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In an exclusive interview, TIE *sat down with the Bush Treasury's chief macroeconomic strategist, Dr. Richard Clarida.*

The Clarida View

Richard Clarida, *Assistant U.S. Treasury Secretary for Economic Policy, takes on the economy, markets, and the significance of America's ballooning current account balance.*

TIE: ***Your recent article on the U.S. trade deficit and the sustainability of capital flows in the*** **Financial Times** ***received some interesting feedback.***

Clarida: That article [October 22, 2002] grew out of work I did preparing a briefing last spring on the current account deficit. With this particular issue of the sustainability of international capital flows, I felt that what was missing from the discussion in the press was an understanding of the causes and the implications: that the U.S. current account deficit is caused, in large part, by a deficit of growth in the rest of the world.

TIE: ***Do you find it ironic that not that long ago, Japanese and European policymakers were regularly lecturing U.S. officials about the "American disease"—spending and consuming at all costs. Yet today some of the same people arrive at G7, IMF, and World Bank gatherings essentially expressing the hope that the American "disease" will continue for a little while longer because it's propping up the world economy. Particularly in the context of autos and housing, do you think the "disease" will continue?***

"We tend to think of automatic stabilizers in textbook Keynesian terms, but a new automatic stabilizer for the United States is the interaction between long-term interest rates and mortgage refinancing."

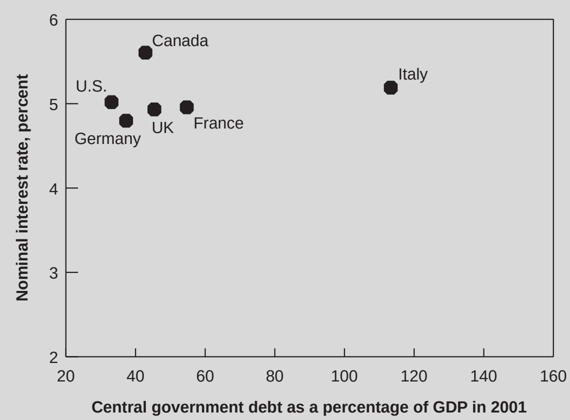
Higher Deficit? Cheaper Debt?

The curious relationship between deficits and the bond market.

TIE: ***Democrats on Capitol Hill rail against the loss of the Clinton surplus and the prospect of more Republican budget deficits "as far as the eye can see." Do you share this concern? To what extent is the deficit tied to the business cycle? Is it baked in the cake, so to speak, for quite a few years regardless of he macroeconomic situation? What effect do deficits have on the bond market?***

Clarida: Well, the following facts are important. Number one, most of the tax cut that President Bush asked for ultimately in the legislative process was deferred, so although some tax cuts came into effect in 2001 and 2002, most only come into effect in 2004 and 2006. If you actually calculate the swing in the fiscal position of the United States, and the Congressional Budget Office, Wall Street, and the Treasury Department have all done this, then most of the swing in the U.S. fiscal position from surpluses last year to modest deficits as a percentage of GDP this year has been due to a combination of the weak economy, the bursting of the equity bubble and the impact that had on capital gains realizations, and increases in defense and homeland security spending.

Figure 1
Nominal Long-term Government Bond Yields and Gross Central Government Debt as a Share of GDP, 2001



Source: OECD, U.S. Treasury Department

Number two, we've analyzed some of the recent data and some recent changes in financial markets to get at this old issue of budget deficits and interest rates. In the current world economy, with an integrated market in government bonds, at least among the G7–G10 countries, and now that countries

Clarida: One of the points I made in that article is that it's incumbent to ask what the policy implications are. I have not found anyone who has recommended any change in the current stance of U.S. policy. There are discussions about U.S. policy in the years 2006 and 2008, but in terms of what we should be doing differently now about the current account of the capital flow, there's no serious discussion about it. The way the debate has played out is unhelpful, and fails to examine the root cause of the capital flow—that there is a pool of portfolio capital in the world that has fewer places in which to invest than several years ago and that capital is seeking safety and acceptable returns in the United States. Even when Europe is growing its unemployment rate is higher than ours, and the Europeans are not happy about that. And obviously for Japan challenges are well documented, and it's not good for Japan or the world economy to go through a second decade like the last one. Really, the answer is for the rest of the world to grow more rapidly, not for the United States to arbitrarily try to slow economic activity.

