Federal Reserve Board Oral History Project

Interview with

Manuel H. Johnson

Former Vice Chairman, Board of Governors of the Federal Reserve System

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Interviewers: David H. Small and Jaime Marquez

Federal Reserve Board Oral History Project

In connection with the centennial anniversary of the Federal Reserve in 2013, the Board undertook an oral history project to collect personal recollections of a range of former Governors and senior staff members, including their background and education before working at the Board; important economic, monetary policy, and regulatory developments during their careers; and impressions of the institution's culture.

Following the interview, each participant was given the opportunity to edit and revise the transcript. In some cases, the Board staff also removed confidential FOMC and Board material in accordance with records retention and disposition schedules covering FOMC and Board records that were approved by the National Archives and Records Administration.

Note that the views of the participants and interviewers are their own and are not in any way approved or endorsed by the Board of Governors of the Federal Reserve System. Because the conversations are based on personal recollections, they may include misstatements and errors.

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MR. SMALL. Today is Tuesday, June 15, 2010. This interview is part of the Oral History Project at the Board of Governors of the Federal Reserve System. I am David H. Small from the FOMC (Federal Open Market Committee) Secretariat in the Board's Division of Monetary Affairs. I am joined by Jaime Marquez, a senior economist in the Board's Division of International Finance. We are interviewing Manuel H. Johnson, a member of the Board of Governors from February 7, 1986, to August 3, 1990, and the Board's Vice Chairman from August 4, 1986, until the end of his term. This interview is taking place at Vice Chairman Johnson's offices in Washington, D.C.

Educational and Professional Background

MR. SMALL. Thank you, Mr. Vice Chairman, for giving us your time. Let's start with your academic studies and what led you into economics.

MR. JOHNSON. I didn't consider economics until I got out of the army. I was a prelaw major at the University of Alabama when I started college. Like most people when they're 18 years old, I was pretty immature. I didn't know what I wanted to do. I think I terrified my parents, because I left college in 1968 and joined the army in the middle of the Vietnam War.

I spent three years in the service. My basic training was in Fort Benning, Georgia. I went to Army Intelligence School and then to a Special Forces Unit in Fort Bragg, North Carolina. I became a ranger and airborne qualified; I was in the 6th Special Forces Group. Then I was in Panama and Korea and was a temporary duty adviser around Asia.

When I left the army in 1971, I didn't have much money. I went back to school at my hometown university, Troy University, and got my undergraduate degree in economics. I wasn't sure what I wanted to do. I was still thinking about being a lawyer, but I took some economics courses, and I had a very inspiring professor, G.T. Stewart. He was a very enthusiastic instructor.

Economics seemed so different than typical emotional reactions to issues when I started studying it. It became a challenge to figure it out. Many students shied away from economics courses. The more I got into it, the more interesting I found it. I had become involved with local and primitive economies when I was a Special Forces soldier. That job usually required trying to pacify an area with public works and providing local services to indigenous populations to eliminate dissent. I picked up some interest there, and that's why I took economics courses when I got out of the army. Economics intrigued me. The more and more I got into it, the more and more everything seemed to be explained by economics. All the world's issues seemed to come back to economic problems. So that's why I decided to pursue economics.

I still thought I wanted to be a lawyer when I got my economics degree as an undergraduate. I applied to law school. I was in the process of going to the University of Michigan for a joint economics–law program when my father-in-law became very ill, and my wife and I decided to stay in the region. I got a fellowship offer from Florida State University (FSU), so I decided to go there and forget about law.

Neither FSU nor any other university in the region seemed to have the kind of law and economics program that Michigan had, so I decided just to stick with economics. I'm glad I did. FSU had a good economics program. There were some interesting professors at FSU. Abba Lerner was a visiting professor, and James M. "Jim" Buchanan had been a professor down there. And there were several former colleagues and students of Milton Friedman on the faculty.

When I first entered the graduate school at FSU, I didn't think I was going to pursue my Ph.D. I thought I would just complete the master's program. But you want to know more and more. And I decided that I wanted to be an academic, so I stuck with it.

MR. SMALL. What was your Ph.D. dissertation?

MR. JOHNSON. I received a fellowship from the Nuclear Regulatory Commission (NRC) to do my Ph.D. on building an econometric model that would help NRC measure regional, economic, and environmental impacts associated with building and operating nuclear power plants. Natural resources and environmental economics was one of my fields of study, along with macro and money. I applied for this fellowship and got it, so I thought I would use my macro model-building capabilities and do something in the natural resource/environmental area. I designed a regional econometric model for measuring economic and environmental feedback and impacts on local and regional economies.

It was a regional science study more than it was anything else. It had a theoretical and an empirical part to it. To do the empirical work, I used a region in South Carolina where a nuclear power plant was built. Then I designed this model that could be used by NRC or anyone else. After Three Mile Island, many remote but potentially catastrophic issues surfaced, and the whole industry practically shut down. So that's what I did my Ph.D. dissertation on. I published a number of related journal articles on natural resource economics and regional model building based on this dissertation.

After that I got into a lot of other issues, like fiscal and monetary policy. My academic career was all over the lot. I didn't want to be pinned down by anything. But when I came to the Washington area at George Mason University, the location near national public policy got me more and more focused on fiscal and monetary policy. So by the time I went to the U.S. Department of the Treasury, that was what I was mostly doing.

MR. MARQUEZ. You were in the School of Public Policy at George Mason?

MR. JOHNSON. No, I started out in the economics department. I helped build the economics program into national prominence. My colleagues and I had a lot of fun building that program, bringing in important economists that won two Nobel Prizes.

When I came to the Washington area in 1977, I wasn't that interested in politics. I started participating in a lot of think-tank programs that drew notice from politicians. I didn't campaign for Ronald Reagan and I didn't follow the campaign, but I was asked to serve on his Treasury transition team and was then offered a policy position.

Working at the Treasury Department

MR. SMALL. You went to Treasury in 1981, and your focus was on fiscal, tax, and budget matters?

MR. JOHNSON. Yes. I had done a number of things on fiscal policy. I had been involved with think tanks and had advised staff people on the Hill who were working on tax and spending legislation. There were a lot of changes going on in the late 1970s, even in the Jimmy Carter years, regarding capital gains and other taxes on capital. That's why I was asked to serve on the Treasury transition team. At the time, I was engaged in a lot of academic research with other people, so when I was offered a deputy assistant secretary position at Treasury, I couldn't take it. I was partnering in all of this research. But when I finished the research, the offer was still there, and I went to Treasury. My first official day at the Treasury was the day President Reagan was shot.

MR. SMALL. Do you remember hearing the news and where you were?

MR. JOHNSON. I was in a staff meeting in the Treasury Secretary's conference room when a call came from the Secret Service. We remained in the meeting and received reports. Donald Regan, who was then Secretary of the Treasury in charge of the Secret Service, was running all over the place. But we stayed in the conference room getting reports and trying to figure out what was going on.

MR. SMALL. For a while you didn't know?

MR. JOHNSON. We didn't know. All kinds of bizarre rumors were flying around. And some people forgot the order of authority. [Laughter]

MR. SMALL. What were the early years like at Treasury? There was the Reagan revolution, and there was a big change in tax policy, foreign exchange policy, and monetary policy. Everything was being rethought.

MR. JOHNSON. It was an exciting period. I look back on those days fondly. You know how it is when you're young and you feel like you're changing the world? It was that kind of thing. Many people were upset with the way the country was going, and they were ready for dramatic change. Paul Volcker had been brought in during that time. We were ready to grit our teeth and put up with some tough times to stop inflation. But people weren't buying into the old political arguments of fiscal stimulus. They wanted to get the country back on track, and they wanted structural change.

