Chief economic advisor to George W. Bush during his first two years in office, Larry Lindsey was previously a member of Ronald Reagan's council of economic advisors, George H.W. Bush's special assistant for policy development (1989-1991), and Federal Reserve governor (1991-1997). In December 2002, he resigned from the White House economic team as part of a dramatic shake-up which also saw the resignation of Treasury secretary Paul O'Neill.

In this interview, Lindsey discusses U.S. economic and monetary policy since the Great Depression and its effects on other regions of the world.

From Keynesianism to Neo-liberalism

INTERVIEWER: You write in your book about the economic ideas of Keynes. How do big economic ideas translate into everyday life?

LARRY LINDSEY: I think it was Keynes who said that today's policymakers are being driven by the scribblings of some defunct or dead academic—I don't remember the exact quote. I think it's in part through the learning process, through education, maybe two or three tiers removed. Rarely is the philosopher himself or herself the teacher of the policymaker, but they come to dominate teaching, academia, the thinking.

INTERVIEWER: And how, talking about Keynes in particular, have his ideas shaped economic policy in this government?

LARRY LINDSEY: Keynes's disciples became dominant immediately after World War II with the fear at that time that the country would enter a recession or depression once wartime spending stopped. The idea was, how would one manage to keep the economy going with the end of the war? It turned out it wasn't a problem; people had saved their money during the war and wanted to buy houses, dishwashers, cars, and everything else, so the problem took care of itself. But Keynes's disciples came into government really starting in the Truman administration.

INTERVIEWER: And how did Keynes's ideas play out [over the years]?

LARRY LINDSEY: During the '30s, we really didn't know what to do. It's important to keep in mind that Keynes's *General Theory*, which was the basis of what we now think of as Keynesianism, didn't come out until '37. What FDR tried to do with the early New Deal was less Keynesianism than it was trying to rig prices by catalyzing the economy. Roosevelt said he'd try everything, and he did. It was a very eclectic mix. But the idea caught on, I think in part with the success in World War II, that in fact when governments spend money, it creates jobs. The great fear that everyone had at the end of World War II in the '40s and '50s and even into the '60s was that we would have a replay of the 1930s.

INTERVIEWER: And how about the ideas of the opposition?

LARRY LINDSEY: For a lot of this period there was no battle. Keynes was so completely dominant in the academy that all other ideas—Hayek, Friedman—were really viewed as fringe. What happened was after we became "all Keynesian," in Nixon's phrase, the ideas seemed not to work so well. I was taught economics that was purely Keynesian in 1972. That was when I was a freshman. It quickly became obvious, in '73 and '74, that that paradigm was not going to work, and by the end of the 1970s the Keynesian solution just simply didn't fit reality. So these ideas, such as Milton Friedman's and Hayek's, people began to reconsider.

INTERVIEWER: Did you find yourself reconsidering that?

LARRY LINDSEY: Well, I was a prisoner of very traditional schools, and it probably wasn't until after I got out of school that I had to start thinking these things through. My thesis was actually a test of responsiveness of people to tax rates. One might think of that as either Friedman-esque or Hayek-esque, I don't know which, but it still contained a good portion of Keynesian thinking. I still think largely in Keynesian terms, but I do think that the ideas that Hayek raised that we now might call neo-classical or supply-side, and ideas that Friedman raised, or monetarist ideas, are also valid ideas, valid paradoxes. It's not that one is right and one is wrong; it's that you really need all three to function. Each one of those basic ideas has within it concepts that are applicable to economic decision-making. Some work better than others. Keynes works very well in the short run, particularly when you need stimulants. Friedman works beautifully over the longer run, particularly for determining the price level. I think Hayek and some of the neo-classical people, the supply-siders, have a better idea of how individuals behave and probably the best way of fostering long-term economic growth.

INTERVIEWER: And the 1980s began to see Friedman and Hayek's ideas work their way into policy.

LARRY LINDSEY: Sure. Jimmy Carter was maybe the high point of Keynesian behavior. It simply was not working, so the public decided it was time to experiment with something else. Decision-makers had to experiment with other ideas, and so the idea of monetarism took root. So did the idea of individual initiative, bringing initiative back into the economic process which, I think, may have had a lot of its roots with Hayek.

