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Weighing the US government's response to the crisis: A dialogue

In this second installment of a three-part series, Professor Richard Rumelt and McKinsey's Lowell Bryan discuss the prospects for the economy, companies, and workers.

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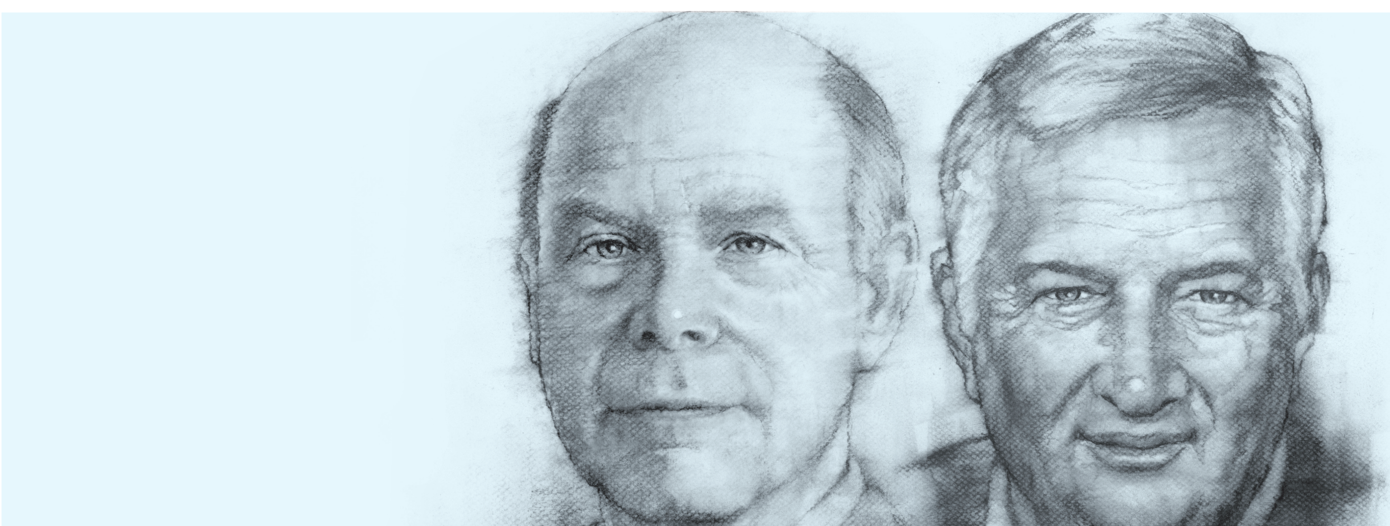

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This conversation is one of three installments summarizing Lowell Bryan and Richard Rumelt's reflections on the implications of the financial crisis. This second part focuses on the public-policy response. The first examines on the broad managerial implications of the crisis, and the third explores what it means for corporate strategy today.

The government response to the financial crisis and its reverberations in the real economy have been extraordinary. Coordinated central banking interventions, direct injections of government capital into financial institutions, and massive fiscal stimulus are just a few of the actions that have taken place in recent months. The potential impact on business is enormous and still too nascent for anyone to fully comprehend.

In the depths of the crisis, Lowell Bryan, a director in McKinsey's New York office, and Richard Rumelt, a professor of strategy at UCLA's Anderson School of Management, began reflecting on the tectonic shifts in government policy underway. Bryan's "Leading through uncertainty" and Rumelt's "Strategy in a 'structural break'" appeared on mckinseyquarterly.com last December. In late April of this year, McKinsey's Allen Webb went back to Bryan and Rumelt and asked them to take further stock of government's response to the crisis since the fall of 2008. Bryan and Rumelt's discussion of the economic and business implications of policy changes make useful reading for executives trying to make sense of the rapid shifts taking place in their strategic landscapes.

The *Quarterly*: *What do you think of the US policy response to the financial crisis over the past few months?*

Lowell Bryan: I sit and marvel at it. It was very hard for me to get used to the idea that the federal government—and I'm talking not just about the Federal Reserve but the Treasury—would be as quick to guarantee all the liabilities of the entire system: $16 trillion dollars or whatever it's been.

The reason I marvel is that we don't know if this is going to be effective or not. We're on a new course here. We have no idea what may come out the other end, in terms of potential inflation, double dips, the role of the US economy, the value of the dollar. We are undertaking as quick a fix as possible of something that took years and years to build up.

There's one of two outcomes from this. One is that the quick fix will work but not fix the fundamentals. And then I'm really concerned, because I don't think we'll have a foundation for good, sound growth. The other is that no matter what we do, we're going to have a deep recession, which will give us time to fix the system—and we will fix the system. We will get leverage down to good levels. We will deal with our trade imbalances. And strategists and their companies will learn how to get by in this environment.

What I'm most worried about now is that we may think it's over before it's over. Because if we don't fix things that have gotten excessive and we've used up all of our gunpowder, it could be really ugly in about three or four years, as we do a big double dip or inflation gets out of control.

