The Post-Crisis Fix:
Regulatory or Monetary Policy Remedies?

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Under the auspices of the US Congress, the newly constituted Financial Crisis Inquiry Commission held its first hearings in Washington on January 13-14, 2010. Established by Congress in the aftermath of the Lehman Brothers bankruptcy, its function is very reminiscent of congressionally-sponsored hearings held in 1932 by the so-called Pecora Commission. As was the case some 78 years ago, the current generation of Wall Street captains was grilled on the specifics of the Great Crisis of 2008-09. Like then, this high-profile exchange could well be key in driving legislation that could shape the US financial system – and an asset- and debt-dependent US economy – for generations to come.

The early betting is that post-crisis remedies will be concentrated in a new approach to regulatory oversight – specifically the imposition of new "macro-prudential" regulations aimed at the twin concerns of systemic risk and financial stability. While this approach undoubtedly has considerable merit, it may not be enough to prevent another crisis from occurring in the not-so-distant future. Also needed, in my opinion, is a major reworking of the mandate that guides the role and conduct of monetary policy. Specifically, the addition of a financial stability mandate could go a long way in forcing central banks to face up to the destabilizing perils of asset bubbles and the imbalances they have spawned in the mix of global saving as well as on the real side of increasingly asset-dependent economies.

There is no quick fix in this post-crisis world – no silver bullet that would inoculate an ever-changing world from the inevitable next crisis. But the world can surely do a much better job of crisis prevention that it did in the free-wheeling decade before the onset of the sub-prime crisis in the summer of 2007. Significantly, it should avoid a backward looking fix that addresses the problems that gave rise to the last crisis. Such a myopic approach invariably misses the excesses that sow the seeds of the next crisis. Instead, the post-crisis fix needs to be as broad-based and comprehensive as possible – in essence, throwing out a big net that would limit as many destabilizing risks as possible. The broad fix should both contain both regulatory reforms and a new approach to monetary policy. Only then, will there be a meaningful chance for a safer and sounder post-crisis world.

Macro-Prudential Regulatory Options

Where the Washington debate ends up is anyone's guess. Right now, the regulatory approach has the upper hand. A resurrection of a Glass-Steagall-type separation between the commercial banking function and riskier capital market activities is certainly a possibility. Senators McCain and Cantwell have introduced just such a proposal – in essence, repealing the decade-old Graham-Leach-Bliley legislation (The Financial Services Modernization Act of 1999) that effectively repealed the original Glass-Steagall

framework. Meanwhile, none other that former Federal Reserve Chairman, Paul Volcker, has offered a similar proposal that would offer full government backstop support (i.e., deposit insurance and lender of last resort access) to the utility-like commercial banking functions of deposit gathering and lending – but no such support to proprietary and speculative capital market activities of financial institutions. The Volcker proposal, which has now been formally endorsed by the Obama Administration, is very specific in arguing that commercial banks be prohibited from involvement in proprietary trading, hedge funds, and private equity activities. In that key respect, it is the functional equivalent of Glass-Steagall II.[1]

A reinstatement of Glass-Steagall-like restrictions on the US financial system is one example of a new "macro prudential" approach to regulatory policy that seems to have gained favor in the current post-crisis debate. The goal of such proposals is to put regulations in place that foster stability of the system as a whole. The inference is that the former approach on "micro prudential" regulations, which were directed at the stability of individual institutions, could lead to investor herding and other counter-productive trends that could be destabilizing to the broader financial system. Other macro prudential proposals that are under active consideration include counter-cyclical capital provisioning for banks, which would require a build-up of reserves in a boom and less onerous capital requirements in a downturn, as well as proposals to revamp bonus-driven compensation schemes of Wall Street executives and risk-takers. So-called resolution authority to unwind failed financial institutions is another option in the macro prudential tool-kit – aimed, in this instance, at the critical moral hazard implications of large financial services firms that have become "too big to fail."

The problem with fixating post-crisis remedies on a macro-prudential regulatory solution is that it ignores the 800-pound gorilla that is also in the same room – misdirected monetary policies. Yes, regulators were asleep at the switch in the Era of Excess. So, too, were their political overseers in the US Congress. But the Federal Reserve was hardly an innocent bystander. Excessive monetary accommodation beginning in the late 1990s was a conscious outgrowth of the Greenspan-Bernanke view that monetary policy should not be used to prevent asset- and debt bubbles and the distortions they foster in the real economy. The Fed believed, instead, that it had both the power and the wisdom to use monetary policy to clean up the post-bubble carnage. The breadth and depth of the current crisis and recession draws that presumption into serious question.

