With deep experience in the worlds of academia and policy-making, former Treasury Under Secretary and Stanford University economics professor John Taylor has been called “one of the most influential economic voices in Washington” by Bloomberg Businessweek. Federal Reserve Chairman Ben Bernanke remarked that his “influence on monetary theory and policy has been profound.” In this first edition of *The Citadel Conversation*, Citadel asks Professor Taylor about his views on global economic issues, the debate over the national debt, Fed policy and his new book, “First Principles: Five Keys to Restoring America’s Prosperity.”

Citadel is pleased to introduce *The Citadel Conversation*, the first in a series of conversations with some of the world’s leading economists, policy experts and market analysts. We believe that powerful ideas drive markets around the globe. By sharing insights and ideas from provocative thinkers we hope *The Citadel Conversation* will provide readers with renewed curiosity and informed perspectives.

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There’s real concern about what the Fed will do as it begins to raise rates – or even earlier. What is the Fed’s best bet to unwind its gargantuan holdings in a credible way? Honestly, I don’t know. What I think the Fed should do is lay out a strategy to gradually reduce those holdings in a credible way as it begins to raise rates – or even earlier. There’s real concern about what the Fed will do. The balance sheet has gotten so big and the holdings so large that we may be on a path where quantitative easing becomes the norm – where QE becomes an accepted tool of monetary policy when the economy slows down. If you look at the language of the Fed, if you look at the statements from the Fed, they seem to see QE as the new-normal, which could be very damaging.

**Q:** Why do you think using QE as a monetary tool, rather than just a temporary emergency measure, would be damaging to the economy?

First, it is nearly impossible to have an understandable or predictable monetary policy when QE is the primary policy tool. Neither the Fed, nor anyone else for that matter, knows how large asset purchases need to be to move rates – and there are huge differences of opinion about what these purchases actually do. Second, QE places an extraordinary amount of power in a government agency. Through QE, the Fed can buy securities backed by mortgages, auto loans, student loans – it’s completely unlimited. There is no justification for any agency of the federal government to have that much power over fiscal and credit allocation policy.

**Q:** What’s the main risk to the economy when the Fed starts unwinding these positions?

Unwinding these positions involves a two-sided risk. If prices start to rise, the Fed may be unable to pull out this liquidity in a timely manner, which could be highly inflationary. But there’s also a danger the Fed could pull out too quickly because there is so much uncertainty about the impact of buying and selling these assets, which could be severely contractionary.

**Q:** You outline two key proposals in your book for reforming the Fed: Ending the emergency measure, would be damaging to the economy?
Fed's dual mandate of promoting both price stability and full employment, and second, instituting a monetary rule along with new reporting requirements to Congress. Wouldn’t these endanger the Fed’s independence and limit its ability to respond to another crisis?

There has been a lot of debate about this, but I believe a monetary rule is an ideal way for Congress to carry out its responsibility to oversee the Fed without micro-managing the institution. In a democracy, it’s important to have oversight, accountability and transparency. My proposal is to require the Fed to report its strategy to Congress, whatever it may be, not to have the Congress dictate strategy to the Fed. The Fed would be allowed to deviate from this strategy, but it would have to report these deviations to Congress and provide the reasons behind its decisions.

The Fed’s dual mandate to maintain both price stability and full employment was adopted in 1977. Paul Volcker, who became Chairman in 1979, interpreted the mandate in a way that was consistent with his attack on inflation. Alan Greenspan largely interpreted the mandate the same way, but more recently, the dual mandate has been used to justify interventions and allow the Fed to pursue a “whatever it takes” philosophy. Requiring the Fed to focus solely on price stability, with the reporting requirements I mentioned, would generate a more rules-based approach and lead to much better economic performance, including higher employment.

Q: Will the euro be threatened?

The euro is threatened, but I believe it will survive. I tend to think the problem is not the euro per se, but the policies these countries have taken. If they don’t fix their policies, I don’t see how the euro can survive, so when I say the currency will survive I’m basing that on the belief that these countries will wise up eventually. In Greece, we have seen a lot of public hostility toward austerity, as the recent elections show. While austerity is certainly part of the IMF plan, there are also measures that are really pro-growth – steps such as privatization, getting rid of price controls, enforcing the rule of law. Unfortunately, Europe has kicked the can down the road for so long, many countries have been forced to undertake massive, immediate cuts rather than a more gradual approach.

Q: Have we reached the point for austerity in the U.S.?