Richard Rumelt: As Lowell pointed out, it's been a surprisingly vigorous response, and we don't know if it's going to work. Spending money may or may not stimulate the economy.

Quantitative easing may or may not stimulate the economy. There's no certainty. The empirical evidence is very, very mixed. The Keynesians will tell you that the Depression was fixed by the spending on the Second World War. But that's really a misreading of history.

What happened during the Second World War was that ten million Americans were put into indentured military service at minimum wage. Consumers endured rationing. And the government rebuilt the industrial infrastructure with cost-plus contracts. After the war was won, it turned out that household balance sheets had been restructured back to almost zero debt. There was this huge pent-up demand to buy anything. And people went back to work at real salaries. To repeat that today, you'd have to take the ten million employees in financial services, draft them into some kind of—

Lowell Bryan: Peace Corps.

Richard Rumelt: —Peace Corps, and have them rebuild the highways for four years, at minimum wage. It's an appealing prospect. But the sanctity of their bonus contracts probably prevents it.

The *Quarterly*: *Let's come back to this notion you raised a moment ago, Richard, about the importance of addressing fundamental structural problems, the importance of resource reallocation. So far, is the policy response helping or hindering the reallocation of resources in the private sector?*

Richard Rumelt: Mostly, it hinders. The real economy boils down to what work people do. I believe we are now in a structural break and that the mix of work being done has to change. If things go right, we will find, in five years, that we are, on the whole, doing a lot less of some activities, and more of others. In my view, a good policy response helps individuals defray the costs of the shift. If you're an auto worker, it's not your fault. On the other hand, if we act to prevent the shift, if we prop up the institutions that have declined, that becomes a problem. If we start creating zombie car companies and zombie banks that are essentially propped up by the government, that's a problem.

The worst policy is to prop up people in jobs that are no longer necessary. The right policy, I think, is some balance where you help people deal with the costs of changes in employment rather than have the costs all privatized, which isn't really fair, because someone's benefitting from the change and someone's losing. And very often, the employees aren't at fault—they're just part of the system and they ought to be helped. But they should be helped in a way other than guaranteeing them jobs doing what doesn't need to be done.

Lowell Bryan: I think there's a potential that we go down the path of trying to protect people, and in the process we put in a lot more rigidities that make us fundamentally less effective at innovation. That migrates to Asia and we, basically, go down the European path. That would be sad for us and the world. But that's a possibility. That's one of the scenarios about how this plays out: we become a safer, poorer place, with less change.

One of the interesting things I see, which is probably a healthy and good response, is government-funded R&D: things like clean energy, health care. Obviously, the military keeps doing R&D too. Behind an awful lot of the raw innovation that takes place, you'll find some government program that's invented something or caused something to be invented. Now, a lot of the R&D doesn't help for a decade or more. But I think that's an area where the government could help—just get the raw engine of research going.

The *Quarterly*: *How worried are you about a backlash that undermines the global system?*

Richard Rumelt: There's an enormous amount of pent-up political anger that currently isn't being expressed, because everybody is afraid that if you get too angry, one of these banks may keel over and die, and then we're back in the soup, as with Lehman Brothers. It's a very delicate and emotional political balance right now—you have institutions that are taking enormous amounts of resources and basically threatening everybody with their imminent failure in order to garner more resources. That has to be fixed. We can't run a world economy with that kind of a relationship.

Lowell Bryan: I'm a little more sympathetic to the people currently in charge of most of these financial institutions, because—not entirely, but for the most part—these people are feeling a lot of anger as a result of things that were done by their predecessors.

Richard Rumelt: Fair enough. It's people playing roles they are inheriting. But the history of depressions and significant downturns shows us that they produce political results that are very long-lasting. Look at the 1873 collapse and what happened in Europe after that. The rise of anti-Semitism and, eventually, Nazism comes out of this. And that's the risk here—we get some fundamental political outgrowth that's dysfunctional.

Lowell Bryan: What I worry about, unless the US shows exceptional leadership, is that the role of the US in the world economy (which I think has been, overall, terribly beneficial since World War II) is at risk. Our ability to be the leaders of capitalism and democracy—our moral authority—has been severely weakened. Unless we work really hard at it, people are going to say, "Well, that was an interesting set of ideas, but I'm going to try this other different set of ideas."

Richard Rumelt: That's exactly right. US intellectual and moral leadership in the world have been severely compromised. The very notion that our government is basically fair and has a certain degree of ability to balance competing claims and adjudicate them in some way—both internationally and locally—that's at risk right now.

Lowell Bryan: I will say that the current administration is moving in the right direction. But it's not just about talking about it, it's finding some real solutions to some of these global economic issues.

My biggest worry is a quick fix leading to inflation, so that by 2011 the Federal Reserve is in a dilemma—either to let inflation get out of control, with all the adverse effects to the currency, or to tighten up and put us into a double-dip recession.