Yet this remains a very contentious issue in the current macro policy debate. For Ben Bernanke, the debate goes to the heart of his macro philosophy – not just as a central banker but also as an academic before he came to Washington. In an early 2010 speech, Bernanke reiterated his long-standing view that blame for the current crisis rests on the laxity of regulatory oversight rather than on inappropriate monetary policy.[2] And he

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[1] See remarks by Paul A. Volcker before the Statutory Congress of the European People's Parties in Bonn, Germany, December 9, 2009, as well his testimony before the Banking, Housing and Urban Affairs Committee of the US Senate on February 2, 2010.

[2] See Ben Bernanke, "Monetary Policy and the Housing Bubble," speech before the Annual Meeting of the American Economic Association, Atlanta, Georgia, January 3, 2010. Bernanke was even more explicit in

underscored the standard argument that monetary policy is too blunt an instrument to deal with asset bubbles – despite the fact that bubble-related distortions on the real side of the US economy ended up engulfing nearly 80% of the GDP (personal consumption and residential construction, combined). When imbalances in the real economy are that large, relying on the blunt instruments of macro stabilization policy might not be such a bad idea, after all. In my view, it is not a question of either-or. While some macro prudential proposals have considerable merit, the role of monetary policy during and after this crisis also needs to be examined very carefully. I reject the suggestion that post-crisis remedies should be outsourced to regulators.

The post-crisis US financial system needs to strike a balance between better regulation, more disciplined monetary policy, and more responsible political oversight. Prudential regulation of financial institutions – whether it is macro or micro – still involves very specific judgment calls affecting the performance of individual companies. While such intervention may be appropriate at times, it is not a substitute for more disciplined monetary policy. Whatever the balance between the two avenues of control of the financial system, it would be dangerous to put too many eggs in the same basket. While some macro prudential proposals have considerable merit, the role of monetary policy during and after this crisis also needs to be examined very carefully.

As the body politic comes to grips with America's post-crisis carnage, it must also take a long hard look in the mirror. The failures of the political oversight function were yet another weak link in the increasingly unstable pre-crisis equation. With these considerations in mind, it is important to stress that any post-crisis fix be framed in the context of a comprehensive and forward-looking approach. By contrast, the narrow and backward-looking approaches of the past are doomed to failure – and to the painful likelihood of yet another crisis in the not-so-distant future.

The Role of Monetary Policy

The experience of the past ten years underscores how difficult it is to break the habit of monetary accommodation in bubble-dependent economies. Each successive post-bubble shakeout has required increasingly looser monetary policy. The only way out of this vicious circle is a judicious and highly disciplined "exit strategy" – in this case, the unwinding of the unprecedented monetary stimulus that was put in place to arrest the Great Crisis and Recession of 2008-09. Unlike the fairly mechanistic withdrawal of the special liquidity (and capital) injections of quantitative easing that have been put in place in the past year and a half, there is nothing neat and easy about a post-crisis normalization of the policy interest rate. That's not to say that central banks are lacking in the tools and skills to restore benchmark interest rate to pre-crisis conditions. The issues in this case boil down to judgment and will – especially, political will. That's because the policy rate

making this point in an extended interview with the editors of *Time* that accompanied his recent selection as "person of the year." The Fed Chairman said, "I don't think that monetary policy was a particularly important source of the crisis." See www.time.com December 16, 2009.

holds the keys to the kingdom of the financial system – and the support that system provides to the real side of the global economy.

The biggest risk to the exit strategy, in my opinion, remains an asymmetrical response pattern of the policy interest rate – quick to slash in a downturn, a crisis, or a post-bubble shake-out but slow to normalize in the subsequent healing and recovery. The post-equity bubble profile of the US federal funds rate in the early part of this decade is perhaps the best – and most relevant – illustration of this bias. Over the 12 months of 2001, the benchmark short-term interest rate was cut eleven times from 6% to 1.75% by a total of 425 basis points; it was then reduced by another 75 bps to 1% in two additional installments by mid-2003. A year later, with its mission presumably "accomplished," the Fed embarked on the road to post-bubble normalization – taking the funds rate up in 17 separate incremental installments of 25 bps per move – from 1% in June 2004 to 5.25% in June 2006.