INTERVIEWER: And how did that play itself out in the Reagan years?

LARRY LINDSEY: The four pillars of Reaganomics, which were considered radical at the time, are almost mainstream now. The first was the concept of sound money; the second was deregulation; the third was modest tax rates; and the fourth was limited government spending. It sounds pretty conventional now, but when Reagan was elected he was vilified by his opponents as being some radical extremist. In fact, now Reaganomics would be viewed by most people around the world as common sense economic policy.

INTERVIEWER: In the late '80s, early '90s you saw Democrats, including Bill Clinton, starting to talk about some of those issues as well.

LARRY LINDSEY: Tony Blair in Britain said, "You know, we're all Thatcherites now." Bill Clinton didn't quite say "We're all Reaganites now," but in practice I think those ideas are considered pretty mainstream.

INTERVIEWER: Is it fair to say that without Reaganomics, what Bill Clinton did wouldn't have been possible?

LARRY LINDSEY: Oh, we wouldn't have had the prosperity that we had without what Reagan did. We also laid down the basic principles of limited government. Those aren't new to

Reagan, certainly, but they were new, say, in the postwar period, that individual behavior and incentives for individuals were very important. And those ideas are now widely accepted as true.

U.S. Monetary Policies and Financial Crises in Emerging Markets

INTERVIEWER: When Bill Clinton came in, they talked a lot about the benefits of free trade and the need for adopting NAFTA, which had been negotiated by Bush. What was the significance of their getting behind NAFTA and pushing it through?

LARRY LINDSEY: Well, free trade has been the one thing that has united economists of all political stripes for over the last 200 years or so. What we were seeing by the 1980s was that free trade was inevitable. We had successfully negotiated tariff reductions with Europe, with Japan. Trade was growing faster than world GDP, and the benefits of trade were becoming more and more obvious to the political establishment. Second, some of what we call the "vested interests" who might in the short run lose some trade were becoming less powerful. Others include some of the old classic industries and also, frankly, includes a lot of the private-sector labor unions who did not want competition. Remember, free trade is good for consumers because consumers have more choices and more people to go and buy from, maybe selling at lower prices. The triumph ultimately of consumer ideology over special-interest power was important. It was very difficult for President Clinton to make that choice. It represented a very important change in the power within the Democratic Party.

INTERVIEWER: And made it difficult really for Republicans?

LARRY LINDSEY: We all became free traders at one point, yes.

INTERVIEWER: And the Clinton administration also talked a lot about deficit reduction, taking a lot of credit for that being a stimulus for the economy in the '90s. What is your view of significance of that?

LARRY LINDSEY: It was a political decision. I think that cause and effect are a little bit confused. We had a long streak of good economic times, and government is a big beneficiary of good economic times. Whenever the economy grows 1 percent, Uncle Sam takes in 1.4

percent more revenue. So in 10 years at 3 percent growth, Uncle Sam gets 42 percent more revenue. You can quickly see, when you look at the numbers, it was this revenue surge that was what took care of the deficits. Any long streak of good economic times and you've got it. ... That was the key to getting rid of the deficits. What is surprising is that now that we may be having a little bit of a slippery slope in the short run. The basic ideas of Keynes are being forgotten; we now cling to the idea of a surplus as a sign of national economic health. They did that in 1930 as well and, in fact, when the surpluses started to disappear, the Congress raised taxes in order to try and get them back. Today we see many in Congress saying, "We know we can't afford to cut taxes when we're slipping; the surpluses are all-important." Keynes pointed out that was fallacious economic reasoning, that in fact you do want to stimulate the economy with tax cuts or with more government spending if the economy is [about] to go into a recession.

INTERVIEWER: We saw during the Clinton years an aggressive push to open markets around the world in developing countries, a lot of capital flying into emerging markets. What was your view of that at the time? Was that all happening too fast? Were there enough institutions in the developing countries to handle that kind of advance?

