Luncheon Address

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Tom Hoenig asked me to discuss what he referred to as two separate but related issues: first, how the Federal Reserve and the administration can and should work together on economic issues, including global crises; and second, how policymakers deal with uncertainty. Both discussions were to draw on the experience of our administration and its interaction with Alan Greenspan's Federal Reserve, but they were not to be reminiscences about him.

I will do as I was instructed, but I am going to start with a brief personal comment about the graciousness that is so much a part of Alan. I began my time at the U.S. Treasury as the unconfirmed nominee in late December 1995, and I immediately became immersed in the rapidly developing Mexican financial crisis. Alan and Larry Summers, then undersecretary for International Affairs, already had developed, with Michel Camdessus and Stan Fischer at the International Monetary Fund (IMF), the view that American and global interests called for serious intervention to try to forestall or limit the crisis. Although in my Wall Street life I had been responsible for one of the world's largest trading operations for a long time, many of the policy issues posed were new to me. Alan, with his experience and standing, easily could have taken a preemptive attitude toward the new boy on the block. Instead, he treated the new secretary as the leader of the United States' effort. Similarly, when we attended the Group of Seven (G-7) finance ministers meeting together shortly after my confirmation, he readily could have asserted primacy at this meeting he had attended so many times before. Instead, he treated me, as representative of the elected administration, as the leader of the delegation.

That was the beginning of a truly remarkable and effective working relationship among Alan, Larry, and me. This followed, I might add, a strong and long-standing relationship between Alan and my predecessor, Lloyd Bentsen—much to the benefit of the country and the globe, with respect to the formulation of U.S. economic policy and the credibility of that policy and of the American economic policymaking apparatus. During my four-and-half years as secretary, Alan, Larry, and I had breakfast once a week—in addition to interacting with greater frequency as issues arose—and never once was there a single leak from any of those discussions, which must be some kind of record for Washington, D.C., and reinforced the mutual trust that was so central to our relationship. Our breakfasts were a mix of serious discussions about economic data, economic policy issues, relevant academic matters—those last being dialogues between Larry and Alan, with my occasional request for translation into comprehensible English—and also political gossip and the like. The only issue off the table was the Fed's interest rate decisions.

Several years into this relationship, Alan was quoted in *Time* magazine for the cover story on the three of us as saying something to the effect that this all worked because none of us approached matters from a perspective of ideology or opinion but worked together on the facts and analysis to reach what we thought were sensible conclusions. We all shared a belief in market-based economics—though we had somewhat different views as to the appropriate role of government in our society—and felt that what happened abroad greatly could affect our own economic well-being. When our initial conclusions differed somewhat, we always were able to reason through to mutually comfortable common ground. The one exception was a technical matter relating to financial modernization, but there Alan simply waited until I left and then quickly resolved the matter with Larry.

With that as a framework, let me move on to examine a little bit more closely our administration's relationship with the Fed around specific issues and some of the questions that could arise about that relationship under other possible circumstances.

President Clinton took office facing an economy that recently had been in recession, and while now growing, had long-term interest rates of more than 7 percent, unemployment of more than 7 percent, great uncertainty about the future among consumers and businesses, and federal deficits that had quadrupled federal debt over the last 12 years and were projected to continue increasing rapidly over the years ahead. President Clinton decided, beginning at a six-and-half-hour meeting in Little Rock, Ark., during the transition, that the best approach to achieving sustained recovery would be a deficit reduction program that was real. It, therefore, hopefully—and this was a probabilistic judgment—would lead to lower fed funds rates, and, of critical importance, to lower bond market interest rates, in both cases measured against what would otherwise be likely for any given level of current and expected growth. In the actual case, this policy did lead to the interest rate effects we hoped for and, more importantly, it also led to greater business and consumer confidence. Alan, as the Federal Reserve Board chairman, reinforced the economic team's views about deficit reduction as the best route to sustainable recovery in his discussions with the president and in his public comments. He never engaged, correctly in my view, in the contentious debate that arose in the political arena about the content of our deficit reduction program—most especially, about our decision to increase income taxes on the top 1.2 percent of payers and to impose a gas tax of 4.3 cents per gallon.

It seemed to me at the time, and it seems to me now, that the administration and the Federal Reserve each played its appropriate role with respect to the two dimensions of macroeconomic policy, fiscal and monetary. We felt that our administration's consistent and absolute refusal to comment on monetary policy and our unqualified support for the independence of the Fed on monetary policy could serve three purposes: keeping monetary policy as free as possible from political influence; reinforcing the credibility of monetary policy by our commitment to its independence; and, hopefully, generating respect for our administration's economic soundness and thus for its economic policy decisions more generally. A former Fed official also thought that our clear and consistent adherence to a "no comment" position on monetary policy may have made it easier for the Fed to work with us in other areas.