There was an incredible amount of tolerance for tough measures then. Paul Volcker told me a number of times, "You're used to having the White House fight you on tough monetary policy." But people, like Beryl Sprinkel, were attacking the Fed for being above its monetary targets in the middle of the 1982 recession. Volcker couldn't believe that he had that kind of free reign from the political types. It made his job easier, but I think it made him feel lonelier [laughter], because there was nowhere to hide. At the same time, the country was ready for that kind of medicine. That was a tough recession. It was very dark in the later days of 1982 if you were in the Treasury, but it was exciting at the same time. There were some frustrations, but you knew you were making big structural headway.

MR. SMALL. You won the Treasury's Alexander Hamilton Award for work during that period.

MR. JOHNSON. It was for a combination of things. I was one of the architects of two major tax acts: the 1981 Tax Act and the 1986 Tax Reform Act. I don't know how many years it took off my life span, but I spent untold hours in the Treasury at night and on the weekends working on those policies and defending my positions. When you're young and idealistic and you see sausage made, it's tough. That was the way things worked at Treasury. You fight among your friends to defend your views within the structure of tax architecture. I have to admit, I thought the fight was tougher getting a set of proposals that the President could announce than it was to get it through the Congress.

MR. SMALL. Was that because of lobbying by particular groups?

MR. JOHNSON. That was part of the story, but also there were just a lot of different paradigms within the Administration. People think that the Reagan Administration was a single paradigm of thought. It was not. It was all over the lot. The President was a very steady force on themes and principle, but he was quite tolerant on the details. The Administration was basically conservative, but there was a lot of room there. There were a lot of different views about how tax policy should be structured and what kind of monetary policies should go with that. I got the award for developing those two pieces of legislation, but also for serving on the Troika (deputies of Treasury, the Council of Economic Advisers (CEA), and the Office of

Management and Budget) and preparing the Troika forecast. I also participated in numerous taskforces. Then, as assistant secretary for economic policy at the Treasury—I don't know how it is now—you got to weigh in on everything, micro and macro. At Treasury you had a large operational role, unlike the CEA. Treasury was a really exciting place to be.

Comparing the Treasury and the Fed

MR. SMALL. You used the term "watching how sausage is made." What are your views about how it's made, say, in a presidential Administration, or the Treasury in particular, in contrast with the Federal Reserve?

MR. JOHNSON. There is much less sausage made at the Fed. Clearly, there are different views at the Fed, just like any other place. But the Federal Reserve had a much more collegial and less political atmosphere. Even though there were many tense moments at the Fed, it was a much more serene environment and one that was more like a temple than the Treasury.

What's the best analogy for the Treasury? You're on the line every minute. There are many issues flying at you. Some of those issues are highly political as well as financial and economic.

At both the Treasury and the Fed, in moments of crisis, there was no time. All the planning had to be done before crises. It was like when you prepare for a football game. If you're not prepared when you go out on the field, you're not going to get the plays right if you are drawing them in the sand in the middle of the game. It's the same thing.

At the Treasury, you had to react to things that were flying at you all the time from the Congress and elsewhere and respond in very short time frames. Then you tried to do long-term planning while in a highly charged political environment. No institution is insulated from politics, but the Fed's sense of independence was sacred, even though it's always challenged on the Hill. There's more of a vacuum in which you can think. Most controversies are purely intellectual at the Fed. Obviously, you have to have people watching your back politically, but that usually doesn't factor into the decisionmaking of the Fed. At Treasury, politics factors into every decision. It's part of the Executive Branch.

MR. SMALL. Was there less debate at the Fed because there is one monolithic staff, whereas at Treasury, there are many different staffs working different angles?

MR. JOHNSON. Yes, there were some competing staff issues. In the days when I was at Treasury, even in the Reagan Administration, there was a career group of Treasury people who were quite dedicated, similar to the Fed but with less bench depth. I don't know if that has died off. It seemed like it was starting to die at the time, but maybe it hasn't. There was a dedicated group of professionals in economic policy who had been there for years. You could ask them any question and get an objective answer. Everybody had their training and their biases, macroeconomically or microeconomically. I thought it was an honest place. I really liked that about the professional staff at the Treasury. You could get honest feedback asking questions, even though they knew the environment was politically charged. However, I did feel at times that certain divisions' staff had institutional biases that made it very difficult for Treasury-wide cooperation.

MR. SMALL. You could get an honest answer about reducing the marginal taxes and not the—

MR. JOHNSON. The Office of Tax Policy clearly held long-standing biases. There have been books written about our battles within Treasury on tax structure. But especially when you get to the policy level, which starts at the deputy assistant secretary level, then decisions get batted around in political terms. What you come out with turns into sausage. Politics plays a role in shaping decisions at that stage, whereas at the Fed, decisionmaking gets to its final moments without politics. In the end, there obviously are some issues, but it's about as insulated as it gets. There are ideological and theoretical differences at the Fed, but at least politics is minimal. It's probably more contaminated today than it's ever been just because of the pressures out there.

Latin American Debt Crisis

MR. SMALL. While at Treasury, you mentioned monitoring the Fed's high interest rates and the recession. During the Latin American debt crisis, do you remember any Treasury views on how the debt obligations should be resolved?

MR. JOHNSON. We worked quite a bit on that. In fact, I always marked the turning point in the recession in 1982 with the collapse of Mexico. That basically was the event that made the Fed decide to start easing policy. The back of prevailing asset prices had been broken, and the Fed could let go of the reins on interest rates at that stage because expectations and events turned from inflationary pressures to deflationary dynamics. That was the turning point.

MR. SMALL. Not only because Mexico was going down, but potentially it could pull U.S. banks down?

MR. JOHNSON. Correct. I remember when I was at Treasury, we got a weekend call on Sunday. Paul Volcker received a call from Miguel Mancera. I think he was the head of the Mexican central bank at the time. Volcker was told that Mexico was defaulting on everything on Monday. At that stage, the U.S. banking system as primary lender to Latin America looked very precarious.

MR. SMALL. Was it easier then to deal with those types of crises, in the sense that you called in the big banks, a limited group, in a room?

MR. JOHNSON. There were a lot of banks then, even big banks. Financial services were more structured and banks were more limited in what they did, but they got into trouble on their traditional responsibilities—lending to sovereign countries. Also, the big banks had syndicated the loans on a very broad scale. It was not yet securitization, but it was getting closer.

Banks were extended on sovereign debt. Walter Wriston, the head of Citi, made the famous comment, “Don’t worry about the due diligence for countries. Countries don’t default. They can tax.” I think that set the stage for the bank culture at the time. It must be like what went on in Europe recently—countries have taxing power. The state and municipal bond market in the United States today has a similar ring to it. “Latin American countries are not very democratic, so they’re safe” was also an argument. But when the right hand doesn’t know what the left hand is doing, you don’t know how concentrated this gets in the entire banking system. That’s what happened.

I learned a couple of things during the Latin American debt crisis. One thing that stuck in my mind as a young person in economic policy at the Treasury was naively telling my Latin American colleagues in the restructuring meetings, “You’re making a huge mistake defaulting. By threatening to default, you’ll never be able to access the capital markets for another hundred years if you do this.”

I’ve modified my views on that. I realize now that the memory of a debt crisis is roughly the lifespan of a bond trader. You find out that a new generation of bond traders comes along, and they’re trying to push a product. New government leadership takes over in some Latin American country or any other emerging market country and claims that “Things are different now.” The government can be trusted, policies are in place—it’s totally different, debt is safe. New investors get sucked right in rather than waiting to see the results.

MR. SMALL. The Reagan Administration was conservative. When issues of moral hazard came up, both with respect to the country and the domestic banks, I imagine that the first inclination was that you don't want to help these guys out. This is moral hazard.

MR. JOHNSON. Yes. Our inclination was to be tough. There had to be accountability for these decisions. The only way the system can learn is through failure. I still believe that today. Of course, you would like orderliness to the process, but sometimes it is not possible. At the stage when Mexico collapsed, you could not easily pull the plug. There needed to be some orderliness to the discipline, but it had to be strong discipline nonetheless. That was the message. Those same lessons are still critical. You can't have a functioning capitalist system without internalizing the risk of your decisions.

