Concluding Remarks

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I have a few reflections. The first one: what a sensational job Martin Baily and John Taylor have done in putting together such a riveting conference. The quality of the discussion has been very high. The people who are here are impressive. And it gives you a good feeling that somehow or other there's an ability here to grapple with some very difficult problems.

I had a hard time keeping up with a lot of the things we've discussed, and this confirms a decision I made a long time ago. When I was secretary of state, I was in the midst of ending the Cold War, and I was really interested in the work I was doing. When I was offered the job of chairman of the Fed, I declined. I see now that I would have been out of my depth if I had taken that job. It was too far ahead of me. But it does raise one question about most of our discussion. That is, we haven't reflected very much on the international implications of what goes on here and what goes on over there. For example, when our Federal Reserve creates massive liquidity, it doesn't necessarily stay here. I suppose some might say that the Federal Reserve is a massive currency manipulator that causes all kinds of problems elsewhere. Somehow, it seems to me—maybe it's just because I have my foreign policy hat on—that these problems need to be taken into consideration.

I thought there was more agreement here than people may have expected at the beginning of the meeting, and it wasn't simply on the idea of going to zero interest rate on reserves. Who could pass a bill in the Congress saying that we want to give banks *x* billion dollars a year? But that's what the Fed is doing, so going to zero is good on many grounds.

I think there also was agreement, as we looked at the financial crisis, that the regulatory system failed. There was probably quite a lot of disagreement, however, on why and what to do about it. At least as I see it, this was a classic case of over-the-shoulder-type regulation. As George Stigler taught us long ago, it simply doesn't work; it's captured. When the head of Citibank says, "As long as the music is playing, you've got to get up and dance," you would think the New York Fed, which was the regulator, would say, "Wait a minute, we want to find out about that music. What's going on here?" But nothing was done—nothing.

So as we try to design a different regulatory system, over-the-shoulder regulation is not the way to go about it. We need to devise something that is simple and easy for anyone to spot so you don't need a regulator. Capital requirements can be spotted, types of trading can be spotted, and leverage can be spotted. So there's a certain automaticity in a regulatory regime that's simple and easy to understand so that anyone can see if you're out of line.

We had a conference here recently on nuclear security, and John Taylor took part in it. We had participants who worked on warheads, on the power industry, and on regulation. We also had some press people. In the nuclear industry in the United States, there is a really effective kind of regulation because all the people who own nuclear power plants recognize that if any one plant goes down, they all will suffer. So they have created their own regulatory mechanism where they visit each other's plants. If they spot something wrong, they say so and it gets fixed. This mechanism is knowledge-based, and those being regulated have a stake in seeing that the regulations work, not only for them but for everybody. It seems to me that's a principle to use when designing regulations.

During the conference, there was also emphasis on the importance of long-term, strategic thinking. When that isn't done, it's easy to get off the track. That's the importance of something like the Taylor Rule, or having clarity in what your procedures are going to be. For example, this is a long-term proposition that we're talking about here: we have a plan, we're going to stick to that plan, and it's going to work.

Legitimate questions were raised about what the Fed has done in an institutional way. I worked closely with the Fed in my role as secretary of the treasury and in other positions, and I've always thought of the Fed as a limited purpose organization, not a general purpose organization. If you say to yourself, "I've got to solve all the problems," then you're opening yourself up to overstepping and you'll wind up getting your wings clipped if you aren't careful. In the national security field, we call that mission creep. You sit in the situation room, you hear something you want to do, and a mission gets designed carefully. The military says, "This is what we can do." Then you succeed and all of a sudden the mission changes. That's when you get in trouble. Mission creep is something to watch out for.

We had quite a lot of discussion about the very important question of intervention. I had several brushes with it that made an impact on me. I recognize this incident is simple compared with the issues you've been struggling with, but when I became director of the budget in 1970, I discovered that a major financial company, the Penn Central, had badly mismanaged its affairs and was about to go bankrupt. My friend, Arthur Burns, who was chairman of the Fed, was a very strong personality and he knew a lot about financial markets. He had been my mentor when he was chairman of the Council of Economic Advisers and I was on the council staff. He thought that if the Penn Central went bankrupt, it would be a huge negative event for the financial system, and he had somehow worked out a bailout with a reluctant David Packard in the Defense Department.

