Morgan Stanley

Leadership Imperatives for a *Post-Crisis World*

June 26, 2009

Stephen S. Roach
Chairman, Morgan Stanley Asia

Like all crises, this too will pass. But the severity of the current debacle — not just in financial markets but also on the real side of the global economy — points to a very different post-crisis healing than that which has taken place in the past. Most importantly, over the foreseeable future, the macro environment is likely to be characterized by the combination of lingering problems in a damaged financial system together with an unusually anemic recovery in the global economy.

Tensions will undoubtedly persist in such a tough post-crisis climate. In sharp contrast to the V-shaped recoveries of yesteryear, when relief was quick and powerful, the next several years are likely to reflect a persistent fragility, punctuated by periodic setbacks. Politicians and policy makers are unlikely to be content with such an outcome. As a result, they should continue to lean heavily on their fiscal and monetary arsenals in an effort to overwhelm the headwinds of a weak and tenuous recovery.

Yet contrary to the buzz of neo-Keynesian thinking, the post-crisis world needs far more than the sheer brute force of pro-growth policies aimed at forestalling a relapse. A break from the broken strategies of the past is an urgent imperative. To the extent actions are aimed at resurrecting the failed unbalanced growth models of yesteryear, yet another wrenching crisis is a distinct possibility. Mindful of such perils, the Authorities need to be tenacious in uncovering the problems and mistakes that got the world into this mess in the first place. Only then, can a crisis-torn world transform imbalances into balance and turn angst into opportunity.

This is not a crisis of capitalism. Ultimately — albeit with seductively long lags in many cases — the invisible hand of creative destruction worked with brutal efficiency. It is, instead, much more a crisis in the governance of capitalism. An ideology of self-regulation supplanted the discipline and oversight that an increasingly complex system required.[1] It will take bold and visionary leadership to reverse that trend and regain control of a precarious financial system and an asset-dependent global economy. But there is really no other choice. The body politic must get governance right in this post-crisis world.

Familiar Patterns

Like most crises, this one has already given rise to a cottage industry of investigations and commissions — all aimed at correcting flaws in the system and thereby avoiding a recurrence of such turmoil in the future.[2] This is a very familiar pattern. In the midst of carnage, a broad cross section of well-intended and hard-working experts from the public and private sector typically come together to frame post-crisis remedies. They invariably produce a very detailed post mortem of what went wrong — instrument by instrument, market by market, company by company, and economy by economy. Reports are released with great fanfare — sometimes followed by action but, more often than not, greeted with blank looks, polite applause, and little follow through.

The very concept of the crisis dooms this approach to failure. History demonstrates that the next crisis is never like the last one. Yet diagnoses and cures are almost always backward looking — at odds with the inexorable growth in complexity of a rapidly changing world. It's akin to

Note: This essay is based on a lecture given by Mr. Roach on June 22, 2009 before the Rafael del Pino Foundation in Madrid, Spain.

1 See "Whither Capitalism?", an essay initially published on February 23, 2009 by Stephen Roach in Germany's *Handelsblatt* as "Dem Kapitalismus eine zweite Chance."

2 See, for example, Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, May 2009; moreover, in May 2009, President Obama signed off on a congressional proposal to create a Financial Crisis Inquiry Commission that empowers a 10-person independent panel to conduct extensive hearings over the next 18 months into the sources of the crisis.

the ever-mutating virus that forever complicates human disease control — viruses that spawn internally generated immunities, which continually frustrate new vaccines. That's not to say obvious flaws in financial systems or policy architectures shouldn't be uncovered and addressed. But rather that there is a limit on any cure that arises from a backward-looking diagnosis.

Take the Asian financial crisis of 1997-98, for example — an upheaval that at the time was billed as the world's worst financial crisis since the 1930s. The post-crisis commissions — one of which I was very proud to serve on — focused on the architectural reforms that would prevent the replay of this powerful pan-regional contagion.[3] Follow through, in this instance, was impressive. Among other things, Asian currency pegs were largely abandoned, current account deficits were transformed into surpluses, depleted foreign exchange reserves were rebuilt, and exposure to short-term capital inflows was sharply reduced. Lessons well learned — at least in the context of what went wrong in 1997-98.

