Department of the Treasury

Credibility and Flexibility for Economic Growth

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The effectiveness of the Department of the Treasury will ultimately depend on the quality of its team, its responsiveness to crises, and its ability to work effectively with other branches of government. Nothing illustrates the importance of these three qualities more acutely than the financial crisis of 2008, during which the Treasury had to demonstrate expertise, flexibility, and political agility. Success in each of these depends on acting quickly in recruiting good people and avoiding the kinds of early mistakes that can permanently damage a secretary's efficacy. It is equally important, however, that the new treasury secretary, working with the new president, lay out a clear set of economic goals and priorities and then stick to them. The policy agenda will need adjustment to reflect day-to-day crises and changing circumstances, but a clearly articulated set of overarching goals will help ensure that long-term objectives do not fall victim to the inevitable brush fires of domestic and international economics. Simply put, no treasury secretary will see his or her priorities implemented without building the right team, avoiding mistakes that have hobbled his or her predecessors and, perhaps most importantly, building the right relationships.

The core functions of the Department of the Treasury—tax policy, international economic coordination and regulatory coordination for financial institutions, and financial crimes enforcement—put the Treasury at the center of any administration's economic policy. The best treasury secretaries served as the president's key internal advisors and external leaders on matters relating to domestic and international economic policy. Treasury is statutorily at the center of all major economic debates, but the secretary's ultimate success in leading the economic agenda will depend largely on his or her ability to forge key working relationships, avoid mistakes, and set clear priorities.

Effective treasury secretaries balance long-term objectives such as crucial investments in human and physical capital with their responsibility as the ultimate guardian of fiscal prudence. While not removed from the political fray, the secretary has responsibility for protecting the country's long-term economic stability as well as responding to short-term objectives. That mix of long-term fiscal probity and short-term pragmatism is evident in the Treasury's

statutory oversight of the Social Security and Medicare Trust Funds—the ultimate long-dated financial obligations of the U.S. government—and its immediate influence over tax policy.

Yet Treasury's central economic responsibilities only lend themselves partially to the kind of long-term planning envisioned by this book. Given that this chapter was written before the worst of the 2008 financial crisis, it does not try to address it in specificity. Indeed, much of what makes Treasury a vital part of any administration's agenda runs completely contrary to goals of advanced policy coordination. The very nature of the economic cycle suggests that the new administration and its treasury secretary should set forth clear objectives and then leave themselves the flexibility to enact the specific measures they would take when they have a clear picture of the country's economic health.

Consider our most recent treasury secretary, Henry Paulson, who came into office riding seemingly robust capital markets and wanted to highlight China and the environment as two major priorities. His legacy, however, will be determined by his handling of the housing and financial services crises. From a pure policy perspective, the Treasury Department under President George W. Bush shifted its attention from how to reform the charters of the government-sponsored housing finance giants—Fannie Mae and Freddie Mac—to how the government could provide the explicit guarantees needed to protect their viability to how they could effectuate a government takeover of both institutions. Those three pursuits—reform, guarantee, and ultimately conservatorship—all took place within a year.

This need for flexibility is only heightened by the fact that the new president will have a true transition. Without a sitting vice president running for office, the new president will almost certainly gain access to information during the transition that will alter his view of the correct economic imperatives. President Bill Clinton, for example, won the 1992 election with perhaps the most detailed economic plan of any candidate in history. By the time of the transition, planning largely focused on what stimulus efforts his first budget should include. By the time he actually presented a new budget based on the information that only became available when his team took office, the agenda had shifted to deficit reduction, which included certain tax increases.

All this does not and should not suggest that any planning is therefore ill-advised or a likely waste of time. While the new treasury secretary will by necessity focus intensely on the financial sector initiatives begun under the current administration, he or she, as the head of the economic team, must lay out a clear set of long-term objectives that transcend the current economic climate. At the outset, it is worth highlighting four areas of universal importance.

First and foremost, any new treasury secretary will confront the seemingly conflicting demands for deficit reduction and investment. The desire to make significant and badly needed investments in physical infrastructure, education, and health care—to name but three domestic priorities—would appear to run contrary to a similarly pressing need to reduce the deficit. Yet the judicious use of revenue increases and spending prioritization do not necessarily make these goals incompatible. Put differently, a focus on growth will drive clearer decision making and make seemingly intractable conflicts look less mutually exclusive.

