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Yale Program on Financial Stability
Lessons Learned

Ray Dalio

By Andrew Metrick, Rosalind Z. Wiggins, and Kaleb B. Nygaard

Ray Dalio, who is the Founder, Chairman, and Co-Chief Investment Officer of Bridgewater Associates, the largest hedge fund in the world, gives his take on the Great Financial Crisis of 2007-2009 and financial crisis fighting more broadly. These comments are based on an interview with Mr. Dalio.

Focusing on the Granular and Getting Around the Politics

In 2007 I wrote that I saw a big debt crisis coming in our Daily Observations to clients. That led to Tim Geithner inviting me to lunch just before the collapse and rescue of Bear Stearns. It was while he was President of the Federal Reserve Bank of New York. In advance of our lunch he had reviewed a few Bridgewater studies laying out our reasoning. The way we anticipated the financial crisis was by examining the numbers with a deep level of granularity and because I had examined many big debt crises in past times.

Tim asked me, "Where did you get these numbers?"

I responded, "They're pretty much all public numbers - a lot of them are Federal Reserve numbers." There were a lot of them. One has to gather them and examine them in detail to do the pro forma financial projections to see debt problems on the horizon.

Nowadays there exists the technological capacity to view what is happening at very granular levels and doing calculations at granular levels using algorithms. However, many policymakers still have an antiquated way of looking simply at aggregates and concepts like supply and demand, rather than looking at what's happening with cash flows at a nitty gritty, entity by entity level. In fact, back in 2007 most policy makers weren't even interested in looking at these pro forma calculations even when they were being pointed out to them. When I offered to take them through the numbers they typically said something like "if we can have the markets have confidence that things will be OK then the markets will come to our support so we just need to show the markets why they should be confident."

That was so macro and so wrong because in many cases the flows and the marker pricing had nothing to do with investors' having confidence, and there is no simple market of the sort they imagine - there are different individual participants, each with their own individual motivations. In most cases back then those in the financial system could have had all the confidence in the world but they still wouldn't have had the money and credit to make the debt purchases that were needed to fill the funding gaps so we wouldn't have a debt crisis.

When policymakers deal with the market with the degree of vagueness I've seen, they aren't going to be able to understand or effectively deal with the situation. Tim was the exception. He wanted to get in the numbers and, from that day forward, and all through the next couple of turbulent years, he was interested in having that perspective.

This was not just an issue for the U.S. in 2008-09. The same thing happened in 2010-11 in Europe when we calculated how lending growth was unsustainable and we were going to have a sovereign debt crisis. We could see that the amount of debt that had to be rolled over plus the amount of new debt that needed to be issued to fund new borrowings would be too great relative to the amount of credit that could be lent. It was obvious that the balance sheets of the banks had expanded from one level to another level and simply could not expand much more. The credit growth that would usually arise from going to the next level was going to have to stop for basic mechanical reasons. That meant that there would be less credit growth and less expansion, which would create a funding gap. In 2009-2010 I explained this to key European policy makers who once again weren't interested into getting into the details. They were looking at the aggregate with the belief that confidence is all that mattered.

During both financial crises I saw the best policy makers impeded from doing the right things by political and legal constraints. I saw that happen many times in other big debt crises. Sometimes rule of law and regulations can come up short relative to common sense. That's because no law or contract can be written with such precision that it is going to be good enough for all types of situations. That's just the way it is.

In moments of financial panic there have to be exceptions to rules. It takes courage by policy makers to do the needed things that aren't clearly by the rulebook. I think that provisions should be made for extraordinary powers to do the unexpected if there is good broad agreement - perhaps via the president, the heads of the two houses, and the head of the Fed (or something like that) allowing them to break certain rules in certain ways under certain circumstances.

Coordinating fiscal and monetary policies well is also extremely important. This will be especially important as we go into an era in which we're going to run bigger deficits and central bank policies are not going to be as effective; therefore, the changes and policies are going to require a greater amount of coordination of fiscal and monetary policy. The greater debts will mean there will be more need for debt monetization and more coordination between fiscal and monetary policy makers. This level of coordination will inevitably lead to increased politicization of economic policies.

Using Macroprudential Policies

If you run monetary policy by changing interest rates or by changing QE, that is not as surgical or precise as macroprudential policies. I think that central banks should use more macroprudential policies to be more precisely surgical to produce a better result. If they see a potential problem with one segment of the financial system, they can focus policy needed on just that segment. We can compare this to cancer treatments. In some cases, today it's possible to target a specific area or troubled part of the body for treatment instead of using the full blown radiation treatment. When possible, this is much better because full radiation

hits the whole body and might do more harm than good. I won't comment on specific macroprudential policies at the moment because there are so many situations and particulars, but the idea of using more surgical interventions is one worth considering.

Communicating During Financial Crises

Before sharing some general thoughts regarding how policymakers should approach communicating about financial crisis interventions, let me say that I believe that having the right people in the right place is so important. Ultimately, it's more important and essential that they do the right thing regardless of the sensitivity to or impact of the communication strategy.

It's helpful to think through a few questions like the following when designing the communication plan, "Who is communicating with whom and for what purpose? What am I trying to achieve? What are the motivations of the people with whom I'm communicating? Do I need to communicate with everyone? Who are the key players?" Then when delivering the actual communication, it's challenging but important that the policymakers don't sound defensive or paint a rosier picture than really exists because they lose credibility. Remember how the real Stress Test is the banks that showed the real problems of the banks signaled the bottom? It gave confidence that the problems were seen which made it more likely that they would be dealt with.

As you go deeper than the generic communication you can begin to engineer your message on a more granular level. Based on the policymaker's goal, there will be some people that matter and others that don't. For example, some of the most important financial crisis decisions have to be authorized by the legislature. How can you engineer your communications to target those individuals in the legislature that you need to win over? Again, if you want to do a good job - engineer it, get specific, break it down.

When we talk about financial crisis communication, some people imagine policymakers are going to do something like FDR's [US President Franklin Delano Roosevelt] fireside chat that's going to be broadcast and convince the whole world. That's not the way of communication today. They should really be thinking 21st century communication. Specifically - how can they communicate either to a specific decision maker or to a specific group?

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