TIE: ***In reality, of course, no one wants to slow the growth of the U.S. economy. One argument that they would probably make, though, is the mix. There is always this argument that the United States needs to rely on international sources of savings to fund our consumption. In an open global economy that may not be a problem, but are you concerned that the situation is out of balance—that it would be useful if we had a higher saving rates particularly in the United States?***

A. I have two observations. The first is that looking ahead at the path the U.S. economy will grow along over the next several years, we would expect that over time, the baton would be passed from a consumption-led recovery to one in which business investment and exports are more of the source of growth in demand. We believe the most likely outcome is for continued economic growth, but at a pace that is not so much being driven by the consumption but by those other components, namely investment and exports.

Second, with regard to saving, President Bush feels it is very important for individuals to keep more of their own money, and we think the tax cuts were very well timed, given the weakness in the economy that we inherited. While some of the extra after-tax income will be consumed, some will be saved. Regarding a particular path for saving, we do think it's important that households make their own decisions.

Figure 2
Real Ten-Year Treasury Interest Rate and the Unified Surplus, Percent

*Daily through 10/22/02.
**Monthly through June, surplus and GDP a year back.

have roughly similar inflation rates with the exception of Japan, it's a fairly straightforward matter to compare the real cost of borrowing across countries. What you see when you do that is no relationship between the amount of government debt a country has outstanding and its cost of borrowing. The relationship is as close to a flat line as you'll get in economics (see Figure 1). In the past, that relationship has been more obscure and harder to find econometrically because countries had different inflation performance, so you needed to sort out how much of the interest rate spread was due to inflation and how much reflected the real cost of borrowing. But now that countries have similar inflation performance, the old empirical finding dating back to the 1980s is very evident in the data. I would also point out, in the U.S. experience, the time series evidence shown in Figure 2.

Because of important innovations I credit Secretaries Rubin and Summers for bringing about, such as the introduction of Treasury Inflation-Indexed Securities, we actually now have good data on the real cost of government borrowing. What you see since the TIPS came into being in 1997 is a correlation between deficits and interest rates—a negative correlation! So in the late 1990s, when the deficits were shrinking, and surpluses were emerging, the real cost of government borrowing went up. And more recently, as the deficits have returned—they're not sizeable, but they have returned—the real cost of government borrowing has gone down. Obviously, government borrowing carries an opportunity cost to society, because ultimately the interest on that debt has to be paid back. The lesson is not that it's irrelevant how much a government borrows, but the cost of that borrowing is the ultimate tax increase that will be required to support the debt. And that needs to be balanced against other needs that are pressing at a particular time, such as a weak economy, or the needs of homeland security. ◆

TIE: ***What about capital spending? How do you size up the situation right now? There are a number of theories for the stagnation of business investment. One is that the corporate CEO is unsure about the current geopolitical situation, so therefore he or she is holding back on making decisions. Another is that the CEO is unsure about the regulatory environment post-Enron. A third theory is that Washington has not produced a big game plan for the economy. In the 1980s, the Reagan agenda produced a vision and the same occurred with the Rubin agenda in the 1990s. Like it or no, the existence of a big idea in both decades provided a sense of investor predictability. As chief macroeconomist in this Administration, what big idea or vision is likely to influence the investment climate in the future?***

Clarida: Well, those are all obviously important factors. I believe the record shows—and the passage of time will only reinforce—that when this President took office, the Administration inherited a very challenging situation. The economy was already contracting, as we now know from the Bureau of Economic Analysis data. Obviously the excesses of the 1990s in terms of equity valuations were only beginning to have their repercussions felt at that time. In addition, we had September 11, which was not only a tragedy in terms of loss of life, but also impacted the way firms and individuals both here and abroad had to recalculate risk and evaluate risk. I sometimes use the distinction between risk and uncertainty of the late economist Frank Knight: Risk is when you know the distribution but you don't know the outcome, and uncertainty is when you don't even know what distribution you're choosing from. September 11 was one of those events. We've seen risk versus uncertainty affecting the pricing of assets and the way the quality of corporate earnings is valued. There has been a flight to quality, quality being U.S. Treasury securities and agency securities.