Second, while the Department of the Treasury traditionally plays a more reactive role internationally, new global issues mean that the new secretary must develop a proactive global agenda early in the administration. Case in point: the current financial crisis will require sustained coordinated global responses. In addition, a wide variety of "new" issues, such as food scarcity, relations in China, and the strategic imperative of global economic development, suggest an enhanced role for Treasury in international affairs.

Third, the worldwide economy has undergone rapid change that requires a new urgency on some seemingly "old" issues. The rise of the service economy, the increasing reliance on technology in the workplace, and increased international competition with the United States all highlight the importance of helping U.S. workers transition to new jobs. Similarly, climbing income inequality in the United States and around the world has heightened tensions and threatens to undermine key elements of the domestic social fabric.

Finally, as the Center for American Progress points out in its papers on progressive growth, certain seemingly non-economic issues are of such pressing importance that they will go to the heart of the economic agenda. Most notably, climate change and the need to transform America's carbon usage should be part of any Treasury policy priority list.[1]

All of these challenges come against the backdrop of dramatic shifts in economic development and wealth creation around the world. Treasury will need to help develop an active strategy for how to position the United States for success in a world of rapid growth in India and China, massive wealth creation in the Middle East, and growing competition for scarce resources.

Personnel and Confirmations

Perhaps the single most important thing a treasury secretary can do is recruit individuals of exceptional competence and managerial skill. Treasury is such a vast operation, and the press of events on the treasury secretary and his or her

senior staff so great, that even the most brilliant secretary cannot be successful without a talented team in place that operates with a clear set of objectives. This involves selecting a staff member to serve as the personnel liaison to screen resumes, talk to the relevant constituent groups, and, most importantly, make sure that personnel decisions get the attention they deserve. Accordingly, there are a few principles to consider.

The importance of the National Economic Council and the Council of Economic Advisors at the White House means that Treasury needs at least a few people who have deep personal relationships with senior members of the White House team. Given the current financial crisis, corporate experience alone will not suffice; Treasury truly needs people who have actual financial markets experience. Last, tax policy encompasses such a broad range of policy, economic, and political issues that building a well-rounded tax team is essential to Treasury's success. This will include expert tax lawyers, economists, and individuals with Washington experience.

Like any well-run organization, Treasury also needs clear lines of authority. For example, the deputy treasury secretary holds a position of tremendous seniority, yet he or she does not have a clear area of responsibility. It is therefore important for the secretary and his or her deputy to quickly define the deputy's purview. And like most modern organizations, the secretary will need legal advice on almost any matter of importance. Finding a general counsel in whom the secretary and deputy have the utmost confidence will greatly enhance the department's efficacy.

Since it is impossible to predict the issues that will arise, the department's credibility will depend as well on having senior members who truly represent a cross-section of Americans. The Treasury bureaus have immensely broad and important responsibilities. Once a bureau head is appointed, it is very difficult to remove him or her, which is why these personnel decisions should be given particular attention. Failure to use a deliberate, focused process that considers all of these principles at the outset will increase the risk that as the pool of remaining jobs narrows, the department will face pressure to fill the open slots with people who do not meet certain important criteria for the job.

The best selection process, however, is obviously for naught if the confirmation process fails. The Senate Finance Committee handles most nominations, with a portion going to the Senate Banking Committee and one residing at the Senate Select Committee on Intelligence. It is virtually impossible to overstate the importance of securing confirmations as quickly as possible. Without confirmation, appointees are limited in the actions that they can take, the way that

they can interact with the press and public, and potentially their willingness to remain on the job.

Historical Lessons

History suggests that nothing limits a secretary's efficacy or credibility more severely than an early crisis. While each episode has its own nuances, one simple example to help set the stage: few secretaries enter office expecting to fight over increases in the debt ceiling. It would seem axiomatic that by authorizing increased borrowing, Congress would feel comfortable with the resulting increase in total outstanding government obligations. Yet in almost every administration, debt ceilings increases have created crises of varying severity.