This underscores the asymmetrical biases of the Fed's post-bubble reaction function. Once the normalization process finally began in mid-2004, it took the US central bank twice as long to bring the policy rate back to its appropriate post-bubble setting as it did to slash the funds rate in the aftermath of the bursting of the equity bubble. Putting it another way, the speed of the normalization – averaging out to 18 basis points per month over a 24 month interval – was less than half the speed of the easing – an average of 40 basis points per month over a 12 month period (see accompanying table).

This asymmetry was justified by two key considerations – persistently low inflation and the ongoing fragility of a post-bubble jobless recovery. Yet in retrospect, the delayed normalization was not without serious unintended consequences. As seen through the lens of the real federal funds rate, it meant that the US central bank maintained an extremely accommodative policy stance long after the emergency of the post-bubble shakeout had run its course (see accompanying chart). Notwithstanding the *ex post* justification for monetary accommodation in recent years, the numbers speak for themselves: Since 2000, the real federal funds rate has been less than its long-term average of 1.9% in all but one year. Over this same period, the real funds rate has been less than zero about half the time.

In short, for whatever the reason, in the decade just ended, the Fed ran the most accommodative monetary policy since the 1970s – hardly a comforting precedent. Notwithstanding the recent contentions of Ben Bernanke, it's hard to believe that the Era of Excess leading up to the Great Crisis didn't draw considerable sustenance from such easy money. With the benefit of hindsight, it now appears that the Fed's asymmetrical reaction function kept US monetary policy in a highly accommodative stance well into 2006. That, in my view, played a key role in fueling the next round of even larger bubbles – twin bubbles in both property and credit markets.

Unfortunately, the same movie appears to be running in the current cycle. Going into the bursting of the subprime bubble in the summer of 2007, the federal funds rate stood at 5.25%. Then, beginning in September of that year, it was slashed to its current level of

near "zero" in 10 separate moves over a 17 month period. And now the Fed – once again citing sustained low inflation and a shaky post-crisis economic recovery and now making explicit reference to an "indefinite" period of monetary accommodation – is sending very clear signals of another delayed normalization. With a striking sense of déjà vu, America's central bank has once again been quick to ease aggressively – hardly surprising in the midst of the Great Crisis and Recession – but also equally reluctant to restore policy settings to pre-crisis norms.

This approach can and has been repeatedly justified by a risk management approach to monetary policy. After all, history demonstrates that the bursting of asset and credit bubbles typically takes a lasting toll on the real side of underlying economies. As a result, central bankers have opted repeatedly to err on the side of caution in implementing normalization strategies in the context of fragile recoveries of post-bubble economies. At the same time, this rationale is very much at odds with the "emergency" feature of aggressive crisis-driven policy responses.

This raises the key question of the post-trauma reaction syndrome: If extraordinary circumstances cause policy rates to be slashed to unusually low levels, once those same circumstances have been resolved and the emergency is effectively over, then why shouldn't there be an equally prompt suspension of the emergency measures? Putting it another way – if the US economy is in a weak recovery as the Fed seems to be indicating, shouldn't the policy rate at least be set at weak-recovery levels? Given the long lags of monetary policy, such forward-looking concerns seem especially relevant. This critical balancing act lies at the heart of the asymmetries of discretionary monetary policy adjustments.

There is another key factor that drives the asymmetrical post-crisis reaction function of central banks – the desire to foster a steep yield curve that then enables crisis-torn banks to "earn" their way back to prosperity. By allowing, if not encouraging, banks to play the spread between rock-bottom short-term borrowing rates and higher yielding intermediate and longer-term market-based investments, central banks can accelerate the healing of earnings-constrained financial institutions. In the US, the Fed discovered this approach in the early 1990s in the aftermath of the savings and loan crisis; it was even more effective in boosting earning for beleaguered banks in the aftermath of the bursting of the equity bubble in 2001 and 2002.[3]