Richard Rumelt: Which they're not likely to do on the eve of an election.

Lowell Bryan: But the issue is, neither one's a good choice. One will cause us enormous external problems. And one will cause enormous internal problems.

Richard Rumelt: We could have rip-roaring inflation.

Lowell Bryan: If we have rip-roaring inflation, the problem is that all the people who are holding dollars as instruments of wealth say, "You just bagged us." That can create enormous anger and it's quite a real possibility.

But I think the more likely scenario is that we'll go through a deep recession, that we'll get through it battered but remain resilient. I do think there's a fair chance that we will fix the credit system, fix the capital markets and that global expansion and global integration will resume. I would say that's more likely than the other scenario I gave you. But they're both out there. And we really are going to depend upon a lot of good policy and a little bit of luck to get us through this.

Richard Rumelt: I agree. I think the problems can be fixed. What the government needs to do—and only the government can do this—is to make decisions about who's going to take the hit. Somebody is going to be worse off here, and right now it looks like the taxpayer. But there are bond holders, there are various equity holders, there are many, many, many interests out there, including national governments and sovereign funds. The system is frozen by the uncertainty about who's going to be left standing when everybody else has a seat. That uncertainty has to be resolved to get the global system working again.

The *Quarterly*: *Where do you think regulation of the financial system is headed?*

Richard Rumelt: Look, I've been a consultant to a lot of financial-services firms. They don't want to hear this, but there's a wide range of financial services—such as deposit taking, term life insurance, and life annuities—that should be utilities. They should be like gas and electricity. When companies compete in these products, it leads either to wild complexity or to risk taking that's simply not in keeping with the buyer's needs. You don't want companies that sell you electricity taking wild risks, and you don't want to invest your life savings in an annuity and then have that firm go belly up when you're 80 years old because it took some risk. All those kinds of financial services need to be like utilities. Competition in this area is oddly unstable. Firms compete, basically, by changing their credit standards. There have been cycles in both banking and insurance for centuries because of this.

Lowell Bryan: I'm not quite all the way where Richard is. I grew up in a financial-services industry that was highly regulated, and it was a little slow moving. I see a lot of benefits that occurred from the risk taking, from the innovation, and from this global capital market that we created, which fueled globalization and the integration of economies.

If you look at securitization from the 1970s until roughly 2000, you see mostly benefits from it. The reason it became unsound is that we allowed too much credit risk to enter the system. Prior to 2000, either the credit risks were assumed by the originator, or the borrower put up so much collateral or equity that no raw credit risk was allowed to pass through to the marketplace.

I would argue that the biggest problem from 1997 on was not that we didn't have enough regulation. It's that we didn't have anybody enforcing the regulation we had. There was plenty of power—in the SEC,[1] Freddie Mac's and Fannie Mae's regulators, the banking system—to regulate a lot of this stuff. You didn't need new powers. What you did need was people intent on making the market work better, as opposed to basically regulating for the short-term benefit of the industry participants.

When you read the stories of what went on in the early 2000s, it was awful. People in charge of regulatory structures basically chose not to regulate. So I believe that this was a man-made disaster. If you're dealing with a nuclear power station and you take out all the rods that control the temperature of the reactor, you're going to have a blowup. And, frankly, we just took out all the rods until we had a blowup.

I'm concerned that we will go back to an overregulated, safe, dull, and slow-growing system. I think we need to find something between the regulation we had in the '60s and '70s—and the lack of regulation we had in the last decade.

Richard Rumelt: I think Lowell's completely correct about these instruments creating value, particularly the securitization of mortgages.

This is very much a crisis cooked up on the New York–Washington axis—the failure of leadership in Washington to regulate, to make sensible laws, and on the other side, to self-regulate and to do the job that people have paid you $5 million dollars a year to do, which is to price risk properly.

Milton Friedman, when he studied the Great Depression, had a very interesting take. Everyone thinks of Milton Friedman as this big free-markets guy. But his explanation of the Great Depression was that the Federal Reserve didn't do its job.

And his explanation of why the Federal Reserve didn't do its job is interesting. What he says is, the New York banks used to self-regulate themselves when there were credit crunches and runs on the banks. They would get together, and they would more or less agree, "Here are the rules. Here's how we're going to handle this crisis." He said once the Federal Reserve came into being, they stopped doing that. They sort of expected that the Federal Reserve would do it.

And so the institutions and the habits, the whole structure of that self-regulation went into disrepair. Then when the crisis hit in 1929, 1930, that institutional framework didn't exist, and then the Federal Reserves sat on its hands. And I think something like that is also a way of looking at what's happened recently. Wall Street could have self-regulated, but it chose not to. And Washington chose not to. And so no sober adult was in charge of these things. Q

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[1] The US Securities and Exchange Commission.

Allen Webb is a member of *The McKinsey Quarterly*'s board of editors.