I think the economy, despite those significant blows, has really shown resiliency. That being said, the economy now is in a period where these uncertainties are having an impact. We have been encouraged by the increase in investment spending that we saw in the second and third quarters on the equipment side, but nonetheless there are questions about the extent that will continue into the fourth quarter. I still believe that the broad array of fundamentals for the U.S. economy is positive: strong productivity growth, low inflation, and a healthy banking system. A healthy banking system makes an enormous difference when an economy is hit by the shocks that ours has been hit by. Not to minimize the challenges you highlighted and some of the issues we'll be dealing with, but I think ultimately that solid fundamentals will prevail.

TIE: ***The Federal Reserve has taken a pretty aggressive approach and gotten rates down sufficiently low to create stimulus and recovery. Obviously, we've had a mild but shaky recovery. A number of events have occurred that contributed to the big uncertainty premium out there. In addition, disinflation expectations have shown up in the bond market, bringing expectations for even less inflation in the future. So, given the fact that the economy has slowed, does it concern you that perhaps the real rate of economic growth may not be as low as we thought before, given the risk adjustment people make?***

"Six or seven years ago, an economy growing at 3 percent annually with 5.7 percent unemployment would have been considered an economy firing on all cylinders."

Clarida: Because of this uncertainty, it is evident that the financial markets, unaccustomed as they are to this new information, are painting with a broad brush now. Companies are being reassessed in terms of their equity price or the interest rates they pay on their bonds. History suggests that over time as the financial markets become more accustomed to the new world in which they're operating, that they won't be painting so much with a broad brush, and the credit markets will more effectively price risk on a company-by-company basis. But I don't think there's any doubt that to some extent that has been going on and that's been a challenge that companies have faced.

TIE: ***Looking at the upcoming situation in Iraq, are there lessons to be learned from past military operations that would tell an investor, particularly a corporate strategist, about what to expect? Obviously you can't offer militarily sensitive advice, but why should a corporate strategist not view this period in extremely negative terms?***

Clarida: I choose to answer that question by talking about previous episodes. In the past thirty years, hostilities in the Middle East have caused spikes in oil prices, and it's not a plus for the economy when that occurs. The extent to which it's a negative depends upon a number of factors. Our judgment based upon our analysis is that we do not anticipate a double-dip.

TIE: ***This is not a perfect analogy, but you could say the Cuban missile crisis in 1962 began a period when the world was suddenly presented with a nuclear holocaust as a real possibility. And even though the Cuban missile crisis was resolved, the prospect of nuclear holocaust was not. Although the nuclear threat hovered over the investment environment during the entire 1960s, it didn't really stop the growth process. People seemed to adjust. New industries were created—bomb shelter industries and the military-industrial complex. Do you see that as any kind of an analogy?***

Clarida: Well, in the first half or two-thirds of the 1960s, the economy was growing rapidly with high productivity growth and low inflation, and that continued to occur long after the Cuban missile crisis. My reading of the history of the 1960s tells me that performance started to deteriorate later in the decade as inflation became a problem. One reason why I think the United States is currently in a better situation than we were in earlier business cycle episodes is because we have an initial low rate of inflation and a sound monetary policy.

TIE: ***Do you worry about China? One of the theories being bandied about is that Chinese companies themselves are not a global deflationary force. By the same token, Japanese, Taiwanese, European, and American companies that invest in China increasingly are a deflationary force as they are able to project globally. As a strong deflationary force, no one knows the boundaries because China's still growing. Recently, a major firm in Mexico relocated to China. Why? Two bucks an hour versus $3.50 an hour in wages. Is China, working with foreign firms, the coming global deflationary monster?***

Clarida: The development record in China over the past 20–25 years has been remarkable. With well over a billion people and with growth at such rapid rates, growth is now not just in terms of the number of boxes that get sent out of the factory, but the sophistication of the products being exported. Perhaps ten or twenty years ago, China was seen as a billion consumers for our widgets, but what has evolved is actually a manufacturing platform with big foreign direct investment (FDI) flows. China is one of the top recipients of FDI in the world.