LARRY LINDSEY: Well, the big problem was that many of those countries had pegged their currencies to the dollar, and the Clinton administration came in and began to talk down the value of the dollar. That meant that these local currencies, the Malaysian ringgit and the Singaporean dollar and the Thai baht, all went down along with the dollar. Because they compete largely with Japan, that made them very attractive for Japanese capital, but for global capital they became the cheapest places in the world to produce. So capital poured in there at just absolutely unprecedented levels. Then the U.S. saw the dollar collapsing and changed its mind and started to talk the dollar up, and suddenly all of these countries, which were very profitable because of the cheap dollar, became notoriously unprofitable when tied to an expensive dollar. The dollar went from 80 yen to 140 yen. It's tough for these places to compete given that exchange rate change, and so we saw widespread bankruptcies. The problem was not the capital flow per se; it was the lack of flexibility in the exchange rates of these countries.

INTERVIEWER: Do you think the Clinton policy of encouraging countries to open up to the capital flows in general was a good idea?

LARRY LINDSEY: I don't think there's any problem with capital flows. I think there is a problem with capital flows when you're linked to someone else's currency, because remember, exchange rates are simply a price, and when you have too much capital come in, one of the things that happens is the price should rise. When they linked to the dollar, the price of their currencies didn't rise, so there was no incentive not to send more capital in.

Let me say it more simply. Exchange rates are part of the self-regulating part of the market. When you have fixed exchange rates, you kill off one of the natural regulators. This caused the boom to be bigger than it should have been in those countries, and it caused the bust to be bigger than it should have been, and the problem was that the U.S. was manipulating its exchange rate for political reasons, and these countries just couldn't keep up with the changes.

INTERVIEWER: At that time you were at the Federal Reserve?

LARRY LINDSEY: Yes.

INTERVIEWER: What was your sense of what was going on then? Did you see this happen?

LARRY LINDSEY: I remember the day very well. I had my screen in my office watching the dollar go down just below 80 yen, and I was worried tremendously about the way that the Treasury was handling the situation. Fortunately, things changed after that, but I think that the policy statements coming out of the Treasury were very destabilizing for the world economy. I think that if you're going to have the world's currency, there are some things you should not do, and one of them is try and manipulate your own currency, because there are others who are going to suffer the collateral damage when you do.

INTERVIEWER: Do you remember the cry for help from Thailand, and what should have been the reaction to it?

LARRY LINDSEY: I'd just left the administration, I was in the private sector, and I had to advise my clients on how to respond. Fortunately, they made money with our advice, but I think that, again, what we were beginning to see was the fallout from this change in dollar policy. Ultimately it meant the end of the fixed-exchange-rate regimes throughout Asia. The one country that did not end its fixed-exchange-rate regime was Hong Kong. It had a major real estate depression as a result and paid for it with frequent raids on its currency throughout this period.

At that point what we were trying to do was to apply standard creditor policy, which is make the guy pay it back, have him cut his spending, raise his sales. When you do that to one country it works. When you do it to an entire region it fails, because these countries trade with one another, and you were trying to tighten the economic screws throughout an entire region. This was IMF policy; this was the U.S. Treasury's policy. It was a dismal failure. It brought about the collapse of the government in Indonesia, something that we're now paying a price for. It brought economic ruin to a good portion of the Asian middle class. It was a very poorly designed policy.

INTERVIEWER: So the scale of the hurt in the region could have been avoided, lessened?

LARRY LINDSEY: I think it could have been dramatically lessened. The boom-bust cycle should have been mitigated. The U.S. should have behaved differently than it did. First, we did not take our international responsibilities seriously, and second, these countries could have done a better job by having a different currency regime.

[But the situation] had deteriorated so far that I wouldn't question the particular actions of what the Fed did. The problem is to prevent the crisis in the first place, and to do so, if you're going to have a world currency, it's important that it be stable. It's important that you have rules of the game set up around the world for creditors and borrowers, and we were negligent in not having set up those rules of the game.

INTERVIEWER: Now that you're sitting here in Washington, what can you do as a policymaker to set those rules?