However, the bank earnings subsidy of a steep yield curve is hardly costless in the broader macro sense – especially if it tempts central banks to stay too easy for too long in a recovery and sets up asset dependent economies for yet another fix from the next

[3] This shows up very clearly in the income statement of US banks over the 1999 to 2002 period. Over that time frame, loan-provisions for FDIC-insured commercial banks surged from $21.8 billion in 1999 to $48.2 billion in 2002; however, that $26.2 billion increase in loan write-offs was more than offset by a $44.4 billion increase in net interest income from $192.0 billion in 1999 to $236.4 billion in 2002. This earnings buffer was very much an outgrowth of the Fed's post-equity bubble yield curve steepening tactics. In the current cycle, it is much more of an uphill battle. While yield curve steepening helped boost net interest income by $16.7 billion in 2008, that was more than offset by a $95.0 billion spike in loan-loss provisions from $57.4 billion in 2007 to $152.4 billion in 2008.

bubble. And it is a key aspect of the moral hazard dilemma – providing banks with the comfort that the central bank will do everything in its power to allow surviving post-crisis financial institutions to earn their way back to recovery. Unwinding the yield curve subsidy is yet another critical consideration in evaluating the efficacy of the asymmetrical post-crisis pattern of the policy interest rate.

A New Policy Mandate

This financial crisis has unmasked some of the most serious policy blunders by central banks since the 1930s. While the so-called sub-prime crisis and the severe global recession it spawned have many culprits, none have been more derelict in carrying out their responsibilities than the custodians of the financial system. Any post-crisis fix must address this glaring fault head on.

Adding a "financial stability" provision to the policy mandates of central banks would go a long way in avoiding this type of problem in the future. Notwithstanding a predictable outbreak of post-crisis remorse, central banks cannot be relied upon to break bad habits on their own. Experience suggests that they have a hard time saying "no" to the siren song of the latest untested theory that is invariably concocted to explain away asset and credit bubbles. Recent history is littered with false claims of those in denial over the twin perils of asset bubbles and macro imbalances.

Discretionary policy making has failed in this important respect. It got caught up in an ideological debate over the risks of bubbles and imbalances. Such temptations can only be avoided by more of a rules-based approach – specifically by a financial stability mandate that is hardwired into the legal obligation between central banks and the body politic. This is especially the case for America's Federal Reserve – long the most powerful central bank in the world, yet at the same time, the one monetary authority that played the greatest role in condoning and nurturing the Era of Excess that nearly brought the world to its knees.

Over the past 75 years, the US Congress has intervened on several occasions to refocus America's monetary authority, and now needs to do so again. For example, Fed policy blunders are widely viewed as central to the Great Depression. In response, the Employment Act of 1946 was enacted that required the Fed to aim its policy arsenal toward avoiding a repetition of the massive unemployment that occurred in the 1930s. Then came the double-digit inflation of 1970s – another outgrowth of poor monetary policy – and the Congress passed the Humphrey-Hawkins Act of 1978, which added price stability to the Fed's mandate. Now, after a decade of asset bubbles and related saving and current-account imbalances, the Congress needs to step in again – this time adding "financial stability" to the Fed's existing dual mandate.[4]

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[4] Not surprisingly, the US Congress has now weighed in with a major legislative initiative that would, in effect, punish the Federal Reserve for its dereliction of duty in the years leading up to the Great Crisis. While the bill proposed by US Senator Christopher Dodd, Chairman of the Senate Banking Committee,

How would this work? Like full employment and price stability, the concept of financial stability is very much open to interpretation. One thing it should not entail would be setting price targets for key asset markets. Instead, financial stability criteria should reflect a combination of quantitative asset pricing and valuation metrics, together with an assessment of asset-related linkages to the expansion of debt and the risks of imbalances in the real economy. There were little doubts of an equity bubble in the late 1990s, or more recently of a confluence of property and credit bubbles. Nor were there any doubts that such bubbles had important spillover effects into the real side of the US economy. Should such situations arise in the future, as they undoubtedly will, a financial stability mandate would require the central bank to "lean against the wind" – in effect, setting its policy rate higher than price stability and/or full employment mandates might otherwise require.[5] In such frothy climates, the monetary authority would also be required to exercise greater regulatory discipline to manage the capital adequacy of financial institutions, as well as the leverage of return-seeking borrowers.