The new secretary also must immediately determine a clear, easily repeated position on currency matters. When President Richard Nixon's treasury secretary, John Connally, announced to a group of European Finance ministers that "the dollar is our currency but your problem," he could not have known how problematic the dollar would become for his successors as secretary. Most recently, Bush administration Treasury Secretary John Snow caused dollar fluctuations throughout much of his first six months in charge, at one point causing the dollar to dip to its lowest level in four years when he explained that a weak dollar could boost exports. He was subsequently corrected the next day by White House Press Secretary Ari Fleischer, who said, "I haven't seen everything he said. [But] there's no change in dollar policy. The position of the government continues to support a strong dollar."[2]

The complexity of dollar commentary is not limited to the first few months in office. On October 21, 1994, the U.S. dollar hit an all-time low against the yen shortly after Secretary Lloyd Bentsen was quoted saying, "We have no plans to intervene" in the market to support the dollar.[3] The steep slide led him to revise his comments the next day, when he stated that "we are concerned about recent movements in the dollar. We would prefer a stronger dollar." His comments stabilized the markets.[4]

While Treasury can and should be a forceful and independent voice on economic policy within the administration, the perception of public disagreement or inconsistency with White House positions seriously undermines Treasury's ability to contribute to policy formation and the secretary's effectiveness as a steward of the economy. Former Bush administration Treasury Secretary Paul O'Neill, for example, resigned from his post as treasury secretary after consistently finding himself at odds with the political and economic agenda of the Bush White House. In the fall of 2002, during a period of continued uncertainty about the economic recovery, O'Neill was focused on a broad-based tax

reform to simplify the code and questioned the need for more tax cuts in the name of economic stimulus. He was overruled by others in the administration, and amid dissatisfaction from the left and the right ultimately announced his resignation on December 6, 2002.[5]

Treasury also has responsibility for a variety of entities over which it has policy control but not specific administrative or enforcement control. The most obvious examples include the Internal Revenue Service and the Office of the Comptroller of the Currency. Both play crucial roles in enacting administration policies while also maintaining very important elements of independence. History is replete with well-intentioned political appointees who attempted to reform or improve regulatory agencies only to find themselves accused of political interference. The new treasury secretary and his or her team must be exceedingly careful to avoid similar missteps.

In light of the current economic environment, the new secretary is also almost certain to face a sovereign financial crisis of one sort or another. Since 1994, a series of economic crises in fast-growing developing economies has repeatedly tested the abilities of the United States and the International Monetary Fund to maintain market stability and encourage economic liberalization. From the $50 billion package created with the United States, IMF, World Bank, and Bank for International Settlements during the peso crisis in 1995, to the default on Argentine loans prompted by an IMF withdrawal in 2001, the nature of each sovereign failure and the efficacy of each remedy varied considerably. The immediate aftermath of each currency devaluation was sharply contractionary—Mexico's gross domestic product shrank by 6.2 percent in 1995, while Argentina's income per capita fell from $8,500 to $2,800.[6]

The policy lessons of these sovereign failures are still hotly debated, but the takeaways for crisis management at the U.S. Treasury are easier to draw. The simplest lesson is to recognize the pattern of instability in developing economies as they begin to realize the benefits of economic liberalization. Within the past 14 years, we have weathered major crises in Mexico, Thailand, Indonesia, South Korea, Russia, Argentina, Uruguay, Brazil, and Malaysia.

Within the new administration, Treasury will need to ensure that any crisis is on the agenda at both the National Economic Council and the National Security Council, and that the president is available to guide any aid and loan package. Externally, the treasury secretary—working with his or her Group of Eight counterparts from Japan, Germany, Great Britain, France, Italy, Canada, and Russia—will play a lead role in negotiating any package with the IMF, the World Bank, relevant regional institutions, and the leadership of the countries themselves.

As our capital markets are truly globalized, events in relatively small sectors of small economies can unravel economic calculations throughout the world. The primary source of economic imbalance in Thailand in 1997, for example, was speculation in real estate, but the subsequent currency collapse caused the Thai currency to lose 20 percent of its value in a single day, and caused the economy to contract by 10 percent in 1998.[7] As the crisis spread to Indonesia, the S&P 500 stock market index fell by 5 percent in August 1997.[8] The U.S. response to any future crisis will need to be both rapid and flexible to contain the risks of financial contagion and to mitigate the real economic impact of financial panics on poverty, living standards, and global growth.