Regarding deflation, when there is rapid growth in manufacturing capacity and supply coming from China or other countries, that would tend to lower the relative price of manufactured goods, and thus impact the terms of trade for countries that are manufacturing exporters. Those price adjustments in and of themselves are not deflationary. In an environment where the rate of inflation is low, companies facing that competition will, instead of slowing the rate of price increase, actually have to cut prices. From their perspective it is deflation, but overall I firmly believe, being a student of Milton Friedman as we all are in one way or another, that ultimately inflation or deflation is a monetary phenomenon.

TIE: ***You're hitting on a key point there that worries some people: that this is not just a relative price experience. Since the end of the Cold War, huge regions of the world have opened up to global markets and they all seem to want to produce for export. So we have this capacity expansion, which is generally a good thing. The key is whether policymakers can keep up with this process. Because deflation is a monetary phenomenon, don't central banks need to be aware of the dangers of slipping behind?***

Clarida: Absolutely.

TIE: ***While the Federal Reserve seems to be doing an excellent job, some people are very critical of the European Central Bank (ECB), the Bank of Japan, and other central banks for failing to see the speed at which this deflationary process is moving. If the Fed goes it alone, are we getting enough from the other central banks to make this situation just a relative change, or something more than that?***

Clarida: I agree with the thrust of your observation that effective policy needs to take into account the important trends in the world economy, and that clearly this is a very important trend with regards to manufacturing production and trade. For obvious reasons I'm not going to get into commenting on particular central banks, but I would say the situation that the ECB faces is a challenging one. The creation of a common central bank for twelve disparate countries is really remarkable, and obviously one of the challenges is not only the different levels of income and growth prospects in the ECB countries, but what that means for individual inflation rates and relative price adjustments.

TIE: ***Are you worried that in the long term, European and Japanese policymakers are going to have real problems with the United States demographically? Like the United States, both Europe and Japan have rapidly aging populations, but the United States has also experienced a recent baby boom. So, we conceivably will be less influenced. The United States could potentially end up over the next two decades in a much better position than our closest competitors, but with smaller export markets and increased resentment against the United States. Do you buy into any of this?***

Clarida: That's something that will play out over the next several decades. I'm by nature an optimist, and although I share with others some frustrations about the current situation, over the longer haul I believe that the incredible assets and talents, not to mention the physical capital and knowledge, in these countries will be fully tapped, and so ultimately this is not something that I would be concerned about. But certainly demography will increasingly be driving economics across a range of issues, and differences in demography will also have important international repercussions. The ones that get talked about the most concern international capital flows, and those aren't 20 years down the road. Those start to kick in eight or 10 years down the road. Obviously the international capital markets will have to adjust.

TIE: ***Could you comment more specifically on the domestic economy? The recovery has been moving along, although there are signs of slowing at least in the fourth quarter. The situation is uneven—a weak second quarter, strong third quarter, and now a weaker fourth quarter, and car sales seem to be a contributing factor. Every time the auto industry wants to remove price incentives, demand starts to give way, and so we have seen weaker than expected car sales. Does this mean the consumer's tapped out, or is this just another form of the relative price situation we discussed?***

Clarida: The economy is on a bumpy road to recovery. You mentioned the saw-toothed pattern we have seen in growth rates. By the time this issue of *The International Economy* hits the newsstand, we'll already know what the fourth quarter numbers were. But the metaphor we like to use is that the economy is in a relay race, and at some point the consumer will hand off the baton to business investment, and that baton as yet has not been passed. That factor has contributed to this saw-toothed pattern, as well as the automatic-stabilizer role that long-term interest rates play, at least on government bonds. We tend to think of automatic stabilizers in textbook Keynesian terms, but a new automatic stabilizer for the United States is the interaction between long-term interest rates and mortgage refinancing. Mortgage refinancing of course was not invented yesterday, but the market for refinancing mortgages has become much more efficient. People have become accustomed to refinancing, so each time around it takes a smaller rate move to trigger a refinance wave, and obviously, the U.S. capital markets are really the most efficient in the world for dealing with what is a very complex financial transaction. So while the road to recovery and expansion has been bumpy, we believe that going into 2003 it's likely to be less bumpy.