Central bankers typically object to this approach. Both Ben Bernanke and Alan Greenspan have argued that the surgical precision of regulatory policies is more appropriate to deal with asset bubbles than the blunt instrument of the policy interest rate. In the end, it may not be a question of either/or – but more a strategy of using both. Regulatory action – to say nothing of the central bank's bully pulpit – can send an important message to market participants. But the policy rate is a far more powerful enforcement mechanism. The point is not to prick every bubble that arises but to intervene when excesses in asset markets give rise to dangerous distortions to the real side of asset-dependent economies. And that, of course, was precisely the case in the period leading up to the sub-prime crisis, when bubble-dependent US consumption and homebuilding activity ended up surging to nearly 80% of total GDP. In such instances, using the blunt instruments of monetary policy to arrest the outsize excesses of bubble-prone economies is both appropriate and desirable.

Yes, such pre-emptive moves could well entail a "growth sacrifice" – an economy that would grow slower than a more free-wheeling approach might otherwise suggest. But the growth that would be sacrificed was artificial from the start. Moreover, if handled correctively – namely, early enough – such a sacrifice need not entail a recession. The resulting growth shortfall would be far preferable to the severe downside of wrenching post-bubble adjustments in financial markets and asset-dependent economies such as those that are now playing out.

A financial stability mandate offers a far more robust framework than the current *ad hoc* scheme for evaluating the hows and whens of the exit strategy. Under the prevailing asymmetrical approach that plays to the downside of post-bubble growth and inflation risks, exit strategies are invariably delayed – thereby setting the stage for yet another

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would strip the Fed of much of its existing regulatory authority, it does not address the need for a financial stability mandate in shaping monetary policy decisions.

[5] See William R. White, "Should Monetary Policy Lean Against Credit Bubbles or Clean Up Afterwards?" Based on remarks made at the monetary policy roundtable at the Bank of England on 30 September 2008.

round of ever-mounting excesses. Under a financial stability mandate, there would undoubtedly be more symmetry to the exit strategy – forcing the authorities to weigh the perils of asset and credit bubbles against the costs of the growth sacrifice. That may well mean a quicker normalization of monetary and fiscal policy than previous policy regimes might have otherwise suggested. While that is not exactly a riskless approach in today's fragile post-crisis climate, I believe it is worthy of serious consideration.

Global Implications

The financial stability mandate would also empower central banks to take on the new and important responsibility of systemic risk regulators. This is one of the new areas of focus in the post-crisis debate on which there is a broad consensus. But the key here, like in so many macro issues, lies in execution – specifically, the mechanism by which systemic risks are identified and addressed.

In essence, systemic risks are all about spillovers – across financial institutions, asset markets, financial products, and economies. By definition, no one central bank can address these complications alone. It would be like putting pressure on one end of a water balloon. In an increasingly interconnected world, systemic risk regulators all need to be on the same page in this critical aspect of policy setting. To do otherwise runs the risk of a fragmented approach to global risk management and regulation – creating market-specific opportunities for "regulatory arbitrage" that could well end up exacerbating global imbalances. Recent G-20 summits in London and Pittsburgh suggest that global leaders want to get serious about establishing a new global policy and regulatory architecture. If that were the case, then collaborative consultations between national authorities in the area of systemic risk assessment would be an important place to start.

Yet it is not enough to discuss systemic risks periodically at high-profile meetings such as G-20 summits. A new framework needs to be established that explicitly incorporates international policy coordination into the global architecture. Such an effort may well require a *global systemic risk manager* to coordinate the surveillance and early warning responsibilities that would mitigate systemic risks. This functionality should reside in an international organization – either the Bank for International Settlements or the International Monetary Fund. But it should be delegated to the professional staffs of the BIS or the IMF who would then need to be insulated from any pressures from their politically-selected boards of directors. This could be an important transformational step for the G-20 – converting the rhetorical flourishes of periodic communiqués into ongoing operational capabilities. A robust global architecture demands nothing less if the world is ever to cope with systemic risks and the global imbalances they spawn.