In the U.S., there are reasonable proposals for reducing spending and curbing the deficit in a gradual way. In 2007, federal spending was about 19.7 percent of GDP; today it is around 24 percent. Bringing the level of spending down gradually, returning it to 2007 levels, say, by 2021 is not austerity. But if we don’t put spending on this path of gradual reduction, pretty soon the day will come when we do have to make massive cuts and we will face austerity. Gradual spending reductions are really the only way to avoid austerity in the U.S.

Q: Paul Krugman has criticized Congress for an economic policy that he calls a “bizarre shift of focus away from unemployment to budget deficits” and suggests we are “repeating many of the mistakes that perpetuated the Great Depression.” What impact do you think Krugman’s call for more fiscal stimulus would have on the economy?

Well, we had a huge short-term Keynesian fiscal stimulus and look where it got us. The historical record here is pretty clear and those who argue for more stimulus are on the wrong side. We had fiscal stimulus in 1970s and it produced stagflation. In the 1980s and 1990s, we abandoned that short-term approach, focused on spending restraint and more long-lasting tax reforms – policies that produced two decades of economic growth. There is plenty of empirical evidence arguing against huge government stimulus packages and little evidence the economy would be worse off without them.

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Q: Krugman also claims that “soaring inequality” is the root of our economic troubles. Do you think addressing inequality is an effective strategy for reviving growth?

Inequality is certainly a concern, but the focus on redistributionist tax policy is misplaced. The ultimate solution to inequality lies elsewhere. The U.S. has slipped dramatically, for example, in the kind of education we’re providing to people who are less well-off – and this not only generates inequality, it perpetuates it. The better way to create jobs and address inequality is to get away from all these Keynesian interventions and manipulations of the tax code, which are actually making things worse. So many provisions of the tax code are basically up for grabs every year, which creates uncertainty and prevents our economy from growing as fast as it has following past recessions. Compare today’s recovery to the early 1980s. The current expansion is now 11 quarters long and growth has averaged 2.4 percent. During the first 11 quarters of recovery in the 1980s, growth averaged 5.9 percent. In which recovery did we have stimulus packages? The best way to get unemployment down is to get policy right – and that certainly does not mean higher deficits and more debt.

Q: Let’s move on to China. Do you see China challenging the U.S. as the world’s economic leader – and if so, will the Chinese economic model replace the U.S. model in terms of influence going forward?

The reason China has done so well is because they adopted our model by shifting away from central planning toward a more market-driven economic system. So who’s really following who? While China has moved toward a U.S. model, the country still has far to go in terms of securing the rule of law and limiting government interventions into the marketplace. The real question is: Where does China go from here and where does the U.S. go? As I’ve argued in my book, in many respects, we’re moving away from the model of economic freedom and entrepreneurial capitalism America has long championed. If we continue to move away from that model, there is less chance China will move toward it, which will be very damaging. In my view, the surest way for the U.S. to lose its role as the world’s economic leader would be to deviate from the principles of economic freedom and market-based capitalism that have made our economy so successful.

Q: On a more personal note, what one book you would recommend to someone who wanted to understand today’s economy?

Well, it’s hard to limit myself to just one. I always recommend Milton Friedman’s timeless classic “Capitalism and Freedom.” Another book I’ve been recommending lately isn’t so much about economics, but about regulatory capture or what we more commonly call crony capitalism – and that’s “Reckless Endangerment” by Gretchen Morgenson and Joshua Rosner. This is an area that is not well understood – but it’s especially important as we continue to debate the proper role of government in our economy. I talk a lot in my book about deviating from principles and rules – and one of problems we saw during the financial crisis is that the government is not doing an effective job in enforcing the existing rules for financial markets. The government had hundreds of regulators on the premises at Citibank and other large banks, but they couldn’t effectively oversee these institutions. This book takes us into an area where we know very little and need to know more.

Q: What’s the new hot area of economics for students today?

I see a lot of interest in applying economics to the entrepreneurial world of high technology. One of reasons Silicon Valley was born is that Stanford encouraged students and faculty to go start firms – to apply academic training to real-life applications. Hewlett-Packard was one of the first; Google also came out of this mentality, which has delivered enormous benefits to our economy. I also see a great deal of focus on applied micro-economics – building experiments to determine the best way to allocate people within firms or how to price advertisements on the internet. Obviously, the financial crisis has generated a lot of work on financial markets and banking as well.

Q: What advice would you give someone considering a career in economics?

My advice for talented students is to find a Ph.D. program that combines quantitative rigor with a real world understanding of policy and business. And of course, when it comes to understanding how markets work, there’s no substitute for sitting on a trading room floor.

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