History demonstrates the next crisis is never like the last one. Can the body politic break the mold of what has long been a backward-looking reform process?

But now, eleven years later, Asia is in trouble again. While the post-crisis remedies developed after the financial crisis of the late 1990s worked reasonably well in the current turmoil, they failed to inoculate Asia against the inevitable next crisis — in this case, a massive shock to external demand that left its increasingly export-led economies ripe for the fall. Every major economy in the region is either in the midst of a sharp slowdown or has tumbled into outright recession. In short, Developing Asia's backward-looking fixation on financial repair did little to prepare it for a shock that was aimed at the heart of the structural imbalances in its real economies. That doesn't mean Asia shouldn't have adopted the menu of widely recommended post-1997-98 crisis measures. It just should have done more. Unsurprisingly, the problems of the past did not turn out to be a good guide to the stresses that were to hit Asia a decade later.

Unlike the crises of the past 25 years — most of which originated in the developing world — this one arose in the rich countries of the developed world. And it was the main engine of the developed world — the once thriving US economy — that was the principal source of a problem that quickly became global in scope. Once again, the rush to judgment is on, with the focus in this case on the flaws in the modern-day financial institutions and the toxic financial instruments that have presumably given rise to this crisis. Cries of regulatory reform are louder than ever — both at the national and global levels. The recently unveiled proposals of the Obama Administration are leading the charge in this area.[4] Can the American body politic break the mold of the backward looking reform process and draw more prescient lessons for the future?

Macro Crisis

The political response will be effective only if avoids the incremental thinking that typically dominates the post-crisis debate. Unfortunately, that may be too much to ask of myopic politicians. But it is well worth a try. In that vein, I have long suspected that there is a deeper meaning to this crisis — namely, a macro overlay that made the micro flaws all the more serious. At work, in my view, was a lethal interplay between the bursting of asset bubbles and the unwinding of destabilizing imbalances — major sources of disequilibria that had all but been ignored during the Era of Excess.[5] Deepening our understanding of these powerful macro forces is essential in order to promote a sustained healing in the post-crisis era.

There is a deeper meaning to this crisis — a macro overlay that exacerbated the micro flaws of a precarious financial system.

The saga began in America. Starting in the late 1990s, the US economy went through an ominous transformation. Income-short consumers discovered the miracle drug of a new source of purchasing power — the seemingly open-ended wealth creation of ever-frothy asset markets. First equities, then residential property, American households drew on asset appreciation to consume well beyond their means — at least as those means were delineated by the US economy's internal labor income generating capacity. Real private sector compensation — the broadest measure of the economy's endogenous income flows — currently stands only about 13% above its early 2002 levels in inflation-adjusted terms. That represents a staggering $1 trillion shortfall from the path that would have been implied from the average trajectory of the previous four long-cycle expansions (see Figure 1 on page 3). Yet personal consumption surged to a record 72% of real GDP in early 2007 — a spending binge without precedent in US history, or for that matter in the long history of any leading economy in the modern era (see Figure 2 on page 3).

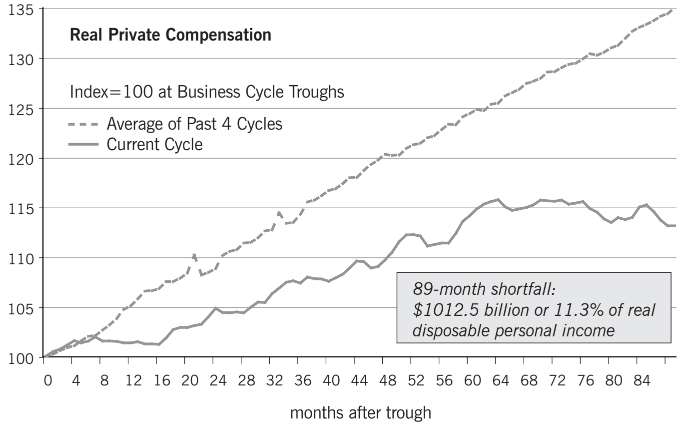
3 See *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture*, Report of an Independent Task Force Sponsored by the Council on Foreign Relations, New York, 1999.

4 See US Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, June 2009.

5 See "After the Era of Excess", an essay published by Stephen Roach in the February 26, 2009 issue of the *McKinsey Quarterly Newsletter* "What Matters".