Events in the United States, too, can cause sudden international financial disequilibrium. The U.S. subprime mortgage market crisis beginning in mid-2007, followed by the collapse of Wall Street investment bank Bear Stearns Cos. in March 2008, followed by the takeovers of Fannie Mae and Freddie Mac this past summer, followed by the global financial crisis in September that led to the collapse of investment bank Lehman Brothers Holdings Inc. and the government rescue of U.S. insurance giant American International Group Inc., are examples of the long string of financial crises that can confront Treasury. They usefully highlight, however, the department's power and its limitations.

Through its oversight of Fannie Mae and Freddie Mac and tax policy, Treasury played a key role in considering responses to rapid house-price declines and the resulting seizing up of credit markets. Treasury, however, had a more modest set of tools with which it could take immediate action after the crisis on Wall Street began to unfold. Indeed, aside from some quite obscure statutory authority relating to the Federal Reserve, nothing that it controlled unilaterally could have made much of an immediate difference relating to the systemic risk posed by Bear Stearn's weakening position. Instead, Secretary Paulson made himself a central actor in that drama by virtue of his insights and Treasury's ability to formulate longer-term reform. As the crisis evolved, it became clear that Treasury needed a broader set of statutory authorities.

This example goes directly to the importance of Treasury's credibility. Without Secretary Paulson's knowledge and relationships on Wall Street, Treasury would likely have played a lesser role in the Bear Stearns intervention. Equally important, unless Treasury had established real credibility with Congress, it would not have succeeded in pushing through the more fundamental changes at Fannie Mae and Freddie Mac, and securing passage of the Emergency Economic Stabilization Act of 2008.

Without its statutory authority over a variety of regulatory bodies, Treasury's influence would be diminished—an important point in the context of

the current debate over financial services regulatory reform. A more proactive Treasury Department over the past eight years might have prevented the crises that now occupy much of the Bush administration's energy, and have cost the American economy so severely. The new treasury secretary will need to ensure his or her department does not make the same mistakes.

Key Relationships

The most successful Treasury secretaries have succeeded in maintaining key relationships with the White House, Congress, the Federal Reserve, other U.S. financial regulatory agencies, Wall Street, and Treasury's global counterparts around the world.

First and foremost is the importance of a close relationship with the new president and senior members of the White House staff. There are certain formal prerogatives that the secretary should seek and guard jealously, including participation in certain meetings with foreign heads of state, membership in the National Security Council, control over certain policy areas, and the ability to speak definitively about matters relating to the economy. For instance, after leaving the Clinton administration's National Economic Council to join Treasury in 1995, Treasury Secretary Robert Rubin continued to participate in the 8 a.m. White House senior staff meetings. This reflected his legacy ties to the White House staff as well as the central role of economic policy in that administration's priorities. Not all White House chiefs of staff would welcome a similar role for Treasury, but such participation might make sense given today's economic challenges.

While these formal protections matter, any treasury secretary ignores the importance of roaming the White House halls at his or her peril. Informal relationships with NEC and Office of Management and Budget directors as well as the head of the Council of Economic Advisers are essential, as are good working relationships with the chiefs of staff of the president and vice president and other senior members of the White House team. The secretary will want to pay particular attention to the role of the NEC, which at its best serves as an honest broker between varying cabinet views and formulates additional sets of policy recommendations. And as Treasury will work most closely with the Departments of State and Commerce and the Office of the U.S. Trade Representative, the secretary's relationship with each of these cabinet officers merits personal attention.

Then there are the critical relationships with Congress, which can begin with the confirmation process. The chairmen and ranking members of the Senate Banking Committee and House Financial Services Committee, the Sen-

ate Finance and House Ways and Means Committees, and more generally the leadership of both bodies will become essential allies or potential adversaries in most matters of importance to Treasury. Any treasury secretary who does not understand Congress will face a significant learning curve that will curtail his or her immediate efficacy during the first 100 days and the first year of the new administration.