The global implications of the post-crisis exit strategy have recently become an increasingly contentious issue of debate. That's especially the case these days in Developing Asia, where liquidity driven surges in equity and property prices are

worrisome, to say the least. This has sparked yet another global blame game. Asians pin the excesses on reckless liquidity injections made in America and Europe. The West blames it all on Chinese currency policy. While there is some validity to each line of reasoning, the dispute goes back to the deep-rooted global imbalances that lie at the heart of this crisis.

This is a classic example of why a globalized world needs a global policy-making architecture. The G-20 cannot take on responsibility for avoiding crises without having a clear understanding of how to manage post-crisis exit strategies. A failure to address the global dimensions of a financial stability mandate would be a major impediment for global rebalancing. Yet that's exactly the direction the world is headed. National governments are now hard at work in crafting their own individual approaches to global issues. This mismatch reflects a dangerous presumption – that the best global policies are the sum of the best national policies. Nothing could be further from the truth.

A new and expanded policy mandate is not a surefire fix for all that ails a post-crisis world. Nor is it an inoculation against future crises. But it is an important step in the right direction. In the rush to regulatory reform, the vengeance of a polarizing populism has fixated on the compensation of risk takers as the major post-crisis remedy. Yet it will take far more than that to create a sounder financial system. Risk taking was excessive, not just because of misaligned bonus incentives, but also because the prices of leverage and risky assets were set far too low by misdirected central banks. New proposals for pay guidelines, regulatory consolidation, or counter-cyclical capital provisioning will work only if they are set in the context of the clearly defined goals and principles of financial stability.

Political Will

Learning the lessons of this crisis is an exercise in shared responsibility. Like the rest of us, regulators, politicians, and central banks hardly deserve special dispensation from this critical reappraisal. In the end, they must be held accountable for their failed stewardship of the financial system. They allowed the bedrock of policy discipline to be supplanted by the ideology of self-regulation – the very last thing that increasingly complex financial markets and asset-dependent economies needed. Never again should the authorities have such open-ended discretion. I have argued that the rules-based approach of a new financial stability mandate for central banks and regulators must be a key piece of the post-crisis financial architecture.

At the same time, I would be the first to concede that the ideological corruption of financial stewardship was a symptom of the ever-seductive excesses of the political economy of growth. The Era of Excess was premised on the mistaken belief that financial engineering – namely, using a credit bubble to borrow against a property bubble – could create a new and lasting period of vigorous growth in the global economy. It's easy to blame the United States but the entire world was more than delighted to go along for the ride. Yes, bubble-dependent American consumers led the way on the demand side

of the equation. But export-dependent economies in Asia and even Europe were equally delighted to sustain their growth imperatives by producing the goods that fed the insatiable appetite of the American consumer. Nor was there much of a complaint from resource-dependent economies in the Middle East, Australia, New Zealand, or Canada. It was the ultimate virtuous circle – one that unfortunately depended on the folly of virtual consumption and the reckless policies that spurred such excesses.

In short, this crisis arose out of the timeworn quest for a shortcut to economic growth. It 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.[6] But I take strong issue with the apologists who claim that 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 financial system – especially 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 as the debate now unfolds, I worry that too much attention is now being focused on micro remedies – ignoring the macro issues that have come to a head in this wrenching period of crisis and recession.

In that same vein, politicians and policy makers face a number of other key macro challenges. The choice between the quick fix and the heavy lifting of global rebalancing is especially critical. It is tempting to recreate 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*.

Nor should politicians be let off the hook in seeking artificial insulation from mounting economic pressures through trade frictions and protectionism. These risks are particularly worrisome in the current climate. Ultimately, it boils down to a choice between the collective interests of globalization and the self-interests of "localization." In times of prosperity and low unemployment, belligerence on trade policy can be dismissed as political posturing. But with exceptionally high unemployment in the aftermath of a severe recession and a weak recovery, politicians are likely to remain under serious pressure to protect increasingly beleaguered workers. The risks of protectionist policy blunders are especially worrisome in the aftermath of the Great Crisis. Only through a better understanding of globalization – especially today's strain that is

[6] See George A. Akerlof and Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, Princeton University Press 2009.

now bearing down on long-sheltered white-collar knowledge workers – can the body politic avoid such dangerous temptations.[7]

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. Our problems also have a very important human dimension – namely, they are an outgrowth of the poor judgment that was endemic in a reckless era of self-regulation. By purging the governance of the system of untested and misdirected 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? This could well be the biggest test of all for the post-crisis world.

