

## **“Thinking about Risks Ahead of Time”**

**Jeff Frankel comment for *FT.com* on**

**Martin Wolf column, “Risks and Rewards of the World Economy’s Golden Era,”  
*Financial Times*, May 2, 2007**

Exactly right. When things look good is precisely the time (1) to remind ourselves that it won’t always be this way, (2) to take advantage generally of the opportunity to make long-term improvements, and (3) to enumerate the specific things that could go wrong – while recognizing that you will not be able to predict which ones of them will materialize – and to do what you can to reduce their odds or to prepare for their consequences.

Robert Rubin thought very much in these terms when he was US Treasury Secretary. Exactly ten years ago, he asked the Council of Economic Advisers to take a look at what risks might be out there and what corresponding advanced planning might be called for. It is not that either Rubin or we thought that these risks, even in the aggregate, were likely. We gave our little assignment the name “the Nirvana project,” which was meant to poke fun at the commentators who were saying that the US had achieved a “New Economy” in which recessions were a thing of the past. It is worth recalling that the late 1990s was even more of a “golden era” for the US economy than today – though the *world economy* in the aggregate is in better shape today than it was then. But Secretary Rubin did not succumb to the hype; he was not bewitched by the records being set by stock markets, tax receipts, employment numbers, etc. He thought this was a good time to take a clear-eyed look at the downside risks, however low-probability they were.

Our report in August 1997, titled “The Economics of Nirvana: What Are the Risks?,” listed 7 possible ways in which the expansion could end. In the event, the US expansion went on to become the longest on record. Four of the risks that had been on our 1997 list arguably played some role when the economy eventually slowed in 2000 and then went into recession in 2001 (overheated economy leading the Fed to raise interest rates, increased oil prices, stock market correction, and a year 2000 fall in firms’ IT spending in the immediate aftermath of artificially high spending to prepare for the millennium bug). Two more of the risks are still out there waiting (the possibility of abrupt ends to either overextension of consumer credit or financing of the international current account deficit).

But more important were the deliberate actions to be taken to shore up the economy when the times were good. At the top of that list was allowing a budget surplus to accumulate during a period of strong growth and rising tax receipts, in preparation for a future that might feature slower growth and that would certainly feature large deficits in Social Security and Medicare. Secretaries Rubin and Summers helped President Clinton design precisely this strategy. It required resisting the political pressures for either big tax cuts or big spending increases. (Clinton’s slogan was originally “save Social Security first,” before Al Gore’s “lockbox.”). The strategy worked well, until January 20, 2001.

Martin Wolf’s excellent column mentions some other major shocks of the past few decades, and observes that none of the big events had been expected, which is what made

them shocks. True. But most of them, if not all, were contemplated as possible risks by knowledgeable analysts, including presidential advisers, even if probabilities of far less than 50% per year had been assigned to each risk. Unfortunately, the Casssandras' warnings and suggestions of what to do were often ignored. Part of the problem is that the advisers were not willing to say that these were *high* probability risks – because they weren't -- and so they did not receive enough attention. Martin's historical list includes several geopolitical shocks. Three disasters came out of the Middle East – Saddam Hussein's invasion of Kuwait in 1990, Al Qaeda's attack on the World Trade Center in 2001, and the terrible consequences of the US invasion of Iraq. All three dangers had been predicted accurately by Richard Clarke, the man who had the counter-terrorism job at the National Security Council until 2003. All three sets of warnings were ignored by the man who occupied the Oval Office at the time.