Most treasury secretaries choose to meet privately on a weekly basis with the chairman of the Federal Reserve. This private, personal communication helps keep both institutions informed of the other's perspectives; helps coordinate policies in areas of overlapping jurisdiction, such as banking regulation; provides a forum for airing of perceived grievances; and fundamentally helps ensure that fiscal and monetary policy do not dramatically diverge. Yet the relationship will only succeed if complemented by two important elements.

First, a clear recognition by the new administration of the Fed's independence is essential. This does not suggest a willingness to capitulate on areas of overlapping responsibility, but rather an appreciation of the dangers of commenting on areas of Fed control, most notably interest rates. Second, the new treasury secretary must appreciate the Fed's bureaucratic strength and persistence. Treasury must remain firm on its views even if these involve disagreement with the Fed.

The financial crises of the past year have only increased the Fed's regulatory importance. The new administration will also want to ensure that decisions made in the heat of a very difficult environment will stand up well over the course of time. That's just one reason why the new secretary needs to develop good working relationships with the heads of the other federal financial regulatory agencies, including the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodities and Futures Trading Commission, the Comptroller of the Currency, and the new regulator of Fannie Mae and Freddie Mac. At the same time, certain institutional bodies can serve to coordinate policy and bring important outside perspectives to the policy debate. The president's Financial Markets Working Group, for example, can serve to convene the right authorities on matters of cross-department concern.

Numerous trade associations representing Wall Street, industry, labor, and community groups will seek to present views on issues before the department. A formal relationship with these organizations serves both sides of this equation: the groups provide valuable insights while Treasury avoids the impression or reality of boasting ties that are too close with any one of them. Yet these groups should not substitute for direct interaction between the new secretary and the chief executives of major financial and industrial companies, and labor and community leaders.

Similarly, allocation of the secretary's scarce time should include direct ties to leading outside economists, labor unions, community and advocacy groups, and others representing a variety of perspectives in the economy. Building and maintaining a broad network will help inform decisions, provide a useful source of market intelligence, and prevent policy initiatives from arriving out of the blue. Previous Departments of the Treasury have found themselves well served by an office of Community Development that institutionalized the important role Treasury can play in community development and the importance of maintaining an active dialogue with community leaders.

Three other sets of relationships bear mentioning in the international sphere: the G7 finance ministers, the president of the World Bank, and the executive director of the IMF. In the past, these relationships seemed of particular importance in times of crisis. Today, enhanced economic interdependence, the rise of new global issues, and the growing importance of non-G7 economies all suggest that the new administration would do well to develop a more proactive approach to international economic relations. Certainly much of the new secretary's foreign travel will be dictated by the need to participate in G7 finance minister meetings and heads-of-state summits.

At times these meetings will seem at best pro forma. Yet these relationships will become a key form of communication in the current crisis or any future events that require international coordination, and could easily become the forum for important discussion about issues such as the economic consequences of climate change. This is not to suggest that new initiatives should replace a firm focus on central issues, such as funding for foreign military interventions or coordination on exchange rates. Rather, it reflects the fact that the new secretary will have an opportunity to expand the definition of issues that appropriately fall under Treasury's purview, and do so in a way that is less reactive than has traditionally been the case.

Focus on the G7 should not, however, preclude giving attention to emerging economies such as India and China, as well as important sources of global liquidity such as those in the Persian Gulf. Similarly, close allies and trading partners such as South Korea, Australia, Mexico, Canada, and Brazil should find their way on to the secretary's policy agenda.

In most administrations, neither the IMF nor the World Bank have occupied large amounts of the secretary's time, except during a crisis. During such crises, however, Treasury's close relationships with both the IMF and World Bank leadership are crucial to a sound response. Though the United States may sometimes wish otherwise, it does not control either the Fund or the Bank—making an understanding of their internal politics and leadership objectives essential to an effective working relationship. In addition, appointments of strong

executive directors (the U.S. representatives to each group) will greatly enhance the influence the United States can exert in both institutions. Having the right representatives would enhance the potential to enact the serious reform that is badly needed, but unlikely—if not impossible—without active U.S. engagement.