Chrysler Bailout

MR. SMALL. Do you remember getting criticism from the outside from those who wanted you to do less?

MR. JOHNSON. Yes, sure. We received a lot of pressure from those who thought we should be tougher and those who thought we should engineer a complete bailout. There was a lot of pressure from the banks, from everyone. One of my first experiences was working on the Chrysler bailout—setting up meetings with Don Regan and Lee Iacocca and fighting off Chrysler over cutting a deal on the warrants the taxpayers held. Chrysler didn't want us to sell those warrants into the market. It wanted us to forgive them to start with, and then Chrysler wanted us to discount them back. I experienced many shouting matches between Regan and Iacocca during that period. It was pretty nasty. They both were hot-tempered people.

But I'm happy to say that we got every dime for the taxpayer. We never knuckled under. I didn't favor the Chrysler bailout. I wouldn't today. But we protected the taxpayers; they got their money out and probably made some in the process. Lee Iacocca did a wonderful job restructuring Chrysler and bringing it out of bankruptcy. He did what I probably would have done as CEO: argued for discounts on the warrants. It's a slippery slope that we get into when you concede to bailouts. You can see all this today. I don't know how we're going to pull ourselves out of this situation today.

I still believe strongly in the moral hazard issue. By "moral hazard," I mean central bank or government subsidies to the private sector which create incentives for excess risk-taking in a way that ultimately imposes large costs on all citizens. The real policy question is always, how do you protect the moral hazard position and make policy in a way that doesn't create systemic disaster? It's a fine line. It is very hard to look over the edge of the abyss and make tough decisions.

MR. SMALL. Does a "not on my watch" attitude bias policymakers?

MR. JOHNSON. Yes, I think it does. Look, I'm as guilty as anybody. I can justify it in my mind, even today. We often wait until a crisis occurs before making regulatory changes. At that stage, it is too late to correct structural flaws that encourage excessive risk-taking.

Financial Crises

MR. JOHNSON. In 1987, the stock market crashed on Monday, and on Thursday of that week, we had a crisis in Chicago. First Options Corp., a subsidiary of Continental Illinois, was the only big lender to the options market. It created all the liquidity for options trading, and it was bankrupt.

We were standing in Greenspan's office with the Chicago Fed president, Sy Keehn, on the phone. Bill Taylor, head of Enforcement [the Division of Banking Supervision] and Regulation, said, "Look, First Options is bankrupt. We've got to shut them down because they want money streamed from the Continental Illinois bank to keep them afloat so they can keep making loans in the options area." There was supposed to be a firewall. We were in a moment of total crisis. We were being told by Sy Keehn that commodity exchanges and the options exchanges were going to shut down if we closed First Options. Alan was brand new as the Fed Chairman. I said to Bill, "Let the money go. We've got to clean this up later." And we did.[1]

MR. SMALL. So someone could call you a big spender.

MR. JOHNSON. I'm as guilty as anybody! [Laughter] Looking over the edge of the cliff, seeing a potential domino effect flash before your eyes is frightening. However, we did clean it up later. We didn't let it rest very long. But this is what happens when bank holding companies are treated like core banks. At that time, a firewall was supposed to exist between holding company subsidiaries and the core bank.

This is the problem when you get into these crises. The game plan has to be worked out way before you get on the field. Once you're on the field, it's too late. Once in a while, you draw a plan in the sand and that works out. But if you don't have the structure right before, you're just sticking your thumbs in the dyke.

That's where we were. At that stage, from a regulatory structure point of view, we had not resolved the wall between the holding company and the bank. There were debates within the Fed. I remember having discussions with Paul Volcker, Mike Bradfield (the Board's general counsel), and plenty of other people about the fact that the markets believed the holding

[1] Editor's note: When First Options faced large financing requirements on October 21, 1987, the Federal Reserve permitted Continental Illinois Corp., the bank's holding company, to inject funds into the options subsidiary. For further information, see Alan Murray (1987), "Passing a Test: Fed's New Chairman Wins a Lot of Praise On Handling the Crash—Alan Greenspan Was Aided By His Ability to Foresee Problems and by Planning—His Independence Still at Issue," *The Wall Street Journal*, November 25.

company is the bank. Its commercial paper was trading like it was in the bank, like it was insured.

My view was always that we were not saying enough. We were not telling the market. We were not driving a wedge between the pricing of holding company paper and the bank itself. We needed to get out there and make it clear to the market that commercial paper of a holding company is not insured. It has to pay a risk premium. I don't think that had been established clearly enough when all of this happened. So the public believed that the holding company was a bailout institution. I think that's the problem today, but on an even larger scale.

How long did it take to get inflation risk premiums out of the Treasury market? It probably took a decade of constant pounding to convince the markets that the central bank was committed to this. How hard did the Bundesbank work over the years to make sure that was the case? It's a never-ending process. Markets want to find those loopholes. When you're in the middle of a crisis and the market is priced a certain way, then you're stuck with those choices, bad choices. So, yes, I'm as guilty as anybody on that. The time to deal with this problem is when there's complacency. When things are good, everybody thinks things are working great.

MR. SMALL. If you could go back and get a one-year running start up to that crisis, what would you have put in the playbook for the 1987 market crash?

MR. JOHNSON. There are a couple of things I would have put in the playbook. I was a strong believer in transparency. I supported everything Ben Bernanke has done on the FOMC. I don't believe in bringing cameras in the FOMC meeting. I would never go that far. But I do believe in transparency as long as there's confidentiality of the decisionmaking process at the time.

I've always believed that the Fed should lay out in clear terms way in advance—in a normal time—what it would do and what it's prepared to do in various points of crisis. I know the arguments. I've been through all the debates. Jerry Corrigan would disagree with me. Maybe Volcker and Alan would as well, I don't know. You want your flexibility. In those times of crisis, you won't ever draw lines in the sand.

But I take the Bundesbank approach. I'm not defending all Bundesbank policy. The market never doubted the Bundesbank's commitment to fighting inflation and tough policy. I like to use this analogy: They announced that they were vegetarians, and they never wavered. But once in a while, after that credibility was established, you could find them eating cheeseburgers. And you'd say, "Wait a minute, you're a vegetarian. What are you doing eating a cheeseburger?" "Oh, we have a cheeseburger once in a while." That's the approach you take. You have to be credible. You have to make hard choices and tough decisions. In a moment of crisis, if things aren't perfect, you can use your flexibility. But you've established the principle, and it is credible in the market place.

The Fed should lay out the architecture in advance: "No bailouts. This is the structure. You don't get this. This is the law." Make it clear, and say it over and over and over again. In the moment of crisis, you might change that. But you'd make that decision then. You don't keep everything secret and say, "We're totally flexible," because the market automatically starts pricing in the bailout.

Working at the Treasury Department

The Plaza Accord

MR. MARQUEZ. The Plaza Agreement, or Plaza Accord, was an agreement between France, West Germany, Japan, the United Kingdom, and the United States to depreciate the U.S.

dollar in relation to the Japanese yen and German deutsche mark by intervening in currency markets. Treasury was in charge of doing the intervention. Can you tell us something about that period? Beginning around 1983 through the Accord in 1985, the dollar was appreciating by significant amounts.[2]

MR. JOHNSON. You're absolutely right. There were some lessons learned then. One important lesson was related to the unwavering position that we had in the Reagan Administration regarding the dollar. Volcker's comment to me was, "When you have the undersecretary of the Treasury attacking the Fed for too loose a monetary policy in the depths of the 1982 recession, what are you going to do if you are a currency trader?" Most of the Reagan economic team was laissez faire on currency. There was practically no wavering from that.

