The Core Problem

An exclusive interview with Larry Summers.

TIE *founder and editor David Smick recently sat down with the former Treasury Secretary and Obama economic adviser to discuss the state of the world economy.*

Smick: For months, financial markets were fixated on the Federal Reserve's December decision to raise short-term interest rates and the potential effects of such monetary tightening on dollar appreciation. After all, the risks are significant. The world's dollar-denominated debt, a lot of it held by emerging market economies, is said to exceed $19 trillion. But has there already been a regulatory "tightening"? The global carry trade appears to be in reverse. Japanese and European bankers suggest their American counterparts, under pressure from regulators, have been pulling back from lending to entities associated with emerging markets. There appears to be an emerging global dollar shortage. Does this trend trouble you? You've talked about the coming weakness in the global economy.

Summers: In general, the risks of slowdown and low inflation—if not deflation—significantly exceed the risks of overheating. The world is probably ready, rightly or wrongly, for a Fed tightening. But monetary policy is nonetheless a fragile exercise, and market expectations could easily become a matter of concern. I think the core thing to be worried about is that you have an industrial world that is very short on demand. Expected inflation from the industrial world over the next decade is running barely above 1 percent, and the real interest rate on average for the industrial world as inferred from swaps or indexed bonds is zero.

On top of that, the emerging markets are much more likely to be sources of capital outflows than capital inflows, in part because of their various problems. I'm thinking about Brazil, and about rising risks in China. Financial institutions in industrial countries are under pressure to build up

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
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capital to concentrate lending at home. So a demand-short industrial world is likely to confront an emerging market sector that is shifting toward much more capital outflow, much less ability to receive investment, and much more depreciated exchange rates. That raises the risk of a cycle where emerging markets pull the industrial world down and, in turn, the industrial world pulls emerging markets down.

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So there are quite significant risks going forward. We're in a new era of problems relative to the problems and challenges that defined the previous generation. In previous times, problem solving involved more adequate monetary and fiscal discipline to avoid inflation. The problem was to stabilize short-run fluctuations. We're now in a period of potential secular stagnation that's more reminiscent of some of the challenges that the world faced during the 1930s and that people worried about in the aftermath of World War II. There's no certainty that those problems are going to materialize, but that's where I see the greater risks.

Smick: Ironically, capital inflows into the United States since the 2008 financial crisis have occurred at twice the rate as before the crisis. And it's not just Russian oligarchs and rich Chinese families. Germans are buying mid-sized U.S. companies. Yet the Anglo-Saxon-style system of liberalized markets and the so-called Washington consensus were supposed to have been discredited as a result of the crisis. Why this love since the crisis of all things American?

Summers: The United States is a safe haven. We are the only part of the industrialized world where there is significant labor force growth and significant dynamism around technology. As for alternative currencies to the dollar, the euro is a substantially more problematic construct than appeared to be the case a decade ago. Indeed, the euro's experience is another good example of the late economist Rudi Dornbusch's dictum: "Things take longer to happen than you think they will, and then they happen faster than you thought they could." Many were worried about the concept of the euro in 1999, and while the first decade of the euro was better in the sense that problems did not materialize nearly as quickly as many people expected, when problems did materialize, they were far more serious than almost any one feared.

Smick: Because of capital inflows—mostly into the dollar, but also into the euro—many European policymakers have worried that the euro is overvalued. ECB President Mario Draghi is moving toward an aggressive form of quantitative easing, with both enlarged quantity and possibly diminished quality of assets purchased. But it's hard to argue that QE is needed because there are huge corporate projects ready to begin in the periphery but are being held up because of the cost or availability of credit. So isn't the ECB's QE really about currency depreciation for the most part? Germany is a giant export platform. Eurozone officials no doubt know that if the German economy, plagued by the VW scandal and the political uncertainty created by the refugee crisis, were to catch a serious cold, the rest of the eurozone would develop pneumonia.

Summers: I am more skeptical of the magnitude of the impact of quantitative easing than many of my friends. Once you grant decently functioning capital markets, I'm not sure of the potency of QE. There is no question of course that QE in the United States in the early post-crisis phase was enormously important. But with financial markets basically working, you have the question of how much investment opportunity there is that people would engage in with the 35-basis-point Bund that they would not engage in with a 100-basis-point Bund. Even if there are such investments, what is their quality?