TIE: ***So you're not worried about the levels of mortgage debt or consumer debt or anything like that?***

Clarida: No, we're not, for the following reasons. Household income growth has been solid, especially after-tax household income. And although obviously mortgage debt is high, the value of the homes that back that debt has also gone up, and in a way that we think is justified by fundamentals, including growth in personal income and demographic factors. Also debt service costs are not at record highs because of the low interest rates. So we don't see a housing bubble. On balance, we think this is something that appropriately reflects the fundamentals, so we're not at this point concerned about it.

TIE: ***Are you concerned that while consumers are enjoying a pretty good fundamental environment, they're still very sensitive to price and other factors? On the employment side, firms are facing the uncertainty premium along with new rounds of downsizing and fallout from the tech bubble. Are you concerned that maybe the employment picture is shaky such that the consumer may eventually develop a confidence problem?***

Clarida: Well, perhaps six or seven years ago, an economy growing at 3 percent annually with 5.7 percent unemployment would have been considered an economy firing on all cylinders. A challenge obviously is that with rapid productivity growth, the economy needs a more rapid increase in demand to reduce unemployment. As President Bush and Secretary O'Neill have said many times, we not satisfied with 5.7 percent unemployment. We're not satisfied with the sluggish growth in payroll employment that we have observed. To date the labor market has not been generating the jobs that would be needed to reduce the unemployment rate. Not to dismiss confidence surveys, but there have been plenty of times in the U.S. experience when sharp moves in confidence over a three- or four-month period never translate into anything. Last October, for very understandable reasons after September 11, confidence dropped dramatically, yet in the fourth quarter of last year, people went out and bought millions of cars and the economy grew at nearly 3 percent. The numbers we track very closely that I think are more relevant to the consumer are the growth in personal income, the interest rate environment, and obviously real wage gains, and productivity will help to support that.

TIE: ***Back to this idea of the investor. Corporate decision makers are looking for a sense of where policy is going for the next five or ten years, or at least for this Administration. Do you sense now that the change in the U.S. Congress frees the Administration to move in a particular direction?***

Clarida: Let me talk about some big ideas that are already accomplishments and that we think will lead to further accomplishments. The tax cut that was passed in the summer of 2001 is a very important part of the President's agenda. And achieving trade promotion authority, for the first time in eight years, will really open up the world trading system, including putting some things on the table that have traditionally not been discussed in trade talks. President Bush and U.S. Trade Representative Robert Zoellick have said they will aggressively and proactively engage in trade negotiations on a variety of fronts—bilateral, regional, and through the World Trade Organization. Obviously trade talks will take a long time, but having a President and an Administration who are very engaged on many fronts will provide many benefits to the U.S. economy and the world economy.

Regarding the investment climate you mentioned, one very important accomplishment this year was getting Congress to pass in March a package of investment incentives that have already boosted corporate cash flow substantially. There are half a dozen different measures of corporate profitability, but one we look at is the measure of after-tax corporate cash flow, because it has the virtue of being consistently calculated by the National Income and Product Accounts and Bureau of Economic Analysis. In part because of those investment incentives passed in March, corporate cash-flow numbers have been rising substantially and actually reflect a very large share of total capital spending.

TIE: ***Are you surprised, given everything the United States has gone through, including an unprecedented election recount, the Fed's slashing of short-term interest rates, the bursting of the equity bubble, and all the rest, that the dollar has not gone into a free fall in relative terms?***

Clarida: You know, only the Secretary of the Treasury comments on the dollar. What I would say is what I said in my *Financial Times* piece, that any adjustments in the world economy and capital markets that over time will take place will do so in an orderly fashion.

TIE: ***Do you have any parting comments?***

Clarida: My first day in this job was September 11, 2001. In the fourteen months I've been here, the U.S. economy has gone into a war against terrorism. The economy has been in a recession and emerged from a recession. We experienced the revelation and repercussions of the corporate scandals of Enron and WorldCom. We saw substantial volatility not just in U.S. but in global equity markets, and of course the world's largest sovereign default with Argentina. I think that as time passes will we appreciate the resilience of the economy in the face of these many and substantial shocks. ◆