Figure 1

Income Shortfall

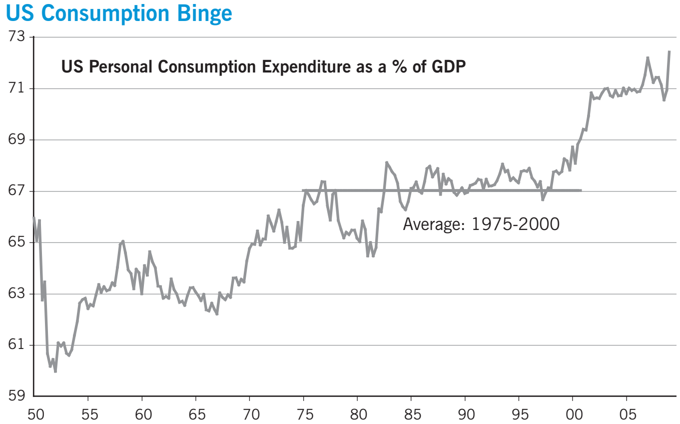


Source: National sources, Morgan Stanley Research

Wealth creation closed the gap — driven especially in recent years by the self-reinforcing feedbacks between housing and credit bubbles. Courtesy of new "breakthroughs" in mortgage finance — breakthroughs, in retrospect, that were more destructive than constructive — homeowners tapped the seemingly open-ended home equity till as never before. Net equity extraction from residential property surged from about 3% of disposable personal income in 2000 to nearly 9% in 2006 (see Figure 3). This provided newfound support to spending and saving that allowed households to more than compensate for the extraordinary shortfall of labor income generation. The result was not only the consumption binge noted above, but also a profound shortfall of income-based saving. The personal saving rate slid into negative territory in late 2005 for the first time since the 1930s.

Figure 2

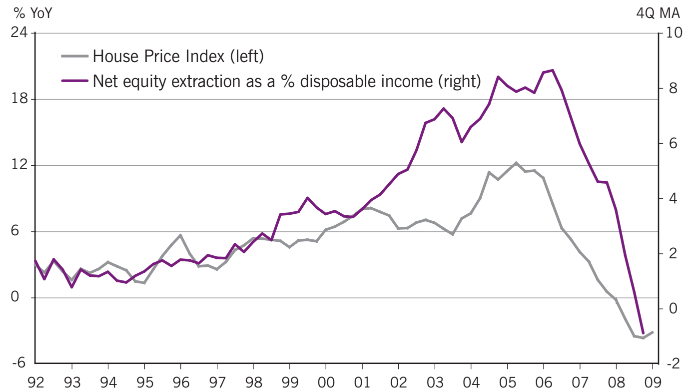
US Consumption Binge



Source: National sources, Morgan Stanley Research

Figure 3

The Asset Play



Source: National sources, Morgan Stanley Research

The story didn't stop there. Lacking in income-based saving, the US imported surplus saving from abroad in order to keep growing (See Figure 4 on page 4). But it had to run massive external deficits in order to attract the capital — sufficient to push the current-account deficit up to a record 6.5% of US GDP by the third quarter of 2006. The impact of that development was global in scope — deficits must always be matched by surpluses elsewhere in the world. Courtesy of America's gaping external shortfall, global imbalances — the absolute sum of the world's current account deficits and surpluses — soared to 6% of world GDP in 2006, nearly triple the 2% reading of a decade earlier. Joined at the hip, asset bubbles and global imbalances stretched the macro fabric of the global economy as never before (See Figure 5 on page 4).

The over-extended, asset-dependent American consumer has become the most destabilizing force in the US and the broader global economy.