This is not an impossible task. It takes focus and a rigorous analytical framework to pull it off – and, yes, the courage to incur enormous political risk. I remember all too well the widely presumed impossibility of curing the Great Inflation of the late 1970s and early 1980s. Policy makers and politicians were utterly convinced that inflation was deeply entrenched in the institutional fabric of the system – a system that appeared unwilling to pay the price for the cure. Paul Volcker begged to differ. And with great courage, he led the assault that broke the back of inflation.

It will take a similar approach – and an equally heroic leader – to face up to the imperatives of the exit strategy. A failed exit strategy that is compromised by the political economy of growth only risks another – and even more serious – crisis in the future. The growth sacrifice of an early exit is the only way out. It must be managed wisely and judiciously – and with great sensitivity to the innocent victims of this crisis and recession. But it is time to break the daisy chain of asset and credit bubbles – and the global imbalances they spawn. If we fail, there may not be another chance.

The Challenge

The prominent role of Paul Volcker in the post-crisis policy debate is emblematic of what appears to be a basic flaw in the American strain of the political economy of growth. Volcker's assault on inflation some 30 years ago occurred only because the US body politic said "enough." Through passage of the Humphrey-Hawkins Act of 1978, the Fed then had the political cover it needed to focus on price stability as an explicit objective of monetary policy. The single mandate, which up until then had aimed policy toward the

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[7] See Stephen S. Roach, "Perils of a Different Globalization" in *The Next Asia: Opportunities and Challenges of a New Globalization*, Wiley 2009.

achievement of full employment, needed to be modified in response to a major shock to the system – runaway inflation. Yet there is nothing in the current dual mandate of America's central bank that provides comparable political cover for an assault on asset and/or credit bubbles and the imbalances that they spawn in the real economy. The mandate shaping US macro policy is in serious need of a major reworking.

With a new mandate would come a new compact between Wall Street and Washington. And that is long overdue. In the brave new era of self-regulation, the scale and complexity of Wall Street turned out to be a breeding ground for destabilizing systemic risks. The policy and regulatory pendulum now needs to swing the other way. And there is good reason to believe that this process in now under way. But there is always a risk that the post-crisis response will be too extreme, shackling the US financial system and ultimately hobbling American competitiveness. Wall Street still excels in providing effective tools for credit intermediation that are essential to productivity-enhancing allocation of capital. That role needs to be preserved at all costs.

While Wall Street deserves its fair share of the blame for the Great Crisis, so does Washington. Predictably, politicians, policy makers, and regulators were all delighted during the boom. Equally predictably, they are not so thrilled with the bust. Yet the populist blame game offers little in the way of a constructive remedy. A more basic realization is needed: Growth for the sake of growth is a recipe for instability, at best, and disaster, at worst. In the Great Crisis of 2008-09, the world came far too close to the once unthinkable worst-case outcome.

That takes us to that undeniably sticky point where the rubber must meet the road in the post-crisis era: Recognition of the possibility of a growth sacrifice – whether it is an outgrowth of inflation control or financial stability – must be incorporated more explicitly into political economy of growth. That remains the most critical challenge in the aftermath of the Great Crisis and Recession. And it defines the fulcrum on which Wall Street and Washington will need to take a careful look at new approaches to both regulatory and monetary policy. A more sustainable financial system – to say nothing of a more stable and safer global economy – demands nothing less.

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Note: This paper will be presented by Mr. Roach at a conference sponsored by the Reserve Bank of India, "Challenges to Central Banking in the Context of Financial Crisis," to be held in Mumbai on February 12-13, 2010. Mr. Roach is the Chairman of Morgan Stanley Asia and author of *The Next Asia* (Wiley 2009).