LARRY LINDSEY: The main thing that you see this administration do is we continually support a stable and strong dollar. We are not going to talk down the dollar as was done in 1993. But we still have many countries out there that are tied to it, although they are fewer. We need to support flexible exchange regimes, we need to support free trade, and we need to support open capital movements. These are all part of the good side of the equation. As far as establishing rules of the game, we're watching them play out now. We have a lot of the remnants of the disasters of the 1990s. Indonesia, for example, still is a problem. We have a fixed-exchange-rate regime in Argentina, which has a challenge ahead of it. And there are other countries in the world that similarly have domestic economic policies that are not in keeping with the rest of the world, and we're going to have to look at those on a case-by-case basis.

Globalization and Personal Economic Freedom

INTERVIEWER: The world is changing so fast. The vice president was talking about how sovereignty is not what it was when he first came to Washington. How do you try to set the new global rules in a world that's moving so quickly and changing so rapidly?

LARRY LINDSEY: What has changed is we have a lot more freedom. That's the key point that's changed. A lot of the old rules involved people not being able to take their own money that they had earned elsewhere. This is often called exchange controls. One of the first things Thatcher did was to get rid of exchange controls in Britain, [a policy] which lasted until '79. You couldn't take more than £100 out of the country if you were British. It was a real restriction on personal freedom, and as a result, if you have restrictions on personal economic freedoms, governments can do a lot of things that, why don't we say, are foolish, and force their population to bear the pain. Now, governments have to behave. They cannot do economically foolish things, because their own publics will take their money elsewhere. One of the situations that happened during the Asian crisis was in Malaysia. The first thing they did was to limit the amount of money that Asian citizens could take out of the country. Well, this is a loss in individual freedom, and I think what we have to remember is that individual freedom puts restraints on governments and governments have to behave sensibly. If they don't, individuals are the ones who can take actions to protect themselves.

INTERVIEWER: One of the issues that we hear a lot—and I'm sure you do, too—is that any global economic system somehow has to take into account the needs of the developing nations. Before, we were talking to James Wolfensohn [president of the World Bank] the other day, and he sees in it an urgent crisis for our children. What can the promise of global capitalism, or whatever you want to call it, provide for developing countries?

LARRY LINDSEY: There are hundreds of millions of people today who think of themselves as middle class—[people] who 20 years ago had no dream of being middle class—thanks to global trade, thanks to open capital markets, thanks to capitalism. It is open markets, free competition, being able to sell your goods and your labor at the highest price you can find and buy goods at the cheapest price you can find that make people well off. The winners of this process are those individuals. The losers, as we just said, are the governments that would rather run affairs for their own ideological reasons. I think that a global trade freedom is probably the best thing we can do for economic development.

INTERVIEWER: What's your response when you see the protesters up in Quebec saying that globalization is unfair, [that it is] stacked in favor of the U.S. and the big corporations? What's your sense of what's going on behind that?

LARRY LINDSEY: A lot of those individuals represent special interests, and the special interests do lose power. If you have a cozy arrangement based on current laws in your government, you really want to see your government be powerful and you want to see individuals be weak, because you don't want people to be able to escape your special arrangement. That's what a lot of this is going on, as far as the protestors go. They're self-interested.

INTERVIEWER: Some of them say that they question the total legitimacy of the global economic system.

LARRY LINDSEY: I'm sure they'd rather be in charge. No, the way you maximize freedom, freedom for all people, is you let people trade anywhere they want, sell their skills, sell their labor to anyone who wants to buy it, and be able to buy goods from anywhere that people are willing to sell to them. That's how you maximize your own well-being, and we're doing that.

INTERVIEWER: We hear stories of sweatshops and buying goods from sweatshops. What is your view on that, and what's the other side of the argument?

LARRY LINDSEY: Well, first of all, in some places the conditions are deplorable, and that's largely because domestic laws are not being enforced. You know, there are some places for law in this world, and they should be enforced. But in many incidences we're talking about people who see the jobs they're taking as an upgrade. They're earning far more in those jobs than they could earn as landless peasants or as sharecroppers, which was traditionally the job they had beforehand. People, as the saying goes, vote with their feet. They go where the opportunity is greatest. That's how tens of millions of people came to America, because it was there that opportunity was greatest. If we look back at the conditions they moved into, they weren't very good, but they were far better than what they left, and that's why they came here. The same thing is true in the vast majority of cases overseas today.