I remember sitting around having these debates in staff meetings. The monetarists were in control of that issue. I was not a monetarist, so I was not a part of that group, but I did sympathize with the position of flexible exchange rates driven by market fundamentals. I have enormous respect for many monetarists, but I'm not a monetarist. I never believed in the stability of monetary velocity and don't today. On the tail of the 1970s, it was a strong group. This era was characterized by capital controls and regulated interest rates. The quantity of high-powered money was easy to define. So the monetarists' prescription of money supply targets to fight inflation seemed more logical. They believed in total laissez faire on foreign exchange. So restrictive money targets could easily be translated to a strong dollar. If you're a trader, there's only one way to go. You didn't see any cracks in the policy.

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[2] Editor's note: The U.S. dollar peaked in late February 1985 and depreciated fairly steadily, falling nearly 11 percent in nominal terms before the Plaza meeting in September 1985.

It wasn't until trade restrictions were about to pass in the Congress, and Jim Baker, then Treasury Secretary, came to the conclusion that won out in Reagan policy circles: We were going to have a trade breakdown if we didn't loosen up our currency position.

MR. MARQUEZ. Would this be an instance of what you were talking about before where politics came in? My recollection is that part of the reaction of the Congress was not so much to the current account in the abstract but to the loss of jobs in their corresponding states, and that the idea was to impose tariffs on certain countries—say, Japan or others. Also, the United States had gone a long time towards the elimination of tariffs for fears of reinventing the—so the solution was to—

MR. JOHNSON. I agree, to some extent. The politics of trade won out over this laissez-faire policy and led to the Plaza Accord. The very strong dollar was perceived to be destroying jobs in trade-sensitive regions of the country. I think the Plaza Accord was the right thing to do. Looking back on it, I was certainly more in the laissez-faire camp when I first joined Treasury. I didn't really want to get into currency intervention.

I was also not as stern a monetary person, so I believed we were pursuing too tough a monetary policy. Not that I wasn't in favor of a tough monetary policy, but not being a monetarist, I didn't buy into the monetary targets. I've always been an interest rate guy guided by leading indicators and not a quantitative target guy. But I believed in free currency markets. However, something had to give. I think Jim Baker showed great insight as Treasury Secretary. However, I do think he was drawn further into managed exchange rate policy than originally intended. Unrealistic currency zones became economically dangerous later on.

Treasury Secretaries Donald Regan and James Baker

MR. SMALL. How important was the switch when Don Regan and Jim Baker flipped jobs? Did things change at the Treasury?

MR. JOHNSON. They did change stylistically. I love both of those men. But they had totally different styles.

Don Regan was a former marine and a great guy to work for. You wanted to work for him. He wasn't really a good Washington animal. He belonged on Wall Street. He instilled confidence. His staff meetings were interesting. He involved everyone in the policy. You were part of the team. It was almost like the Marine Corps. There was great esprit de corps at Treasury. He was very rigid. He had 7:30 a.m. staff meetings. But he never was comfortable with Washington. He just didn't understand—or didn't want to understand—the nuances of Washington. He was not ideological, although people thought he was. He came from Merrill Lynch on Wall Street. He was loyal. He constantly strived to understand what Reagan wanted as President and wanted to help deliver it for him. So he was a loyal Treasury Secretary.

Baker was much more understanding of how Washington worked, how the political system worked. Esprit de corps was not as high under Baker when he came in even though he was a former Marine. He liked to work in a tight little circle of people. I was lucky enough to be in that circle. If you were outside that circle, you didn't really know what was going on. He didn't have the kind of staff meetings where everybody got their marching orders, where everybody understood what the game plan was. Baker held it close. He wanted to control the media. He wanted to control the policy. He was right about Washington. He said, "You can't do everything in Washington. You pick out two or three things that are achievable." It may not be easy, but that's your game plan, and you concentrate on those issues, and then you let the assistant secretary who's covering their area manage their policy. They're accountable if they screw it up. But those people are in the dark about the game plan for key issues. Baker kept it close. He was a great guy to work for. He was a savvy Washington person who understood the media well and managed media relations well.

I enjoyed working for them both. I think the swap came at the right time. Don Regan did a lot of great things as chief of staff, but he didn't understand the President's relationship with his wife. That was not good.

MR. SMALL. Bob Woodward, in his book *Maestro,* wrote about the relationship between Jim Baker and Paul Volcker. Do you have views on what that relationship was like?

MR. JOHNSON. They got along well. Baker is a shrewd guy. He had great people skills, yet he could be tough. I think Volcker found him a formidable person. I know Paul was not comfortable with the G-7 and the way they were managing currency after the Plaza Accord. I think he felt that they were limiting his choices, which they were in many ways. Yet I never thought Baker was trying to purposely box in monetary policy for purely political reasons. He thought the stable thing to do for the country was to create currency coordination. I was not a currency coordination type, myself. I supported Paul on this issue. Where Paul and I disagreed was on the macroeconomic picture. It wasn't over exchange rate management by the G-7.

MR. SMALL. Knowing what you now know about the Fed, do you think Jim Baker understood the Fed well—how it worked, how you deal with it?

MR. JOHNSON. I think as much as anybody in that job, unless he or she has a pure monetary background. I thought he understood it enough for his job. But he was not a monetary theoretician. I think he saw monetary policy as one piece of the puzzle. Policy was a big balancing act. That's why the Plaza Accord—to balance the trade risks against exchange rate risks. He tried to identify where the pressures were and address them. He was a problem solver—not a purist, by any means. If you were a monetary purist, he was not going to make you happy.

I had some of my own frustrations with his undersecretary David Mulford. Some of the things that were going on in the G-7 with currency intervention drove me crazy. When I was at the Fed, we had a big confrontation with the Treasury over that. The Fed was trying to restrain inflationary pressures, and Treasury was still undermining our efforts with heavy dollar selling. Of course, we sterilized the interventions, but the contradictory policies confused the markets and added risk premiums to interest rates.

Bush Task Force on the Regulation of Financial Services

MR. SMALL. Did you have much involvement with the task force headed by Vice President George H.W. Bush? The task force was formed to make recommendations to simplify the regulatory structures of the financial services industry. It consisted of the heads of the federal regulatory agencies, the SEC, the Attorney General, the director of OMB, and others.

MR. JOHNSON. Yes, I was involved in that. I was always a big believer in deregulation through a holding company approach. Also, I favored simplification of the layers of regulation that existed with state and multiple federal regulatory agencies. This is still a problem.

After the stock market crash in 1929 and the Great Depression, the banking acts in the 1930s and the Glass-Steagall Act were created to separate other financial activities from banking due to the perception and reality of self-dealing. Over the years since then, a lot of technological change had taken place; there was a lot of financial innovation. The Glass-Steagall Act was becoming outdated in its original form. Banks were becoming more sophisticated. We had deregulated interest rates in the 1970s not because regulators necessarily wanted to, but because financial innovation was getting around the regulatory structure to compete for customers. It was becoming impossible to have capital controls and interest rate controls, so those were deregulated. There were more and more ways around the Glass-Steagall Act. It became harder and harder to deny financial companies involvement in some related activities, especially some of the more limited ones. Glass-Steagall drew a clear line between all of them, although there were minor loopholes for less than principal amounts of some services.

The one major principle here is that of moral hazard. After the 1930s, when we created deposit insurance—but even when we created the central bank in 1913—we created a safety net to smooth out financial volatility and allow banks to have emergency access to discount financing from the central bank when the private market would not supply credit for risky activity. We created deposit insurance to help stabilize the volatility of deposits in the banking system and protect public savings.

These services are basically subsidies. I'm a big believer that when you give somebody a subsidy, the risk that is subsidized no longer becomes fully priced into their own risk calculus. Then you have the potential to overconsume, or you overinvest in the area that's subsidized, just like anything else. If you don't offset that encouragement in some way, you're going to get overexpansion, or what we call "bubbles." At that point, there's no pure free market in banking or finance. The prices are distorted in the marketplace toward risk-taking, and it's up to the central bank and other bank regulators to offset that in the pricing mechanism. So you have to have regulatory requirements on the structure of banking.