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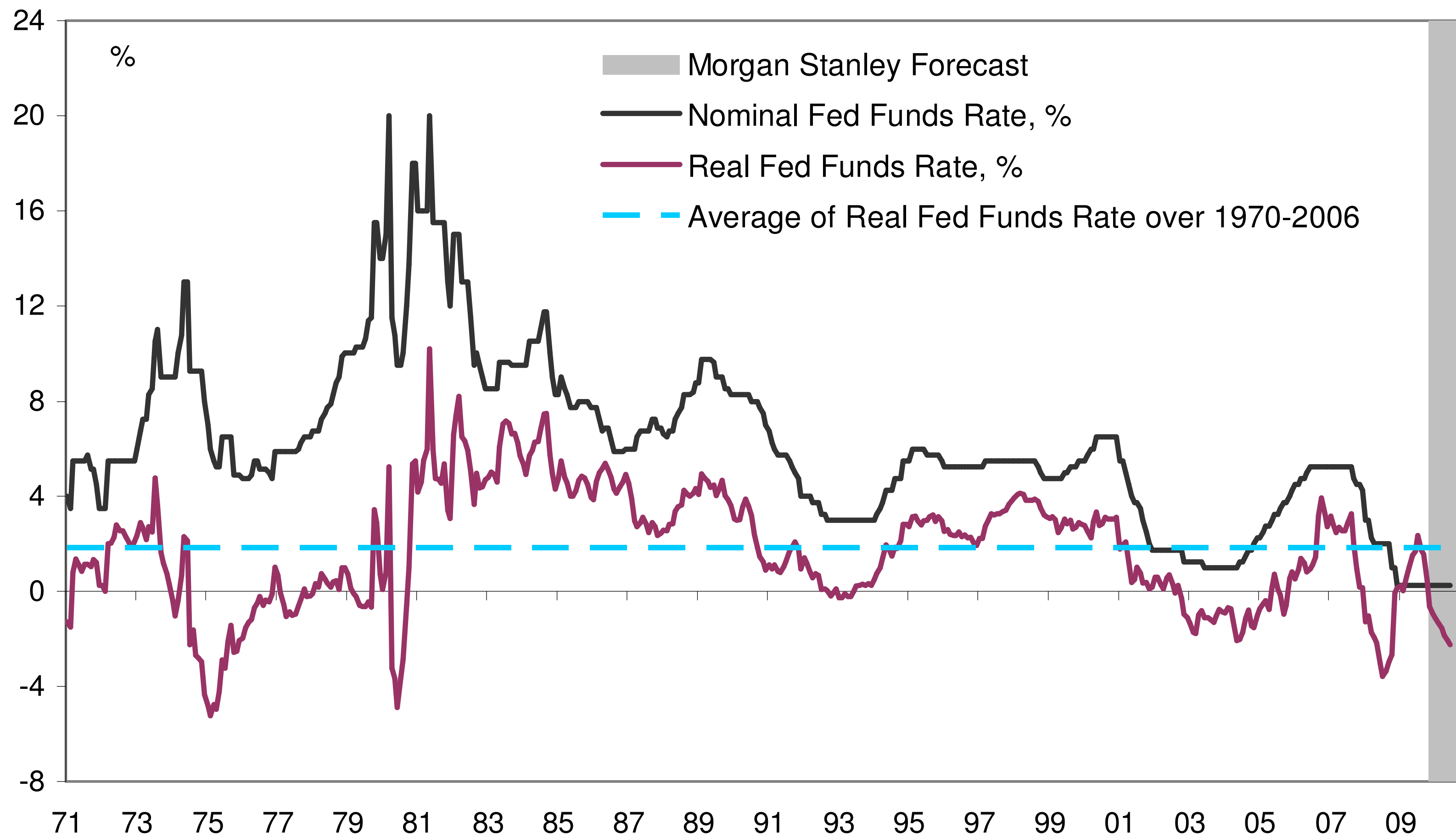
Reserve Bank of India
First International Research Conference 2010
Mumbai, India
February 12, 2010

Figure 1. The Asymmetries of Fed Policy

DATE	FED FUNDS TARGET
January 2001	6.50%
December 2001	1.75%
Reduction	475 bps
Number of Cuts	11 over 12 months
Average Reduction	43 bps
Speed Per Month	-40 bps
June 2004	1.00%
June 2006	5.25%
Increase	425 bps
Number of Hikes	17 over 24 months
Average Increase	25 bps
Speed Per Month	+18 bps
August 2007	5.25%
December 2008	0 to 0.25%
Reduction	500 to 525 bps
Number of Cuts	10 over 17 months
Average Reduction	51 bps
Speed Per Month	-30 bps

Figure 2. The Fed's Policy Rate



Source: Haver Analytics, Morgan Stanley Research

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