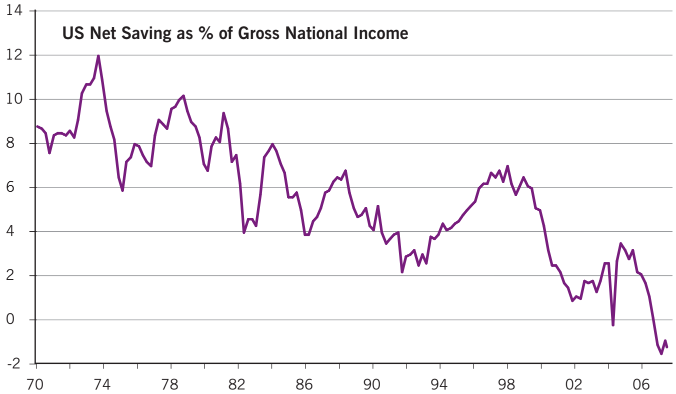
Like all eras of excess, there were tantalizing explanations as to why these problems should be ignored. The so-called Bretton Woods II framework was a prominent excuse — a purported symbiosis between the United States and a China-centric Asia that many argued cemented the financial underpinnings of the world's biggest consumer to the world's major exporters.[6] In the end, there was one fatal problem with this line of reasoning — it all hinged on ever-expanding property and credit bubbles. When those bubbles burst, a deadly feedback mechanism came into play: Powerful post-bubble adjustments hit the world's most over-extended consumer — setting in motion forces that sapped external demand for the world's export-led surplus savers. The once

6 One of the first discussions of this concept can be found in M. Dooley, D. Folkerts-Landau, and P. Garber, "An Essay on the Revived Bretton Woods System," National Bureau of Economic Research Working Paper 9971, September 2003.

virtuous cycle quickly became vicious, with wrenching macro adjustments exposing the micro flaws of a precarious financial system and setting the world up for the worst financial crisis and recession since the 1930s.

Figure 4

America's Saving Shortfall



Source: IMF, US Bureau of Economic Analysis, Morgan Stanley Research

Macro Fix

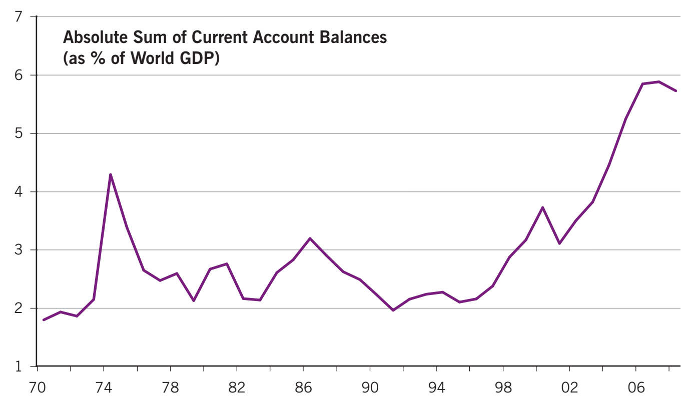
The above argument implies that a crisis-torn world needs more than micro-based regulatory reform. That very consideration is now being actively debated in the world's major political capitals. One of the most contentious aspects of this debate involves the thorny problems of systemic risk — in effect, the cross-product and cross-border interdependencies of financial institutions, complex securities, market structures and economies. A consensus has coalesced around the concept of a systemic risk regulator — a new or existing authority who should be charged with managing these complex interdependencies.

I am not in favor of reinventing the wheel here. Systemic risk is actually nothing new — it is jargon for complexities that have always been at the core of interdependent macro systems. Sure, those complexities may have morphed into different forms over recent years — compounded by the cross-border linkages of globalization, new technologies of financial engineering, and a massive increase in the scale of global financial institutions. But that doesn't mean market-based systems have lost their ability to contain such risks. Central banks, by setting policy interest rates that, in turn, provide important benchmarks for the price of risky assets, can still exercise ultimate control in fulfilling this function. It is just a question of whether they have the political will — or the independence — to do so. Rather than attempt to create a new systemic risk regulator, I would argue that it is more important to take a careful look at the central banking function, itself — namely, considering the possibility of making explicit changes to policy mandates that would force central banks to make systemic risk control an integral part of their mission.