After the 1930s, bank holding companies were established to separate some of those risks out. The bank itself, which was taking deposits and making loans and had access to the Fed's discount window and deposit insurance, would be walled off within a company. This bank that had the subsidies would be simply a subsidiary of a larger company walled off from the larger company, which was allowed into some other very limited financial services and could raise money at the holding company level through floating commercial paper, equities, or other forms of funding. The holding company could downstream money to the bank, but the bank was never allowed to take insured funds and upstream them out of the bank. That's what the holding company structure was for.

I always strongly supported that structure under the assumption that it had to be strictly enforced. You couldn't let gray areas form around the holding company. It had to be clear to the public that the banking subsidiary was the only insured facility. No funds in a core bank were allowed to be used to fund any other nonbanking activities of the company. I think as long as that model was pursued vigilantly, it was a safe model. There's always been debate about whether you can enforce firewall laws.

European banks and Far Eastern banks have never had that kind of structure. They do everything directly through subsidiaries of the bank. It has always created difficult international regulatory issues.

MR. SMALL. What was the role of Vice President George Bush's task force? Don Regan was Treasury Secretary.

MR. JOHNSON. The role of that task force was to support this bank holding company model and push deregulation and regulatory consolidation/simplification within the framework of bank holding companies.

Generally, the Reagan Administration position was deregulation within a holding company structure, and that was what the Bush task force—or Treasury, for certain—was promoting. We floated legislation, but I don't think we got anything fundamental through in those days. When I got to the Fed, we did make some decisions to loosen up Glass-Steagall through the loophole of the "primarily engaged" language, but it was always within a holding company structure. Again, the architecture is only as good as you enforce it.

Moving from Treasury to the Fed

MR. SMALL. Let's talk about your transition to the Board. How did that come about, and what was the process like?

MR. JOHNSON. After two big tax bills and five years at the Treasury, I was totally burned out. I was going to leave. In fact, I was already considering an academic chair at Southern Methodist University in Texas or returning to George Mason University in Virginia. I went to see Jim Baker and told him that I was done. I was burned out. I had to leave. He said, "Give it a few days, then come back and talk to me once you think that through." When I went back to see him, he said, "What would make you stay?" I said, "I don't think there's anything. I've seen enough sausage made." The 1986 Tax Reform Act was a long, difficult experience. So I said, "I'm ready to head back to academia."

He said, "What if a position came open at the Fed?" I said, "I hadn't thought about that." He said, "Well, think about it." Chuck Partee's position as a Governor at the Fed was coming open. I came back, and I said, "I admire the Fed. That's a place where you don't have to deal with the politics anymore. That might make me stay in Washington." He said, "There's a position opening up. I'd like to recommend you for that. But you have to lay low." If names surface too early, you become a target. So I didn't say a word about it.

Jim Baker went to President Reagan with the recommendation, and Reagan said, "Okay." Baker told me that the President had approved the nomination, and, if I was okay with it, he would announce it. He said, "There's one other Governor position open. We want to put both forward at the same time. Just stay quiet on it." So they did. Wayne Angell ended up as the other nominee. Both nominations were cleared, and then they were announced from a very tight circle. The Fed nomination was the only thing that kept me in Washington.

MR. SMALL. Was there anything special about your nomination hearings?

MR. JOHNSON. It had been played up as controversial. There were already two Reagan appointees on the Board. With our confirmation, you would now have a majority of Reagan appointees at the Board. That became a big event, much bigger than I wanted it to be. There was speculation that a majority of Reagan appointees on the Board would change the dynamics of the Fed. Most of the stories written suggested a political motivation, but that was just not true.

I spent five years at the Treasury working with the Fed and engaging in many luncheon and breakfast meetings between the two organizations. I admired Paul Volcker. He was highly respected. There were people in the Administration that didn't like him and wanted to replace him. They floated names to replace him, but President Reagan, Jim Baker, and even Don Regan, with a monetarist view, did not want to replace him. In the end, they stuck with Volcker. Some of that was the pressure of the markets, but most people just respected him.

February 1986 Vote on the Discount Rate

MR. JOHNSON. There was this controversial out-voting of Volcker that I assure you was not political. There was no political understanding. It was an intellectual disagreement, for the most part. I think Volcker was determined to exercise his authority. Paul would probably disagree. There's a long story about trying to work out a compromise behind the scenes before the vote. In the end, I think he was worried about the currency issues. Personally, I think he was too stubborn in trying to enforce his will against the G-7 when the macroeconomy was slipping away.

We had seven to nine Reserve Bank discount rate requests pending with the Board to lower the discount rate. They had been pending for quite a while. The economy was clearly deteriorating. We ended up with a negative quarter of real growth around that time. We were right on the verge of recession and OPEC had collapsed, so inflationary pressures were declining. I think Paul was trying to break the back of the currency zone system. My view was that the macroeconomy couldn't afford that debate.

We had to go ahead and move. There was never a cabal of four people that sat around in a meeting and said, "We're going to take over the place and run all this." We didn't talk. In fact, there were clear Sunshine rules, so we avoided group discussions like the plague. I certainly knew where the other three Reagan appointees stood. I knew that if we all decided one day to take a stand, we had the necessary four votes. When Angell and I talked, we knew that if we decided to vote for a discount rate cut, that was going to swing it. In those days, the fed funds rate didn't control monetary policy; the discount rate did. FOMC procedure required targeting borrowed reserves, so when the FOMC voted, it voted on a spread of the discount rate relative to the fed funds rate in order to produce the desired amount of borrowing. At that time, the discount rate was kept below the funds rate for this purpose.

I never understood why the FOMC was comfortable with that approach. Paul was very shrewd in the late 1970s and 1980s when he engineered a tough monetary policy. I always assumed this approach was used to enhance his control. I'd be fascinated to know the inside details. I never had a long talk with him about this procedure. It was a very shrewd plan to come up with that spread. It handed all the power to the Board. All the Board had to do was get four votes for a discount rate cut, and the funds rate had to move in order to maintain the proper interest rate spread associated with the borrowed reserve target. When the discount rate was changed, the funds rate had to automatically be adjusted to fulfill the borrowed reserve target directive of the FOMC. The FOMC never had to do anything unless it wanted to change the borrowed reserve target other than ratify the new levels of the funds rate.

When the Board met on February 24, 1986, four Governors, including myself, argued to lower the discount rate. Paul disagreed and held firm, expecting the four Board members to back down. Efforts to reach a compromise ensued, but Paul saw the whole discussion as a challenge to his leadership and would not give in. So, after a protracted discussion, the Board voted 4–3 to cut the discount rate, and Paul was in the minority. He walked out of the Board Room, and we had to fashion a statement without him.

In the end, we postponed announcement of a cut in the discount rate when Paul agreed to call Karl Otto Pöhl (president of the Bundesbank) and Satoshi Sumita, who was head of the Bank of Japan at the time, to see if we could coordinate a rate cut in all three countries to avoid exchange rate pressures. And we did. We achieved two global coordinated rate cuts out of this policy effort. That had never been done before. I don't think it's been done since. Coordination finally broke up on the third effort, because there were leaks coming out of Japan to their banks. We decided we couldn't coordinate anymore.

That was an amazing period. Now, I am sure that the Reagan nominees on the Board would not have supported this policy just for currency stability if we hadn't believed that the domestic macro decisions were right. And I think they were, to this day.

I do think we became too aggressive, and a fourth discount rate cut went too far. Oil prices had collapsed in 1985, and OPEC had broken up. I think we hoped it had collapsed permanently, but OPEC was put back together. We realized then that we went a little too far.

MR. SMALL. What was the atmosphere like during and after the discount rate vote, and how did it affect the relationship among Board members?