The U.S.-Mexico Relationship and Free Trade in the Americas

INTERVIEWER: A couple of weeks ago we interviewed President Fox in Mexico, and obviously he and President Bush have a very good personal rapport. What is your sense of how the U.S. relationship with Mexico will play out?

LARRY LINDSEY: I think that Mexico is going to become probably our most important nation. Often at times we thought of that as Britain in the past. I think that's going to change. You know, 30 percent of U.S. trade now goes north; 30 percent goes south. Only 20 percent goes east, and 20 percent goes west. Not all of that goes to Mexico, but that's an important trading partner. We've got 90 million Mexicans, roughly, who travel across the border quite a bit. We have a more common labor market than we might think. We share this continent together, and I don't see much option. I think it's rather good [that] Mexico is going to become the most important country to the United States in the decades ahead.

INTERVIEWER: Have you seen the two presidents together?

LARRY LINDSEY: Just once, and they have good relationship. One of the things that impressed me about President Bush, and why I think he's such a fiscal free-trader, is he was governor of a state that shared a 1,000-mile border with Mexico. That border is an economy unit in and of itself, and it has been transformed by NAFTA. It's a tremendous thing to say, and the people in Mexico are benefiting so much from that trade and the ability to trade with the United States. It's a fantastic thing to see.

INTERVIEWER: We talked to President Fox and also [Jorge Castaneda], the foreign minister of Mexico, and they talked about a long-term vision of a coming together of two economies. What's your sense of how realistic that is?

LARRY LINDSEY: I think it's realistic. You never know what's going to happen. It's interesting: The world was coming together before the first world war also, and the share of world GDP that was involved in world trade, it's roughly what it is today. But World War I ended all that, and now we're proceeding again. If history continues on its recent course, the U.S. and Mexico are going to become very good friends and more integrated. But one thing history teaches us is that when you least expect it, along comes the surprise. So I don't think anything is inevitable.

INTERVIEWER: I just want to talk some about the free trade of the Americas and the long-term vision there.

LARRY LINDSEY: There are enormous benefits to be had from free trade that are still underexploited, particularly in the Western hemisphere. There are obviously a number of ways this could go. Brazil, for example, [which] has interests in South America, is the largest country in South America. It has a different image or role for itself as being the big player there. Many of the other countries in South America prefer the giant to the north, and so there's some conflict there. But I think over time our economies are going to become more integrated.

INTERVIEWER: Was that the goal of the free-trade agreement?

LARRY LINDSEY: Oh, I think so. Obviously, again, one of the best things we can do for development in South America is free trade. We have a vested interest in that, and I think that's also part of what's driving our goal here.

The U.S. Role in Global Financial Crises

INTERVIEWER: Mexico had a peso crisis in the mid-90s. What is your sense of what was going on there and what the U.S. did?

LARRY LINDSEY: Mexico had at that point a peso crisis every six years starting in 1976—'76, '82, '88, '94—and the reason had to do with their election cycle. Every six years the Bank of Mexico and the government of Mexico went on an unsustainable spending spree and money-creation spree to increase election prospects, and a crisis always followed. The U.S. every time stepped in, in part because we felt we had little choice. I don't think '94 was any different. The good news is that [the] one-party state in Mexico has now ended. Plus, it's a much more pluralistic society. There's an independent central bank. Things have changed, and I think that's all for the good. I think that the six-year Mexican peso crisis cycle was a function of the old politics, the old style of governing. It's not going to be part of the new international Mexico.

INTERVIEWER: Right away the Mexico bailout was seen as a problem, a crisis. There was fear of contagion. What was your sense of what might happen at that time?

LARRY LINDSEY: The Mexican bailout sent a signal that we were going to be engaging in bailouts. Remember, the people that got bailed out were foreign holders of Mexican government obligations, and in a sense, we were trying to bail out our own citizens. The price of the bailout was terrible for middle-class Mexicans. But it signaled to banks and other rich investors that the U.S. Treasury at that time was going to adopt a bailout policy, and that, coupled with the dollar policies and everything else, meant there was no stopping huge capital flows into Southeast Asia, which is where the next crisis happened and [the] next effort at bailing out [took place]. Again, the people who were bailed out there were largely people who'd done the investing.