There is also an important global overlay to considerations of systemic risk. As we have seen all too vividly in this crisis, cross-border spillovers are the rule — not the exception — in increasingly integrated global capital markets. Disparities in country-specific regulations have led to a regulatory arbitrage that has compounded global imbalances. This adds unnecessary volatility to markets — underscoring the need for a cross-border harmonization of regulations, as well as for a regulatory authority charged with monitoring and sounding the alarm on the global ramifications of systemic risk. Again, my vote is to go with the existing central banking structure to deal with this aspect of the problem — in this case, empowering the Bank for International Settlements with the authority of the global systemic risk regulator. Given its long standing concerns over mounting global imbalances, as well as the rigor of the analytics it has developed to assess this problem, the BIS is certainly deserving of this important responsibility.[7]

Figure 5

Global Imbalances



Source: IMF, US Bureau of Economic Analysis, Morgan Stanley Research

But the reworking of policy mandates needs to start with the central bank that, in my opinion, is most responsible for this mess — America's Federal Reserve. In looking back at the Era of Excess, there are compelling reasons to believe that the bubble-driven distortions of the US economy — as well as the global imbalances they spawned — would have been considerably different under an alternative monetary policy regime. Had, for example, the Fed run a tighter monetary policy in the early part of this decade, the excesses of property and credit bubbles most assuredly would have been tempered. Yes, an asset-dependent US economy would probably have grown more slowly as a result — as would have been the case for the rest of a US-centric global economy. But in retrospect, that foregone growth would have been a small price to pay in

7 The annual reports of the Bank for International Settlements have long warned of the systemic perils of mounting global imbalances. See, for example the Introduction to the 74th annual report of the BIS, "A Time to Rebalance?" published in June 2004.

order to avoid the crisis-induced shortfall that could now be with us for years to come. Before the Fed is given new powers in the post-crisis era — very much the intent of the Obama Administration's regulatory reform proposals — a careful reconsideration of its old powers is in order.

Systemic risk is nothing new. It can best be addressed by rethinking the central banking function — both for individual economies as well as for the international financial system.

A New Mandate for the Fed[8]

Mindful of the costs of a decade of misguided monetary policy, I believe that the US Congress now needs to alter the Fed's policy mandate to include an explicit reference to financial stability. The addition of those two words would force the central bank not only to aim at tempering the damage from asset bubbles but also require it to use its regulatory authority for promoting sounder risk management practices. The Obama Administration has proposed that the Federal Reserve be empowered as America's new systemic risk regulator. That expansion of power should not be taken lightly, nor should it be granted without greater accountability. The explicit incorporation of financial stability into the Fed's policy mandate would align concerns over systemic risks with destabilizing bubbles and imbalances — a welcome development after years of neglect and excess.

The US Congress now needs to alter the Fed's policy mandate to include an explicit reference to financial stability.

This is not the first time the US Congress would have to refine the Fed's policy mandate. The initial effort arose in the aftermath of the Great Depression. Determined to avoid a repeat of the massive joblessness of the 1930s, the Employment Act of 1946 required the Fed to set monetary policy with an aim toward full employment. That approach worked reasonably well for about 25 years. Then came the Great Inflation of the 1970s, and the Fed's unwillingness to tackle this wrenching problem. In response, the so-called Humphrey-Hawkins Act of 1978 was enacted — requiring the central bank to add price stability as a policy target. At the time, the Congress felt the Federal Reserve needed the full force of the law to tackle an increasingly corrosive inflation problem. And with good reason. It was the wisdom of that legislative initiative some 30 years ago that empowered Paul Volcker and his courageous assault on double-digit inflation.

Just as the Fed's inflation blunder of the 1970s sparked a legislative remedy in the form of the Humphrey-Hawkins Act, there is good reason to believe that the Fed needs to be bound by a new law to avoid bubble-prone mistakes in the future. The charge in this case is financial stability — code words for avoiding the imbalances associated with the asset and credit bubbles that are at the heart of the current crisis. As was the case with the original full employment target, as well as with the subsequent objective of price stability, Congress need not specify precise targets with respect to financial stability. That should be left up to the Fed — allowing the monetary authority to develop the metrics and tools that would enable the execution of the expanded policy mandate (see Figure 6).