MR. JOHNSON. When we were in the Board Room in an executive session talking with Paul, Ted Truman had a note delivered into me. I still have the note to this day. It says, “Please don’t let it happen this way.” I held up the vote for a long time, to the point that Wayne Angell looked over at me and said, “Are you with us or not?” I was trying to delay the vote to allow Paul to lead the decision. In the end, I think Paul was determined to see if he could use his personal credibility to back down the majority. I could not continue to delay the vote in good conscience.

After the vote, Paul got up and walked out of the room. We called in the press person to draft the announcement. You felt like you were making the decision to drop the bomb. It felt lonely and cold in the Board Room, but we drafted an announcement.

As soon as we finished, I went to my office, picked up the phone, and called Jim Baker, because I knew Volcker and Baker were having lunch that day. I told Jim what happened and said, “Nobody wants this to happen. You’re having lunch with Paul. You’ve got to talk to him. See what you can do.” I got a call back from Baker, and he said he thought he’d made some headway with Paul and that we should talk to him again.

When Volcker got back from lunch, Wayne Angell and I went into his office and said, “If you’ll work with us, we’ll work this out.” The time was ticking. You could see the clock ticking toward 4:00 p.m. I went over to Volcker’s office after the market closed. It was getting close! We sat in his office and worked out an agreement on calling our central bank colleagues. We went back into the Board Room. Martha Seger and Preston Martin were furious that we had postponed the decision. It took about a week before it all came together.

Karl Otto Pöhl is a great friend of mine. When Volcker called him about coordinating the rate cut, Karl Otto was in Israel. Karl Otto agreed, because Paul said his job was on the line. He said, "I'm going to resign if we can't work this out." Karl Otto got the Bundesbank board to pull together. The Japanese were a little easier. In those days, you called up the Ministry of Finance, and then they okayed the policy. The vice minister of international finance, Makoto Utsumi, was an old friend of mine. It was worked out. That was a great moment, globally, in international coordination.

These events did change the dynamics at the Board. The Fed was no longer a big, dictatorial place after that. Paul knew that the Fed had become a more democratic institution. He worked more with the Board afterward. The other dissenting Board members were very supportive of Volcker and mostly deferred to his leadership. However, Henry Wallich was a separate intellectual force and highly respected. He was an old-school gentleman and rarely rocked the boat. Unfortunately, he became ill with a brain tumor and really wasn't himself during this period.

Being Vice Chairman of the Board

MR. SMALL. Soon after, Vice Chairman Martin left in April 1986, and you became the Fed's Vice Chairman in August 1986. Did that role change your life much?

MR. JOHNSON. The vice chairmanship is an interesting position. It can be important or not that important. It's not empowered with any special authority other than you are the spokesman in the absence of the Chairman. It's a separately confirmed position—it's the only other official position in the Fed that has to be nominated by the President and confirmed by the Senate. It is the natural fallback if something happens to the Chairman.

When I served in that role, there weren't any clear definitions for it other than those things that I mentioned. To me, once you held that position, you needed to become a consensus builder. If it became a separate power center to the leadership, things wouldn't work well. Of course, you had to have confidence in the Chairman. I don't think I ever dissented in that position. I had plenty of internal discussions, especially over foreign exchange. I was pretty tough on foreign exchange issues with the Treasury; I think Alan Greenspan was happy to have me be the "bad cop." I did not want to agree to some of the swaps that we were being pushed to do by the Treasury Department. I know I put Ted Truman through a lot of grief in those days. He was always trying to iron that out. He'd engineer these intervention arrangements. I was always trying to slow him down. [Laughter]

MR. MARQUEZ. During that period, I think the Board and Treasury intervened more often than since then and before then. There were a lot of interventions on both sides.

MR. JOHNSON. I was never comfortable with a lot of that, especially when we had made macroeconomic decisions to tighten policy, and the G-7, and especially the Treasury, was going out and engineering massive dollar sales. I thought it was completely counter to what we were trying to accomplish. It was putting risk premiums into the interest rate market. The argument was always that it was sterilized. Well, it made sterilization difficult. To me, it was counter to the fundamentals of our policy. We had to move rates further than we otherwise would have because of dollar sales.

There are times for intervention to avoid a speculative one-way street. I learned that lesson in my Treasury days. There always has to be the threat of something. It should be used very sparingly, just like my point about the Bundesbank being vegetarians and eating a cheeseburger once in a while—of course, you've got to do that once in a while. But you've got to have credibility, which means consistency with economic fundamentals.

I think the currency zone system came unglued over time because it was not consistent with fundamentals. I thought Jim Baker's personality and the strength of his coordinating abilities made it work for longer than I would have thought it would work. It probably created some goodwill among governments in coordinating other structural policies. I think he saw it as a way to reach more agreement on structural coordination and other issues. Everybody was under the tent. You show that you're willing to cooperate in a G-7 community, and you can ask for things.

The Greenspan Years

MR. SMALL. You came to the Board in February 1986. Shortly thereafter, you had that first discount rate vote. After that, the discount rate was lowered uniformly through the end of Volcker's term in August 1987. Then Alan Greenspan became the Fed Chairman and raised the discount rate. Was it because economic conditions changed that Greenspan saw the economy differently? Was he defensive about squandering the legacy of lower inflation, so he was going to take no risk?

MR. JOHNSON. I think there are a couple of things there. One was macroeconomic. When Volcker left the Fed, the economy was strengthening. OPEC had gotten its act back together. Oil prices had started rising again, which was a big relative price. Over time, sustained moves in the oil price can affect expectations. Inflationary expectations were starting to build up as the stock market boomed. People were feeling wealthier and spending more. There was a growing divergence between stock prices and bond prices. When they're moving in sync, it's one thing. When they're starting to diverge strongly, it's a real red flag. Stock price increases were defying the higher bond yields.

When Alan Greenspan joined the Fed, those economic forces were starting to develop. At that time, the FOMC's position—and the Board's, because we were still in those borrowed reserve target days—was to let market pressures gradually push up the funds rate and then eventually adjust the discount rate as borrowed reserves increased. The fed funds rate was really a stealth instrument. You wouldn't announce anything and just let the funds rate firm up. Let the spread widen a little bit, so we could gradually work our way into a tighter policy. The discount rate in those days was the big announcement. It was like dropping a bomb. We were trying to avoid the big announcement.

There were two things going on with Alan. He could see the macroeconomic pressures building. Alan was getting beat up pretty bad in the press as a political hack when his nomination was first announced. Having been part of the Nixon Administration and the Ford Administration as CEA chairman during the era of wage and price controls, his political nature and commitment toward fighting inflation was suspect. His mentor, Arthur Burns, was already tainted as too political. There were a lot of media stories suggesting that "Alan Greenspan is another Arthur Burns."

MR. SMALL. He was a student of Arthur Burns.

MR. JOHNSON. Right. Alan felt the suspicion. He was very sensitive to it when he came to the Fed. He was quite worried about his credibility. There was resistance to a discount rate increase by the Board. In the end, I think we all conceded to his wishes to raise the discount rate because we understood the credibility issues. We didn't want those doubts about the Fed's credibility. We were all gritting our teeth. This was going to create really big ripples. But we went through with it, and it did create big ripples. It was probably inevitable. We had already allowed the funds rate to drift up, so the discount rate would need to adjust at some point.

Anyway, as a matter of timing—and I think maybe Alan was right—the later we waited, the worse it might have gotten. Anyway, we decided to go ahead. I remember having to tell Jim Baker when the Administration was starting to gear up for a presidential campaign.

MR. SMALL. By that time, he was the campaign manager for George H.W. Bush?

MR. JOHNSON. No, that was a little later. He was still Treasury Secretary at the time. He was very gracious. That's one thing I love about Jim Baker. He was not happy. He knew the consequences for the campaign, but he said, "You have to do what you have to do. I'll respect your decision. This is going to give us a lot of pain."