Policy Initiatives

The macroeconomic agenda of the 44th president will determine how some of the most important pending policy issues will be resolved. The financial crisis will be the most pressing concern, but longer term issues will need immediate attention. Tax policy falls most squarely into this category. There is bipartisan support, for example, to reform the Alternative Minimum Tax but strong disagreements about how to pay for such reform. Similarly, all of President Bush's tax cuts will expire by January 1, 2011. Decisions relating to both issues will depend substantially on the overall economic plan embodied in the new president's first budget. Yet other areas, while not uncontroversial, allow for greater long-term planning and will likely require attention regardless of the president's macroeconomic agenda. The first challenge will be administering the massive government effort to remove illiquid assets from the balance sheets of financial institutions.

The housing crisis of 2008 highlighted the complexity of the government's relationship with Fannie Mae and Freddie Mac and the need for a comprehensive reevaluation of that relationship. Legislation passed in July 2008 was an important step forward in giving Treasury the authority it needed, and the decision to place them into conservatorship averted a serious crisis, but the major issues relating to their future remain unresolved.

The new administration will face the difficult decisions concerning their mission, ownership, size, and governance. Often wrapped into the Fannie and Freddie regulatory debate is the Federal Home Loan Bank system. The FHLB has grown rapidly and has been of considerable value in providing liquidity for banks and thrifts during the housing crisis. Some critics have noted, however, that governance of some banks, and regulation of the system more generally, has not kept pace with this growth, thus exacerbating the risk that one of the banks will face financial difficulty.

Financial regulatory modernization will also be at the top of the new secretary's list of policy priorities. The current financial crisis exposed the truth that our alphabet soup of regulatory agencies is out of date. Our antiquated methods of financial services regulation, which regulate banks heavily but other parts of the financial services sector hardly at all, are serious contributors to

the current financial turmoil. Reform proposals vary dramatically, but some consensus exists around the following principles.

First, to the extent that investment banks wish to tap the Federal Reserve for funds previously limited to deposit-taking institutions, they must face closer regulatory scrutiny. Second, investors need greater transparency to understand the risks embedded in many balance sheets of financial institutions of all stripes. Third, executive compensation systems should reflect the long-term interests of shareholders. And fourth, overlapping regulatory jurisdictions and "venue shopping" undermine the entire regulatory regime.

The SEC and the Fed have begun to work more closely, so some action is likely even in the absence of dramatic new legislation. The new treasury secretary needs to continue those discussions immediately, while legislative proposals for more far-reaching financial markets regulation reform could be a major preoccupation of the new administration.

As outlined in other chapters of this book, the federal budget deficit, while very large, is not an insurmountable challenge, though it has become even more complicated given the obligations associated with addressing the financial crisis. The twin deficits in the federal budget and the current account deserve immediate attention. In the past seven years, both have ballooned.

The federal budget reached a record deficit of $413 billion in 2004, and is projected to come close to $500 billion in 2009, causing the total debt outstanding to increase from $5.7 trillion in January 2001 to $9.4 trillion in April 2008.[9] Meanwhile the trade gap reached a record of $763 billion in 2006, more than double the $361 billion in 2001.[10]

Any budget deficit is a deferred taxation, with interest. In 2007, 9 percent of federal spending—more than $200 billion—was used to pay interest on the federal debt.[11] The current account deficit is financed by a mirrored value in capital inflow, either because foreigners purchase U.S. debt (whether governmental, corporate, or personal) or because the ownership of assets is transferred to foreign parties (through foreign direct investment). Both are natural parts of a free and open economy, but are also unsustainable at these levels in the long term.

Demographic trends and policy realities will make it even harder to balance our twin deficits. As baby boomers age into the Medicare and Social Security systems, and as the cost of health care continues to rise, the financial strain on those programs will unavoidably constrain our fiscal policy. Even a basic analysis of the financial health of Social Security has been politicized in the aftermath of President Bush's 2005 efforts to change the structure of the system. So while proposals abound to fix the looming deficit, a political consensus has not emerged over the best way to fix it.

Medicare is equally contentious and at least as pressing. The largest portion of Medicare, Part A, which pays for inpatient hospital expenses, is funded, like Social Security, through a portion of federal payroll taxes; through 2007 these dedicated taxes collected more in revenue than was spent on Part A. The remainder is collected in a trust fund invested in U.S. Treasury Bonds. In 2007, Part A collected $223 billion in revenue and had program expenditures of $203 billion, leaving the trust fund an accumulated $326 billion in assets.

