FALSE PROSPERITY AND THE CHALLENGE OF CENTRAL BANKING
• CAUSES OF A FINANCIAL CRISIS
• BALANCING STABILITY AND RISK-TAKING
• CHANGING BALANCE OF PUBLIC AND PRIVATE POWER
• DEALING WITH FINANCIAL AND REGULATORY COMPLEXITY AT HOME AND ABROAD
• MORAL HAZARD
• SYSTEMIC RISK
• REGULATORY CAPTURE
WALL STREET-WASHINGTON CONNECTIONS

- PEOPLE AND REVOLVING DOOR
- TRADE ASSOCIATIONS, POLITICAL CONSULTANTS, AND ADVOCACY/LOBBYING
- LAW AND LEGAL ENFORCEMENT
WALL STREET-WASHINGTON CONNECTIONS

• INTEREST RATES
  ➢ FED/ECB LIQUIDITY

• CURRENCIES

• DEBT
  ➢ SPAIN, ITALY, PORTUGAL
  ➢ FINANCIAL REPRESSION

• REGULATION

• OVERSEAS MARKET ACCESS
A FEW PERSONAL OBSERVATIONS
MEGA FORCES

• WALL STREET AND WASHINGTON MUST BE SEEN AGAINST BACKGROUND OF A NUMBER OF MEGA FORCES

➤ GLOBALIZATION
➤ TECHNOLOGICAL CHANGE
➤ LARGE-SCALE COMPLEX SYSTEMS
➤ TENSIONS BETWEEN CENTRALIZATION AND DECENTRALIZATION
MEGA FORCES

- Massive indebtedness and deleveraging requirements in US, Europe, Japan
- Shifting global financial imbalances
- Shifting balance between public and private sector; future of capitalism
- Shifting global governance
- Changing dynamics of financial services industry
  - Consolidation
  - Shadow financial system
MEGA FORCES

- INCONCLUSIVE DOCTRINAL DEBATES ABOUT
  - MACROECONOMIC POLICY (AUSTERITY VS. GROWTH)
  - NATURE OF EFFECTIVE REGULATION (ROLE OF GOVERNMENT)
  - FINANCIAL STABILITY VS. CREATIVE DESTRUCTION
  - WHAT’S TOO BIG OR TOO COMPLEX TO MANAGE?
MEGA FORCES

- WORLD’S MASSIVE INVESTMENT NEEDS; SHOW MUST/WILL GO ON...
  - RESOURCES
  - URBANIZATION
  - OTHER INFRASTRUCTURE
MEGA FORCES

- PUBLIC OPINION
  - INCOME DISTRIBUTION
  - ROLE OF FINANCE
MEGA FORCES

➢ MARKETS RULE
  ▪ SENATOR WHITEHOUSE – “BANKS WIN”
  ▪ SINCE AT LEAST THE ROTHSCILDS
  ▪ GLOBAL SCOPE, POLITICAL CLOUT
NEW POLICY IMPERATIVES

MY VIEW ...

• TOO BIG TO FAIL OR TO MANAGE: BREAK ‘EM UP
• CAPITAL REQUIREMENTS: TOUGH, SIMPLE
• REGULATORY ASSESSMENT: COST-BENEFIT
• VOLCKER RULE: SIMPLIFY OR START AGAIN
• DERIVATIVES: ERR ON SIDE OF EXCHANGES / TRANSPARENCY
• TOUGHER TREATMENT/ACCOUNTABILITY OF WALL STREET CEOS
• TOUGHER TREATMENT/ACCOUNTABILITY OF TOP REGULATORS
SOME CONCLUDING OBSERVATIONS

 ISSUES TO FURTHER EXPLORE

• ETHICS
• THE SHADOW BANKING SYSTEM: HOW MUCH TO REGULATE?
• WALL STREET AND WASHINGTON IN 2020: THE DEBT NEXUS
• THE “NEXT” WALL STREET, HOW DIFFERENT?
• THE FUTURE OF REGULATION, INCLUDING GLOBAL-NATIONAL BALANCE
SOME CONCLUDING OBSERVATIONS

ISSUES TO FURTHER EXPLORE

• IS BANKING DE-GLOBALIZING?
• IS MORAL HAZARD POSSIBLE AND CREDIBLE?
• CAN SYSTEMIC RISK BE MANAGED?
• CAN FINANCE BE A NOBLE PROFESSION?
SOME CONCLUDING OBSERVATIONS

• THE COMING POLITICAL CONFLICT: TWO ECONOMIES, TWO GENERATIONS

• SCOPE FOR NEW INNOVATION

• THE NEXT CRISIS, FROM WHERE?
  ... ALWAYS A DIFFERENT DIRECTION
  ... ALWAYS ABOUT LEVERAGE
  ... ARE CRISES THE “NEW NORMAL?”