Our hands-off policy worked well for our entire eight years—despite occasional qualms by some—and I think true central bank independence is clearly the optimal regime for our economy, given the difficult politics around maintaining sound and disciplined monetary policy. Nevertheless, it is worth reflecting on the difficulties that could develop under circumstances less propitious than ours. The elected administration is held responsible by the electorate for economic conditions and therefore for the effects not only of the administration's decisions, but also for Federal Reserve monetary policy. In that context, how should an administration react that consistently has a different interpretation of current and future economic conditions than the Fed's and thus a different view as to appropriate macroeconomic policy, has a different philosophy about monetary policy, or simply believes that the Fed is incompetent?

Fortunately, we never had to face any of these problems, and I believe that our relationship with the Federal Reserve was a good model for the future. But that relationship occurred in the context of congruence around fundamental economic views and around a fact-and analysis-based approach to economic policymaking and a compatibility of the temperaments and dispositions of the principal actors involved, including the president. Contrary conditions could create difficult challenges in managing the relationship between the administration and the Fed.

At this point, let me raise two germane issues on which there may not be broad agreement. The first is how much effect the Fed has on bond market interest rates. My judgment was, and is, that while the

Fed certainly has significant influence, the behavior and psychology of the bond market also can be affected significantly by many other factors, including perceptions about fiscal policy and future fiscal conditions, or, as now, vast inflows from central banks seeking to bolster exports by supporting the dollar. Bond market interest rates therefore can disconnect under some circumstances to a substantial degree from current and expected fed funds rates.

Second, and I recognize that what I am about to say could be highly controversial, I believe the Fed should not only pursue sound and disciplined monetary policy, but it also should stand for the principle of sound and disciplined fiscal policy. Fiscal policy is the other ladle in the macroeconomic punch bowl, and consistency in use of the two ladles is powerful and inconsistency can be injurious. Further, unsound fiscal policy can lead over time to serious economic trouble, and, like monetary policy, discipline in fiscal matters is also politically difficult. This view on the Fed has embedded in it two controversial underlying questions. First, is discipline on fiscal matters an imperative over time or, as has been said, did Ronald Reagan prove that deficits don't matter? The opposite view, of course, is that there is no fiscal free lunch. Both the difficulties of the early '90s following the deficits of the '80s, as well the experience through the rest of the '90s when the longest economic expansion in American history was associated with deficit reduction, suggests that deficits do matter. The second question of course is should the Fed stand for *any* principle on fiscal policy?

In our administration, the effective relationship between the administration and the Fed provided coherent and mutually reinforcing fiscal and monetary policy regimes, may well have buttressed the credibility at least of the administration and perhaps also of monetary policy, and created a strong base for working together on many other issues, including financial crises, G-7 meetings, currency interventions, international financial architecture reform, and much else.

As I have mentioned already, from the beginning of my time at the Treasury, I was up to my ears in what became known as the Mexican financial crisis, and that was followed, roughly two years later, by the so-called Asian financial crisis. This ultimately spread to Brazil, Russia, and elsewhere and threatened, especially in the December 1997 phase of the Korean crisis and in August 1998—with developments in Russia and the failure of the hedge fund, long-term capital management (LTCM)—to engulf the United States and the industrial countries in a global crisis. In my view, while debates will long continue about some of the crisis response decisions, the basic approach of using monetary and fiscal policy in the affected countries and structural reform, combined with conditional temporary financial support, was necessary to restore confidence in financial markets. Restoring confidence was absolutely requisite to avoiding deeper and more extended financial crises. In any case, the efforts worked to bring relatively rapid recovery to the countries that instituted serious reform and to avoid all encompassing global economic disarray. In all of these situations, the Treasury and the Fed working together as one greatly enhanced decisionmaking on the tough probability and trade-off judgments involved in addressing these crises and increased the credibility of those decisions.

Two of many instances that exemplify our working relationship stick out particularly in my mind. The first is what sometimes seemed to be an almost permanent residence at the Treasury of Ted Truman—the Fed's legendary senior international economist—during the Mexican crisis response. Second was a dinner at the Jefferson Hotel, where I lived, in December 1997. Alan and Ted joined Larry, David Lipton, Tim Geithner, and others from an extraordinarily talented Treasury team in a free-flowing exchange of views; sifted through options to confront a crisis we had never expected to face, disarray in the globe's 11th-largest economy, South Korea; and laid the groundwork for later finding an effective approach to that crisis. Integral to all of this crisis response was market confidence that the Fed skillfully would use its exclusive power to provide liquidity to the financial system, which the Fed in fact did do in 1998, in the context of the Asian financial crisis, Russia, and LTCM.

Again though, all of this constructive engagement raises the complicated question of how to manage a disharmonious relationship between an administration and the Fed in the many aspects of addressing financial crisis. We never faced these problems—quite the contrary—but they certainly could occur and be hugely injurious.