MR. SMALL. Does moving, or the possibility of moving, right before an election—the assumption "Let's not do anything and get through the election" to be apolitical—

MR. JOHNSON. I think there's always a feeling in the markets and elsewhere that, when you get close to a major election, the Fed's preference is to delay until it gets past it. I think there's some truth to that. I've been part of discussions in my Fed days concerning whether we really think that fundamentals justify a change in policy or can it wait a few weeks, because nothing is quite that certain, within a narrow window, that it can't wait a few days or weeks to avoid political controversy. Unless you think it's totally unavoidable, why bring on a potential challenge to your independence? Appearing arrogant in the face of an election could create a campaign theme for politicians. However, if we thought market expectations were going to ratchet up or down on the basis of a delay, I don't think we would have hesitated in changing policy.

I wasn't there, so I don't know what the internal dynamics were, but the most difficult situation that I observed from the outside was the delay after the contested election between George W. Bush and Al Gore that was decided by the U.S. Supreme Court. I do think Alan—but I haven't talked to him about this, so he may find me totally wrong—wanted to get through that election. But it was contested and held up. Then the Fed had to make a dramatic change right after the election was resolved, but it wasn't until January or February. It had to wait much longer than expected. If you had it to do over again, would the Fed have moved before, knowing what happened? I don't think anybody would have predicted such a delay, but the wait was costly.

Another example I remember, several months after I left the Fed, was as a consultant regarding a Treasury refunding period. I was asked a question by a financial institution that had clients on a conference call. The discussion involved an upcoming FOMC meeting that turned out to be on the day of a Treasury refunding. Speculation in the market, evidently, was that the Fed would never change policy during a Treasury refunding. It would be very disruptive. I was asked what I thought. I said, "I can tell you this. I never cared whether Treasury refunding was actually occurring. I didn't look at the calendar to see whether a Treasury refunding was coming up during the FOMC meeting. I'm not saying that the Chairman wouldn't notice, or the Treasury wouldn't mention it at one of our lunches or dinners and remind the Fed that the FOMC meeting and Treasury refunding were coming up at the same time." I said, "I don't remember the Fed ever considering postponing a policy decision during a Treasury refunding or whether we thought it was important to do so." I guess I got lucky with my analysis because, lo and behold, the Fed moved on the day of the refunding. [Laughter] Everybody thought I was a genius. But that was the culture, and I made it clear that the Fed doesn't think that way.

It doesn't think that way about elections. If the FOMC thought that a change really had to be made, it would make it. Even today I wouldn't change that view. I think the Fed is under political pressures more than it has ever been. I don't know how that gets factored in today. I'd hate to be Ben Bernanke.

MR. SMALL. Going back to the first discount rate increase under Greenspan, you might have felt that things looked okay.

MR. JOHNSON. Yes, except that bond and stock values were diverging dramatically. We didn't like the dynamics. Somebody was wrong. The bond market was wrong, or the stock market was wrong. The stock market was booming and ignoring the rise of long-term interest rates. The yields on stocks had gone to nothing compared to bonds. It was a troublesome dynamic.

MR. SMALL. What did Greenspan bring to that discussion that Volcker might not have?

MR. JOHNSON. Alan was much more attentive to the fine points of the economy. The major difference between Alan and Paul was that Paul was the ultimate in big thinking; he didn't want to know the details. He thought in fundamental, almost moralistic terms. He hated to be bothered with noisy numbers.

During our economic briefings on Monday mornings with Board staff, Paul was notorious for sitting in the Board Room reading the newspaper. I remember saying to him, "Paul, you can't sit there with the *Wall Street Journal* in front of your face while Mike Prell is giving his presentation. You're hurting their morale." He would smile. He thought it was funny. They all respected him anyway. Those were his cigar-smoking days. He was the only Board member that used a big recliner chair. Everybody else had those big leather Board chairs. He'd literally lean back in his chair, smoking a cigar and reading the *Wall Street Journal,* while the briefings were going on. Of course, he always heard everything that was said. He was bigger than life.

Personal computers were becoming more commonplace. Just before I left Treasury for the Board, we had PCs on our desk[s] so you could get financial market data from Reuters. There was only one little Telerate machine at the Fed when I got there. It was in Steve Axilrod's office. It was a little black box with a green screen. That was the only real-time financial data at the Fed. When I got here, I said, "Paul, come on. You've got to modernize this place. You've got to get some PCs in here." He said, "I'm not ever having a PC on my desk. But you can bring them in if you want." Ted Truman and Mike Prell brought him a paper report at the end of the day summarizing the financial markets.

Alan was mesmerized with every nuance in the data. In one FOMC meeting, Greenspan started boring in on commodity prices and asked about the tomato market. Mike Prell said something like, "The tomato market? The price of tomatoes? What's that got to do with this?" Alan absorbed huge amounts of data. He was very intellectually curious about detailed data.

Staff were somewhat frustrated by both Chairmen. Volcker didn't seem to ever listen to anything they said. But the truth is, he did listen, and he heard what they said but did not think it very important. Volcker was somewhat of a procrastinator. He made big decisions, but he put off decisions on little details for a long, long time, just letting small pieces of evidence accumulate until he could clearly see the fundamentals, then he'd react. Alan was a micromanager, but only on macroeconomic and monetary issues. Alan was not very interested in regulatory matters.

MR. SMALL. When the stock market crashed in 1987, you were conservative and a believer in the free market, and, as the new Fed Chairman, Greenspan had similar thinking. But another key player, Jerry Corrigan, might be viewed in the Volcker camp of thought and as a believer in heavy-handed regulation. Was there a clash of cultures?

MR. JOHNSON. There was more of a culture clash between Jerry and me than Alan and Jerry. Jerry and Alan got along great. In spite of his supposedly "Ayn Rand" background, Alan basically accepted institutional structures as they were. He believed in laissez faire—in theory. Early on, I think Alan's biggest problem was that he was like a detached professor watching it all happen like he was in a laboratory. During the stock market crash, Jerry had to emphasize, "Alan, you're the Chairman of the Federal Reserve. People are expecting us to act. They're expecting you to be the leader. This is not a laboratory. You can't just observe this like some professor." He got into the job very well over time, but those were early days. I think Jerry would say the same thing. Jerry and I respected each other and worked well together during G-10 central bank meetings in Basel, Switzerland. However, I believed more in the market's efficiency given the right structure. To me, Jerry believed in "animal spirits" no matter what.

MR. SMALL. When the stock market crash occurred on that Monday, Greenspan was out of town.

MR. JOHNSON. He was on the way to Dallas. There's a famous quote from Alan after he arrived in Dallas. Robert Boykin, president of the Dallas Fed, met him at the plane. Alan asked, "How did the market end up?" Boykin says, "Down 5-0-8." Alan says, "Wow, what a comeback! That was great. Only 5 points." Boykin said, "No. 508 points." People forget today that that was 23 percent of the market. For that to be the case today, what would it be? When the Dow average was up at 14,000, you're talking about a 3,000 point decline in one day. It was that equivalent. Today it would still be 2,000 something on the Dow Jones Industrial Index.

MR. SMALL. How much did you learn about the financial plumbing?

MR. JOHNSON. I learned a lot about plumbing. I was chairman of the Payment System Risk Committee. I learned a lot, and it was tedious. So much of the payment system risk analysis was bogged down in the minutia of the language. Most of it could be simplified into very clear points if you could break through the language of the payment system, but the system was quite complex.

MR. SMALL. Is that crisis an example in favor of housing monetary policy and regulatory policy in the same institution because you need the expertise?

MR. JOHNSON. The Fed has always argued that point. The Bundesbank used to argue the opposite point. They always felt that it added an element of political pressure that they didn't want. When making a decision, they didn't want to know if some bank was failing. Their argument was always that they did not want to cross that moral hazard line. It's better for them not to know that their actions are going to cause some bank to fail, because that's the marketplace; that's the bank's risk. The central bank should stay focused on price stability.