So I suspect that QE will operate through exchange rate mechanisms and spillovers more than some of the discussion suggests. Inherently, we have a sort of uneasy set of global understandings that basically say that if you're a major region of the world, you're not allowed to manipulate your exchange rate for competitive advantage. And you are allowed to respond to domestic conditions with easy monetary policy. But easy monetary policy that has a significant part of its impact through the exchange rate is sort of an ambiguous character.

There's an important opportunity for Europe to respond to the various challenges associated with refugees and security with concerted European action drawing on the credit of Europe taken as a whole. I'm not confident they will take advantage of this opportunity. This is a formula for generating an amount of much-needed fiscal stimulus at the European level that is well worth consideration by European policymakers.

Smick: Further on that point, to what extent is the world therefore flirting with trouble on the currency front? With a weakening economy, China has recently depreciated its currency and no doubt will want to weaken the yuan further over the next several years, some say by another 15–20 percent. The Japanese would do the same were it not for the fact that the rise in the dollar has already dramatically increased Japanese food and energy prices less than a year away from Upper House elections, and at a time when Prime Minister Abe's political base is vulnerable. To what extent is the world playing with fire on the currency issue? Would it at least be wise to put the issue of a currency accord, with some kind of rules of the road, on the table for G-20 discussion?

Summers: To understand, you have to start with some fundamentals. There's a historically unique problem of a chronic excess of saving over investment demand. Drawing on the work of economist Alvin Hansen, I've labeled this "secular stagnation." The secular stagnation theory does not imply you'll always have stagnation. But the actions you take to prevent stagnation are very problematic in terms of sustainability, such as what the United States did in the 2003–2007 period by nurturing the mother of all housing bubbles. During the same period, Europe tried what we now recognize were manifestly unsustainable credit flows to the European periphery. The world as a whole over the last few years saw unsustainably large flows to emerging markets. And now, everybody wants to get more of the scarce pool of demand by having a weaker currency.

So competitive devaluations on a systemic basis are a much larger risk than they have been at any point in my memory. Will that risk materialize? I'm not sure. But it is certainly something to worry about.

I don't have great confidence that the international economic cooperation process would be able to contain that threat were it to loom. The United States is simply not in the position it was earlier, given that we were at the front edge of the financial crisis. In recent years, the United States has been reluctant to employ assertive leadership, and the rest of the world has been reluctant to accept assertive American leadership. It's hard to imagine where else the impetus to contain competitive devaluation would come from. From a desperate United Kingdom? I doubt it. They seem very eager to restore their relationship with China. From a Europe that feels itself to be most acutely in need of greater competitiveness?

In retrospect, the 1985 Plaza Accord addressed a much simpler problem. Then, basically one currency had caught a speculative bubble. That's a very different situation from one where fundamental forces are creating a dynamic of competitive devaluation. Currently, there's both more difficulty and less capacity in addressing the risk.

Smick: The challenge is enormous, to say the least. But aren't there risks to inaction? For several decades, the United States served as the world's consumer of last resort. Look at how that turned out. Can the U.S. economy achieve acceptable levels of economic growth while serving as the one major country willing to tolerate an overvalued currency? To be sure, currency relationships in the long term are determined by savings imbalances. But can the politics in America withstand the current exchange rate situation?

Summers: Unlike Fred Bergsten of the Peterson Institute, I tend to view a strong currency as in America's interest. I tend to regard many of Fred's arguments for getting to a weaker currency as a way of gaining competitive advantage as teetering on the edge of being dangerous.

Fred does make a good point, though, when he suggests that cycles of protectionist intensity in the United States tend to coincide with periods of extremely strong currency. And there is a risk that if the U.S. current account deficit were to increase back to 5 percent of GDP, if the renminbi were to drop 15 percent from its current value, and if the euro were to fall below parity, then you would see much more tendency towards protectionism in the United States.

Smick: Let's look at China. Does anybody really know what's going on? The Chinese government claims 6.5 percent growth, but with manufacturing flat and services growing at about 5 percent, wouldn't that be more like 2.5 percent growth? Producer prices are dropping by 10 percent and wages are going up by 10 percent, which means the large companies are finding it difficult to be profitable. Why is so much capital pouring out of China? What do they know that we don't know? Are you worried about a period of prolonged Chinese political turmoil? Are you

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concerned about a continued scenario of excess supply capacity where China continues to export disinflationary, or deflationary, pressure to the world?