Figure 6
New Mandate for the Fed

PROBLEM	RESPONSE	POLICY TARGET
GREAT DEPRESSION: 1930s	EMPLOYMENT ACT OF 1946	FULL EMPLOYMENT
GREAT INFLATION: 1970s	HUMPHREY-HAWKINS ACT OF 1978	PRICE STABILITY
GREAT CRISIS: 2008/2009	REGULATORY REFORM OF2009/10	FINANCIAL STABILITY

This will require the Fed to adjust its tactics in two ways: Firstly, monetary policy will need to shift away from the Greenspan-Bernanke reactive post-bubble cleanup approach toward pre-emptive bubble avoidance. Yes, it may be tricky to judge when an asset class is in danger of forming a bubble. But, in retrospect, there can be little doubt of the profusion of bubbles that developed over the past decade — equities, residential property, credit, and many other risky assets. The Fed mistakenly dismissed all of these developments, harboring the illusion that it could clean up any mess afterwards. The extent of today's devastating mess is clear repudiation of that hands-off approach.

This would be the third time the Fed's policy focus has been modified since the end of World War II.

There would be no room in a new financial stability mandate for the ideological excuses of bubble denialists. Alan Greenspan, for example, argued that equities were surging because of a New Economy; that housing forms local not national bubbles; and that the credit explosion was a by-product of the American genius of financial innovation. In retrospect, while there was a kernel of truth to all of those

8 This section is based on the essay "Changing the Fed's Policy Mandate" originally published by Stephen Roach as an editorial feature in the Financial Times on October 28, 2008.

observations, they should not have been decisive in shaping Fed policy. Under a financial stability mandate, the US central bank would have no such leeway. It will, instead, need to replace ideological convictions with common sense. When investors and speculators buy assets in anticipation of future price increases — precisely the case in each of the bubbles of the past decade — the Fed will need to err on the side of caution and presume that a bubble is forming that could pose a threat to financial stability.

> The Fed will need to shift away from a reactive post-bubble clean-up approach toward pre-emptive bubble avoidance, as well as become much tougher in exercising its long neglected regulatory function.

The new mandate would encourage the Federal Reserve to deal with financial excesses by striking the right balance between its policy interest rate and the tools of its regulatory arsenal. In times of asset-market froth, I would favor the "leaning against the wind" approach suggested by some with regard to the policy interest rate — in effect, pushing the federal funds rate higher than a narrow inflation target might otherwise suggest.[9] Yes, the US would undoubtedly pay a short-term price in terms of foregone output, but that price would well be worth the benefits of a more durable expansion.

Secondly, the new mandate will require the US central bank to be much tougher in exercising its long neglected regulatory oversight capacity. For good reason, the Fed has been equipped with other tools in its policy arsenal that can and should be directed at financial excesses — specifically, margin requirements for equity lending as well as controls on the issuance of exotic mortgage instruments (negative amortization and zero-interest rate products come to mind). In addition, of course, the Fed should not be bashful in using the bully pulpit of moral suasion to warn against the impending dangers of mounting asset and credit bubbles.

Of equal and related importance is the need for the US central bank to develop a clearer understanding of the linkage between financial stability and the open-ended explosion of new financial instruments — namely, derivatives and structured products. Over the past decade, an ideologically-driven Fed failed to make the critical distinction between financial engineering and innovation. Complex and opaque financial products were viewed as testaments to American ingenuity. Unfortunately, the Fed understood neither the products nor the incidence of their distribution. Never mind that the notional value of global derivatives hit some $516 trillion in mid-2007 on the eve of the sub-prime crisis — up 2.3 times over the preceding three years to a level that was fully ten times the size of world GDP. The operative view in US central banking circles was that an innovations-based explosion of new financial instruments was a huge plus for market efficiency.

Driven by its ideological convictions, the US central bank ended up flying blind on the derivatives front. Drawing a false sense of security from the "originate and distribute" technology of such complex products, the Fed took great theoretical comfort from a presumed diffusion of counterparty risks. These so-called innovations became the mantra of the Brave New World of finance — billed as a new source of liquidity to the system that could serve as a shock absorber in times of distress. Yet as the aftershocks of the sub-prime crisis painfully illustrate, trust in ideology over fact-based risk assessment turned out to be a fatal mistake. The derivatives implosion was not only concentrated in many of the world's major financial institutions but it was also a critical source of illiquidity and an amplifier of market shocks.

The lessons of the inflation problems of the 1970s, as well as those from the asset bubbles and the Fed's regulatory laxity of the past decade, should not be lost on the US Congress: America's central bank cannot be entrusted to correct these mistakes on its own. Ideological and even political biases can — and have — repeatedly gotten in the way of the policy discipline required of an independent central bank. A new financial stability requirement must be explicitly hardwired into the Federal Reserve's policy mandate. Only then can the Fed be transformed into the systemic risk regulator that Washington is now seeking.