Of course, systemic failure is everyone's risk. So the tough problem is figuring out where the line is between moral hazard and systemic failure. And assessing systemic risks argues for combining regulatory and monetary policy. There's a fine line there.

I accept the notion that it's useful to know the condition of the banking system. After all, it is the primary source of monetary transmission. But there is a risk to knowing too much about bank balance sheets, especially if you are directly responsible for monetary policy and maintaining price stability. It could make you blink when you shouldn't blink. A good example today is the Fed's decision to engineer a complete bailout of AIG's credit default swap payments to large banking institutions. This decision was the ultimate in moral hazard exposure.

Proper regulatory policy has always required "haircuts" on failed securities holdings of banking institutions. The rule is supposed to be mark-to-market or at least fair value. This regulatory failure is a strong example of the influence of large bank interests on their primary regulator. Some policymakers have tried to argue that this situation was a matter of systemic risk, but it is difficult to see how properly assigning at least some losses can cause systemic failure.

I think it's quite useful sometimes for the central bank to have regulatory authority. I used to defend that approach pretty strongly. But I am not sure anymore, since it has been shown that it creates a large moral hazard risk.

Federal Reserve Regional Structure

MR. SMALL. The Fed has this odd regulatory structure of working through the Reserve Banks because that's where the examiners are. The Board delegates authority to the Reserve Banks when appropriate. Do you think that structure works well?

MR. JOHNSON. I think it's an obsolete structure. I thought that even when I was at the Fed, given the way the technology was changing, especially in the payment system. I think the only arguments you can make for Reserve Banks today are as intellectual centers, maybe regional data-gathering to foster regional support.

MR. SMALL. One argument you hear is [about] political support for the Fed's independence. You've got these 12 [Reserve] Banks, the board of directors, the small banks, and the businessmen when the Fed needs—

MR. JOHNSON. That's a powerful network. That is a strong argument—that it creates a community support network. That could be dangerous, too, if you're pursuing bad policies.

The Fed Experience

MR. MARQUEZ. What Fed experience did you take away with you to your next line of work?

MR. JOHNSON. The professionalism of the Fed is outstanding. I loved serving at the Fed. The integrity of the system, all of it was great. Perhaps the most important experience for me, which carried onto my next line of work, was learning to analyze information objectively and accept the results even if they did not fit your theory. It's important to have an intellectual framework, but to conduct policy successfully you must be willing to question your assumptions if the evidence doesn't support your model.

MR. MARQUEZ. That reminds me of something along the lines of what you were saying earlier about your eclecticism, for example.

MR. JOHNSON. Yes, my experience definitely made me a more pragmatic person, knowing that the world is much more complex than any macroeconomic model.

MR. SMALL. Speaking about going forward from here with all the financial regulation and ideas that are on the table, do you think there are some issues there that the Fed experience helps you understand better?

MR. JOHNSON. I'm not happy with most of this financial reform. But one part of reform that I think is an improvement over what existed before is addressing the "too big to fail" question. I don't think they've done enough in the reform legislation. It could be much stronger. Also, there could be more transparency in the derivatives markets by moving toward exchanges. On most of the other changes, I think the Congress is creating another layer of regulatory control that is already in place. I have never felt that the Fed, nor other financial regulatory agencies, lacks the power to do what it needs to do.

MR. SMALL. Have you given up on the bank holding company structure as being practical?

MR. JOHNSON. I'm very frustrated about it. I still think that's the way to structure things, but I must admit that there is very little of this model left intact today. We now have wrapped the federal safety net around everything, not just the financial system. The entire economy has access to the safety net. There's massive moral hazard out there today, on a scale that I never imagined. I don't know how to put it back in a bottle. It's very frustrating. I thought that in the 1980s we had a chance to make the holding company model work, that we could limit access to the safety net and let banking institutions fail, to create discipline in the system. But I think the discipline has broken down. Look at Europe today. This is probably too simple an analogy, but when people ask me, "What's happening in the world?" my comment is, "Europe is becoming Argentina, and we are becoming Europe." By that statement I mean the United States is vastly expanding its welfare state in a way similar to Europe, and Europe is moving toward third-world status.

MR. SMALL. Do you think, in principle, the Volcker rule would let the Fed or the country allow more failure over on the securities side? Then you can more easily let the securities firms—

MR. JOHNSON. Yes. I'm not against the Volcker rule. I haven't called Paul. I thought about calling him a couple of times, saying "I support you." I'm a little worried that there are some extremists that are using the Volcker rule to completely denounce the entire financial system. I'm all for getting conflicts out of the core bank and moving them somewhere else. I'd still like to think we could do it in a holding company structure, but I'm almost at the stage now where I'd support going back to Glass-Steagall. This is a pipe dream, but my preference would be to scale back the financial safety net to a very small sliver of core banking and let the rest of the financial system assume responsibility for its risk-taking. Even if this could be achieved, it would be difficult to convince the marketplace that bailouts would not occur in a crisis.

MR. SMALL. If you were to reconsider and take that chair back at a university and have the academic life, what kind of issues would you like to study or teach?

MR. JOHNSON. If I went back to academia, I'd do a lot of symposiums on the kinds of things we've been talking about. I am more concerned about the structure of the financial system and the economy than I am about monetary policy.

I think the Fed's done a wonderful job on monetary policy over the years. I think Bernanke was the man of the moment recently. I wish he'd be a little stronger—more out front—on banking reform and the bailout problems. I know that's not his forte. He's a macroeconomist, and I think he's an excellent one.

We're fortunate to have had him at the Fed when the system collapsed, because I'm not sure other personalities could have accomplished the liquidity requirements the economy needed. But the bailouts, in my opinion, have gone way too far. I don't completely blame the Fed for that. I think the Fed, the political system, the Treasury, big bank influence, et cetera, are all to blame. We've bailed out the world and lost most of the market's ability to instill discipline. Now we're under a big command-and-control system that I hate to see, because it's not possible for regulation this vast to succeed. History has proven this point time and time again.

MR. SMALL. Has the Fed's experience of essentially hitting the zero lower bound on the federal funds rate caused you to rethink about what the optimum inflation rate might be? It might be higher to let real interest rates go lower.

MR. JOHNSON. I don't think the Fed should consider changing its preferred range on inflation rates. I don't think the concept you are suggesting accounts for market expectations very well. Added risk premiums on interest rates could easily offset the intended result. Many of the problems we face on jump-starting the U.S. economy are structural. The structure of the monetary transmission mechanism is severely damaged, as we have discussed. So credit flows to productive job-creating activity is weakened. Repairing these structural flaws should be a strong focus of policy.

MR. SMALL. Do you have any thoughts on the proper sequencing of the exit strategy?

MR. JOHNSON. I think the Fed has probably planned that out well. I don't know all the details, but I've followed what is in the public domain. I can read between the lines of what they're saying. It looks like they've stress-tested everything and have a pretty good plan for phasing out special lending programs and allowing securities holdings to run off as they mature. Longer-term low-quality securities are a tougher problem, but it looks manageable at this point.

As long as things are orderly, I think you can accomplish a smooth exit. I ran into Ben and asked him some broad question about this, and he pointed out that quantitative easing is not so simple. He said, "It's not that easy even if we want to ease. Securities mature, the balance sheet runs off."

The Fed is at least set up now to pay interest on reserves. I know the debate is going on in the FOMC about whether to manage the interest rate on reserves rather than the funds rate. There are a lot of menu items to allow the Fed to work its way out of this. I have confidence, as long as they're politically insulated, that they can do it. I think the fear is political pressure. When you've got this kind of debt built up and you've got to float that level of debt to the public, having the Fed support debt purchases with direct buying or with very low interest rates could be a serious problem in the future. We're now into the same potential problem we had in the 1940s and 1950s, trying to work our way back out of this.

MR. SMALL. Thank you.