I thought it was a bad idea, and I used all the arguments you could easily imagine for why it was a bad idea. Half of me was convinced that I was right, but the other half of me was saying, "What am I doing arguing with Arthur Burns?" Then, all of a sudden, Bryce Harlow, a savvy political counselor to both Eisenhower and Nixon, walked into the room. He said, "Mr. President, in its infinite wisdom, the Penn Central has just hired your old law firm to represent them in this matter. Under the circumstances, you can't touch this with a ten-foot pole." So there was no bailout, and guess what? No dominoes fell. Arthur Burns had thought a lot about what the repercussions would be and he flooded the system with liquidity, among other things. In other words, he addressed the system as distinct from the company. Not only did no dominoes fall, the whole event was a very healthy development from the standpoint of the financial community because everybody had to realize that "apparently we're not going to get bailed out even if we're very big, so maybe we should run things better." So it was a healthy development.

I think it is important to recognize—and I think we all instinctively do realize—that once there are bailouts, people's behavior changes, and the change in behavior is very undesirable. So it's important to figure out how to arrange things so that people who have the decision to make on bankruptcy can stand up to it. It is not easy to stand up to it if you are there. I've seen this in a number of cases. I've just finished reading a biography of President Eisenhower. Obviously, he had to stand up to a lot, mostly in the national security field. In 1945, General Eisenhower was the only one at Potsdam who opposed dropping the atom bomb. On at least two occasions when he was president, all of his advisers—civilian and military, state and defense—said, "Mr. President, you've got to use the nuclear weapon on this crisis." But he declined. He was very skillful at working on something in a strategic sense. He said, "The hard part is to have the courage to be patient." It's essential to have a strategy. But then to carry out the strategy, you will be confronted with a lot of difficult situations and you will need to have the guts to stand up to them.

When President Reagan took office, inflation was in the 'teens, the economy was going nowhere, and the Soviet Union was running wild. Paul Volcker at the Fed realized what needed to be done to get inflation under control, and President Reagan knew it, too. All who were advising him knew that you can't have a decent economy with that kind of inflation. So Paul went ahead and acted. My belief is that he could not have done so if President Reagan had not put a political umbrella over him. Paul has told me on a number of occasions that there were a lot of press conferences where the press served up questions inviting Reagan to criticize Paul, but he never did. People would run into the Oval Office and say, "Mr. President, he'll create unemployment. You're going to lose seats in the midterm election." And he said, "Well, if not now, when? If not us, who? Volcker is doing the right thing and we've got to support him."

What I'm saying here is that in order for all of the fascinating and important issues you have been talking about in this conference to work, there have to be some people at the top with guts who are willing to look at these things and see them through. It isn't easy.

I will finish by going back to the very interesting remarks by Larry Summers. Basically, he said that the financial side of the economy was badly mismanaged. Remarkably, even though that was going on, the real economy kept going, but finally the financial mismanagement knocked it down. Then the rescue came along, and fundamentally it focused on getting the financial community straightened around, and it more or less has worked. But the real economy is still down, and the huge amount of stimulus from the Fed and from fiscal policy has not succeeded in rejuvenating the real side. So it seems to me that the lesson of this story is that we should stop focusing on the financial community and think about what it takes to get the real economy moving. Then, Allan Meltzer was saying, you reduce the uncertainty and get a regulatory system in place that is constant and that people understand. Everybody knows the personal and corporate income tax system needs to be reformed—that's not even controversial—so why don't we do it? We have the template of the 1986 tax act that passed the Senate 97–3. Some of these things could be done, and they're the kinds of things that would get the real economy going—accommodated, of course, by access to capital and so on.

Let me once again turn to John Taylor and Martin Baily to thank them for putting together a really stimulating day. I want to say again how impressed I am with the quality of the people who have spoken to us and answered questions and with the high caliber of the conversation.

Thank you.