One lesson I would draw from all of this experience, as we approach the selection of a new chairman, is that the chairman of the Federal Reserve Board should not only have great insight about reading economic data, strong macroeconomic understanding, and a deep commitment to sound macroeconomic policy, but also have a keen understanding of the psychology of markets and of business and a feel for the politics of Washington, D.C., and of the global financial policy community. Putting all those together is a tall order, but Paul Volcker and Alan Greenspan show it can be done.

To underscore this point about the importance of understanding the psychology of markets, let me mention a few situations in which the administration and the Fed worked on together. In 1997, we had to decide whether to comment on a severe one-day equity decline that set off shivers around the world. Twice we intervened in the foreign exchange markets when we felt that the markets had overshot greatly and that there was the potential for surprise and in one instance when that intervention was tied to promised Japanese policy changes. The administration and the Fed were periodically pressured to take measures or provide warnings on what seemed like stock market excesses and, in the context of architectural reform, to support IMF issuance of credit warnings on countries. All of these matters, as well as the many actions taken during the Mexican and Asian financial crises, posed difficult and uncertain questions around how markets might react to various possible decisions or comments and about how to best describe what we were doing. In all those cases, having a market-savvy Fed chairman, in addition to having a Fed and an administration that worked together, contributed greatly to reaching better outcomes.

Looking forward, our loss over recent years of the fragile political coalescence around fiscal discipline; our currently projected 10-year fiscal deficits; the increase in entitlement costs that becomes increasingly great as we move into the middle of the next decade; our extremely low personal savings rate and high levels of personal debt; and our large current account deficits, all suggest, in my view, that the next Fed chairman could face—at some point in the future—an even greater need for the understanding and experience to deal with serious market difficulties.

That is a good segue to the question of facing complexity. In dealing with all of the matters I just described, the administration and the Treasury both took the view that meaningful economic issues were inherently complex and uncertain, and that all judgments were, as a consequence, about probabilities and tradeoffs, not absolutes or simple nostrums. For example, the administration economic team's recommendations to President Clinton with respect to deficit reduction in 1993 and, working with the Fed, with respect to the financial crises in Mexico and in Asia, Brazil, and Russia always were expressed as probabilistic judgments, with the recognition that these measures might not work. President Clinton always made his decisions in exactly that same spirit. Recognizing complexity and uncertainty not only lead to decisionmaking that corresponds to reality—and thus better decisions—but also should lead to intense effort to better understand the facts and the analysis in order to make better judgments about the probabilities and tradeoffs, and to serious thinking about contingency plans in case matters don't work out as you hope.

Recognizing uncertainty and complexity should not be confused with indecisiveness. In fact, the recognition of uncertainty is the predicate for well-grounded decisiveness and strength. I ran a risk arbitrage operation for many years. That was all about deciding, but on the basis of recognizing and analyzing all of the many competing considerations, and then reaching a probability-weighted conclusion, not on the basis of simple conviction, belief, or opinion. Further, we then reexamined our decisions if the facts changed, to see if adjustments should be made.

A probabilistic approach also leads you to recognize that decisions should be evaluated on the quality of the decisionmaking, not on outcomes. The United States lent support to both Mexico and Russia, and the view of many in Washington, D.C., is that we made the right decision in Mexico because it worked. But we made the wrong decision in Russia, where it didn't. My view is that both decisions were right and that both represented the optimal balance of risks and rewards based on everything that could be known at the time. This probabilistic approach and all that goes with it, deeply internalized, is how economic policy issues should be addressed.

Looking forward, sound decisions in the face of uncertainty and complexity may be much needed because, in my view, our country is at a critical juncture for the longer term. We have great strengths, including our cultural embrace of change, the dynamism of our society, and our sheer size. On the other hand, we face great challenges, including the fiscal deficits, entitlement commitments, personal savings and debt positions, current account imbalances, and much else, such as historic competitive challenges from China, India, and elsewhere and serious shortcomings in the requisites for meeting those challenges (for example, a world-class public education system, adequate investment in basic research and infrastructure, and a great deal more). We also need the resources to fund these requisites for competitiveness within the context of a sound fiscal regime that promotes growth-conducive interest rates, business and consumer confidence, and a sound currency. Our society's great resilience in the past is a hopeful augur for the future, but there's much work to do and that requires decisionmaking that recognizes the immense uncertainty and complexity of the issues we face, and the hard probability and tradeoff judgments that need to be made.

Let me close by saying again that the relationship between the Federal Reserve and the administration during the Clinton years contributed greatly, in my view, to the formulation of effective economic policy and to the credibility of those policies. I think there's much to learn from how and why that relationship worked and much to reflect on with respect to the problems that might occur under other circumstances.

Finally, let me thank Alan for providing me with a truly remarkable experience, the opportunity to work with him in the way we did, and the relationship among him, Larry, and me, as we together addressed so many of the difficult economic issues of our day.