Starting in 2008, however, expenditures in Part A will exceed revenues. The program will draw down on the trust fund, which is currently projected to exhaust itself in 2019. In the absence of the depleted trust fund, general revenue or cuts in program spending will be required to make it whole.[12] The reason: surplus payroll taxes earmarked for Medicare in prior years were used by the government as a source of funding for general programs, and those debts will now begin to be redeemed.

The new secretary will also have to engage in government investment to grow the U.S. economy. It is clear that the economic policy focus of Treasury will need to expand beyond the Bush administration's view on the correlation between investment and growth. While economists can analyze the extent to which recent growth has come from consumption rather than investment, there is little doubt that the new administration will need to invest more heavily in our human and physical infrastructure, as Gene Sperling examines in his chapter on progressive growth in this book. It is important to note here, however, that the purview of Treasury should expand beyond the need to expand valuable programs such as the Earned Income Tax Credit that reward work, to supporting an economic infrastructure that spurs innovation and entrepreneurship.[13]

In the international arena, overseas financial services coordination and liberalization should become a key focus of the new secretary. Financial services are critical to both U.S. trade interests and to the economic growth in developing nations. From the U.S. perspective, financial services employ more than 6 million Americans, and contribute more than 8 percent of total U.S. GDP[14] (the 2008 financial crisis will diminish these numbers, but not change the industry's fundamental importance). Liberalization furthermore drives critical innovation in telecommunications and information technology.[15] Just as importantly, liberalization in financial services helps developing countries by providing competition in critical aspects of economic growth, allocating resources more efficiently and increasing access to capital.[16]

Economists Wendy Dobson and Pierre Jacquet estimate that financial services liberalization could have added $1.3 trillion to the global economy in the

period from 2000 to 2010.[17] "Liberalizing services has a force-multiplier effect, reverberating across an entire economy," adds former U.S. Trade Representative and current World Bank President Robert Zoellick. "Every product, idea, or consumer benefits from a more effective and efficient service sector."[18]

This is not to suggest, however, that a blanket approach to liberalization either makes good policy or practical sense. From a policy perspective, emerging economies need the opportunity to develop indigenous financial markets and financial institutions. A robust domestic lending base can help minimize the risks associated with rapid transfers of foreign direct investment. The new treasury secretary, working with USTR, will need to develop policy that balances these concerns as the new administration considers how to pursue a general agreement on trade in services. Ira Shapiro and Richard Samans examine this topic in their chapter in this book on USTR, especially involving China. It will be incumbent on Treasury, however, to make sure that financial services remains a central element of trade liberalization efforts.

Similarly, the new treasury secretary will need to engage China directly over its exchange rate policies, but must do so within the context of a larger range of bilateral issues. As Shapiro and Samans argue elsewhere in this book, the Sino-U.S. Strategic Economic Dialogue started by Bush Treasury Secretary Paulson is the place to discuss not just exchange rates and other one-sided issues, but rather opportunities for the United States and China to work cooperatively. China has already made steps to strengthen worker rights, environmental protection, and product safety; strong engagement by the United States will allow China's economy to continue to grow without placing undue external risks on the rest of the world.[19] The Strategic Economic Dialogue provides a useful forum for these types of issues.[20] It is important to remember that Treasury will have a statutory obligation to opine on China's approach to currency shortly after the new administration takes office.

The new secretary's policy agenda will also include IMF and World Bank reform. The rise of middle-income countries such as China, India, and Brazil as economic powers has fundamentally altered the economic power dynamics within the IMF and the World Bank. Meanwhile, the integration of global capital flows and the buildup of foreign currency reserves have allowed middle-income countries to opt out of many IMF and World Bank lending programs.[21] These developments are unquestioned successes, but they now require the IMF and World Bank to engage in fundamental reform.