Political Will

This crisis didn't have to happen. I categorically reject the "inevitability excuse" — the notion that the world has once again been engulfed by the proverbial 100-year tsunami. This all too convenient justification is nothing more than a cop-out by those who were asleep at the switch during the Era of Excess. Yes, cycles of fear and greed date back to the inception of markets. And those powerful animal spirits were very much at work this time, as well.[10] But I take strong issue with the apologists who claim little could have been done to avoid the devastating repercussions of the so-called subprime crisis. Instead, there is compelling reason to hold the stewards of the

9 Bill White, formerly Economic Adviser and Head of the Monetary and Economic Department of the BIS, has long been a leading proponent of this approach. See, for example, William R. White, "Should Monetary Policy Lean against Credit Bubbles or Clean Up Later?"— a paper based on remarks made before the Monetary Policy Roundtable of the Bank of England on September 30, 2008.

10 This point is developed in great detail in G.A. Akerlof and R.J. Shiller, Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism, Princeton University Press 2009.

financial system — those in Washington as well as those on Wall Street — accountable for much of the blame.

In free-market systems, the body politic renders the ultimate judgment on matters of governance. The emphasis above has been on monetary policy and, specifically, on a new mandate for central banks. That is not meant to take the place of other regulatory reform proposals that have been offered in recent months. But I worry that too much attention has been focused on micro remedies — ignoring the macro issues that have come to a head in this extraordinary period of crisis and recession.

In that same vein, politicians and policy makers face a number of other key macro leadership imperatives: The choice between the quick fix and the heavy lifting of global rebalancing is especially critical. It is tempting in a climate where the first signs of healing (i.e., "green shoots") are evident to lapse back into the old strain of economic growth that got the world into serious trouble in the first place. Why not, for example, let Americans go back to excess consumption and the Chinese revert to saving and exporting? After all, as many argue, both societies are culturally inclined toward those extremes. I don't buy that logic for a second, but I certainly concede that there is a compelling political expediency in maintaining such a *status quo.*

Does the body politic have the vision and the courage to look beyond the short-term and make tough choices that could provide a lasting cure for a crisis-torn world?

Nor should politicians be let off the hook in facing up to the mounting risks of trade frictions and protectionism. The choice between the collective interests of globalization and the self-interests of "localization" are especially critical in that regard. In times of prosperity and low unemployment, belligerence on trade policy can be dismissed as political posturing. But in the midst of severe recession and soaring unemployment, politicians are under serious pressure to protect increasingly beleaguered workers. The risks of protectionist policy blunders are especially worrisome in such a climate. Only through a better understanding of globalization — especially today's strain now bearing down on long-sheltered white-collar knowledge workers — can the body politic avoid such dangerous temptations.[11]

In the end, we can't delude ourselves into thinking that the lessons of this crisis rest solely in new rules and regulations. They are a necessary — but not sufficient — condition for a more robust post-crisis architecture. As I have tried to argue above, our problems also have a very important human dimension — namely, they are an outgrowth of the poor judgment that was endemic in this reckless era of self-regulation. By purging the governance of the system of these ideological biases, the authorities will be much better positioned to avoid the dangerous interplay between asset bubbles and global imbalances in the future. No, I do not harbor the illusion that such steps will banish the threat of financial crises in the future. But to the extent the body politic rises to the occasion, the inevitable next crisis should be far better contained than this one.

This raises the biggest question of all: Do politicians have the vision and the courage to look beyond their normal short-term horizons and make the tough choices that could provide a longer-lasting cure for a crisis-torn world? Only time will tell, of course. But this could be the biggest leadership test of all for the post-crisis world.

Stephen S. Roach is Chairman of Morgan Stanley Asia, serving as the Firm's senior representative to clients, governments, and regulators across the region. Prior to his appointment as Asia Chairman, Mr. Roach was Morgan Stanley's Chief Economist.

11 See Stephen Roach's essay "Perils of a Different Globalization" published on March 20, 2006 by Morgan Stanley Research.

Morgan Stanley

www.morganstanley.com