INTERVIEWER: What's your sense of the pace of global crisis?

LARRY LINDSEY: I worry less about the pace of change than I worry about the tendency for people to forget the lessons of the past. I mentioned before that there are many in this town who forget the lessons of 1930. They've been saying: "Oh my gosh, you can't spend the surplus in the forms of tax cuts, even though the economy is going down. We have to preserve the government's surplus at all costs." That's exactly what they did in 1930. It's forgetting the lessons of the past that I think is the biggest threat.

INTERVIEWER: History is a guide, and while you're here in Washington, there will probably be some kind of financial crisis somewhere around the world. What is your sense, when the time comes, of how you might deal with it, and where you would draw the line? How will you decide what to do?

LARRY LINDSEY: It depends on the circumstances at the time. I think the key is to forget the shibboleth of the moment that may be driving consensus. There are some basic rules that work, and that is you want to have power and responsibility be in the same place. People who take risks should bear those risks—they got the reward for them; they should take the down side. What you want to do is you want to protect innocent people, people who did not get any benefit from the risk. That should be the focus of government policy.

The U.S. Federal Reserve and Paradigm Shifts in Institutions

INTERVIEWER: I'm going to ask you just a bit about the Federal Reserve. We were struck at the sense that the outside world is moving faster and faster, and inside the Fed things happen very slowly, very stately. You are still very connected. Can you talk about what it was like working there?

LARRY LINDSEY: It's a place that of necessity should not be driven by the panic of the moment. It should be a very reflective place, and it is. The pace is stately by Washington standards. The meetings begin on time; the atmosphere is very cordial and collegial. There's no rancor.... It's a good place for reflection and calm and considered judgment, not spontaneous political action. ... People are reflective. But the action, of course, that often takes place [is with regard to] institutions that are failing. We have staff people at the Fed who, when they close the doors at the bank at 3:00, their job is to get through the books and allow [the bank] to open at 9:00 the next morning under completely new management. We have experts who can do that. And so the Federal Reserve itself, the board of government, may have to stay up late to approve certain measures at that time, but fundamentally I think it's still a place of reflection.

INTERVIEWER: What's your sense of the Fed's role in the Great Depression?

LARRY LINDSEY: There was a case, again, where they were following a concept that had a lot of currency at the moment, that ignored the basic lessons of history. They were thinking in terms of something called the "real bills doctrine," which meant—well, I'm going to simplify it a little bit, but if the economy goes down in size you need less money. And I suppose it makes some common sense, so they did. Of course, when you create less money, lo and behold, you shrink the economy further, and that was part of the cycle that they were in. It took a while for them to get out of it.

[But nowadays,] what's important for people to keep in mind is that decision-makers are largely driven by the institutions in which they work, that someone who's viewed as virtually godlike in his powers, a Chairman Greenspan—and he'd be the first to say it—is just a human being carrying out certain roles that his job requires him to do. There are no miracles, no miracle workers in government, and perhaps people have a little bit too much faith in institutions. At the same time, those institutions often don't allow the flexibility that's needed because they tend to be driven by the ghosts of history and not by the needs of the moment. To stay creative, everyone's got to be driven, I think, almost the way a private-sector decision-maker is driven, and try not to get too stuck in the encrustations that build up on the institutions in which you're working.

INTERVIEWER: Let's just talk about Reagan and Reaganomics and some of the ideas that he took on board frequently. What were they about?

LARRY LINDSEY: I think it was, again, an encrusted paradigm that was failing. A lot of people had their reputations, their lives, based on a set of beliefs that was obviously no longer working. We were having double-digit unemployment and double-digit inflation at the same time. Reagan said the way you've been operating is what caused that; let's try a new course of action. People, and institutions in particular, develop vested interests in the way things have always been done, and challenges to the ways that things have always been done therefore aren't treated very favorably.

INTERVIEWER: Without getting into specifics, are we living through a period of paradigm shift now?

LARRY LINDSEY: That's a question that we're going to know much better the answer to in about 20 years. My suspicion is no. I think we're going to be staying in the basic idea of free trading and greater freedom. The good news is I think freedom is going to win out and the power of the state is going to lose. That's a side I'm on, and I think history is on that side.