First, both institutions will need to redefine their role in the global economy, particularly in relation to middle-income countries. Secondly, both institutions are under pressure to reform their governance. While the IMF continues as the

premier organization for global economic cooperation and the lender of last resort, its day-to-day lending operations have declined. In response to this change, the IMF will need to answer two key questions about its role. Should the fund retrench to focus on the core mission of exchange rate surveillance and global financial stability or invest in new tools and activities, such as expanded technical assistance programs? And can the fund engage all of its members, including rich nations, on economic reform and stability or will it increasingly focus on the development mission in low-income countries?

Underlying both these concerns is a question of how the IMF and the World Bank can collaborate while delineating clear areas of distinct responsibility.[22] Georgetown professor Dan Tarullo, a Senior Fellow at the Center for American Progress, argues that the mutual dependence of each organization's mission and the need for significant reform in both suggest that the reform agenda should support renewed focus on their unique missions—particularly for the fund. The IMF's core mission of monitoring exchange rate regimes and ensuring financial stability is as critical now as it was 60 years ago.[23]

Reform of the World Bank stems less from structural changes in the global economy than from questions about the bank's effectiveness in its mission. Over nearly 60 years, the World Bank's largest projects have often been linked with corruption in developing countries and the enrichment of political leaders there. Under former World Bank presidents James Wolfensohn and Paul Wolfowitz, anticorruption reforms were begun. These were neither popular nor entirely effective, but nevertheless deserve sustained attention. The new secretary must work with World Bank President Zoellick to ensure these efforts continue.

Though less insidious, doubts about the efficacy of World Bank programs are critical to its relevance. Allan Metzler, an economist and author of a 2000 report on World Bank reform, recently testified that the World Bank "spends or lends about $20 billion a year but neither we nor they know which programs are effective and warrant expansion or retention, and which are ineffective and inefficient and should be abandoned."[24] A third critical question facing the bank is whether to move from loans to grants in its development programs.

The Bush administration proposed that 50 percent of funds be dispersed in grants, while European nations and Japan have balked at such a large shift, instead proposing 10–20 percent levels. And a large opportunity also exists for the new treasury secretary to work his or her global relationships to press the bank to increase its role in the promotion of institutional capacity building outside of direct lending. These efforts could include helping emerging economies develop sound regulatory policies, environmental and labor protections, and incentives for environmentally sound infrastructure enhancements.[25]

Governance reform in the IMF and the World Bank will need to move hand in hand with these policy reforms. The new treasury secretary should focus on three basic goals. First, developed countries such as the United States, Japan, and most member nations of the European Union must maintain significant roles in the decision making of both organizations. Second, middle-income countries need to have a voice in these multilateral institutions commensurate with their rising economies. And third, low-income countries, despite being prime beneficiaries of both organizations, also need to play a meaningful role.[26] This will be a hard set of goals to square, but if other reforms are to proceed at both institutions then the new secretary will need take an active role in developing specific policy proposals in this arena.

Lastly, Treasury will continue to play a key policy role in the struggle with global terrorist networks. The Treasury Office of Terrorism and Financial Intelligence is primarily focused on freezing and seizing funds suspected of use for terrorist activities, enforcing economic sanctions against "rogue" nations, protecting the integrity of the financial system, fighting financial crime, and assisting in the hunt for Iraqi assets. Within the TFI is the Office of Foreign Assets Control, or OFAC, which has the power to designate a person or organization as a sponsor of terrorism and then freeze or seize the target's assets indefinitely while requesting that the United Nations take similar action on a worldwide basis. Also within TFI is the Financial Crimes Enforcement Network, or FinCEN, which has the power to designate a person or organization as a sponsor of terrorism.

Issues for the new treasury secretary will include coordinating on terrorism financing. Sixteen agencies or departments, including the Department of the Treasury, the Department of Justice, the FBI, the State Department, the Defense Department and the Defense Intelligence Agency, the CIA, and the Department of Homeland Security, are all involved in the effort to combat terrorism financing. The new secretary will also have to staff Treasury enforcement areas in order to pursue compliance with the Patriot Act, anti-money laundering statutes, and intelligence coordination, with priority setting especially around terrorism financing and hidden foreign assets. And the new secretary will also have to detail the role of the IRS in tracking whether non-profit organizations are linked to terrorists, and the use of IRS agents for investigating terrorism financing.