Summers: It's very hard to judge from the outside. There certainly are a lot of things to worry about in China. The fact that they poured more cement and concrete in China between 2011 and 2013 than the United States did in the twentieth century suggests a profound unsustainability. And whether they succeed or whether they don't, the world is going to be very different. Success in China does not mean going back to the old way. It means making a successful conversion from a heavy economy to a service economy, and that's not going to bring commodity prices and commodity demand back. The issue is slightly less whether China succeeds or fails than the reality that a China that's in transition to a new place is going to have some very important and challenging aspects for the global economy, particularly for commodity producers.

Smick: Regarding China's new Asian Infrastructure Investment Bank. One theory says the United States really botched the chance to participate in a great opportunity. Yet other analysts argue that in a couple of years, the United States is going to look back and be thankful it didn't get involved. What China is desperate to find, they say, is a place to offload half the world's excess supply of steel and cement. So for China, a globally supported infrastructure bank makes sense. But if you believe China's reserves are not $4 trillion, but much smaller, then China has no choice except to get the world's financial sector behind the financing of this infrastructure bank. But does a new institution with China as the primary financial intermediary (and supplier of all construction labor) make sense for the rest of the industrialized world? The risks of infrastructure investment in emerging markets are tied to the lack of adequate cash flow. What's your take on the AIIB?

Summers: I'm not sure how it's going to work out financially. I think competing clubs are quite dangerous, and for the United States to have left the appearance in many people's minds, whatever the reality, that it was trying to dissuade its allies from joining the AIIB, and then for Britain to lead the charge into it, was not a high point of U.S. economic diplomacy.

Smick: True, and in the Republican Party in particular, the free trade consensus seems to have weakened dramatically. But back to the question of quantitative easing. At this time, large parts of the world are running, in one form or another, QE and/or low interest rate policies to pump up asset prices. In the United States, stock markets since 2010 have soared. Those who held major stock holdings got a windfall, but was this fair to average working families who don't own major stock portfolios outside of their pensions? It's as if the affluent received a free winning lottery ticket.

I've been a strong advocate for more of the burden of stimulus coming on the fiscal side than on the monetary side.

Summers: The question of the distributional impact of monetary policy is much more complicated than people say. On the one hand, more liquidity and lower rates pump up asset prices, and that's good for rich people—and for people's pensions. On the other hand, we tend to think that savers are richer than borrowers, and lower interest rates therefore should be good for borrowers relative to savers, and that's a very egalitarian effect.

I don't think the people who argue that our low rate/high liquidity policy has been distributionally perverse take adequate account of what it has meant for mortgage rates for middle-income families, for car loan rates, and for greater availability of consumer credit, or for the difficulty it's caused affluent 401(k) owners. One needs to be careful rushing to judgment about the distributional consequences of monetary policy.

Smick: Both political parties seem to be dubiously promoting what I call the "$250,000 myth." Republicans suggest the entitlement system can be fixed, the tax system reformed, and defense spending increased, and no one earning less than $250,000 will face the risk of higher taxation. Donald Trump says it is just the billionaire hedge fund owners who will shoulder the burden. Democrats have a wish list of progressive spending items and, once again, only those making $250,000 and above, they say, will take the hit to pay for these items. Isn't the "$250,000 myth" just that—a lie? There is not enough revenue above the $250,000 income level to do all the things both parties are proposing in this campaign.

Summers: I think you make an important point. The savings on entitlements that could come from limiting their

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accessibility to the rich are very limited. And it would detract from the universality that is a defining and desirable feature of Social Security and Medicare. I also agree that taxes should be more progressive, but there are limits on what can be taken from the wealthy.

Smick: Isn't the greatest flaw of the central bank community its failure to understand asset prices? That is, to predict whether asset prices are overvalued or not? Look at the vast number of economists associated with central banking who never saw the 2008 financial crisis coming. Are you worried that we have a world where equity market prices have become too central bank-driven? Have the central bankers maneuvered themselves into a weak position relative to their governments where monetary policy is expected to do what it was not necessarily designed to do alone?

Summers: It is infinitely easier to identify bubbles *ex post* rather than *ex ante*. And not many people have made fortunes multiple times by recognizing bubbles either in the official sector or outside it.

The essence of democratic governmental institutions is that they're supposed to distill the conventional wisdom and act on it, and the essence of bubbles is that the conventional wisdom is dead wrong. To expect democratically accountable institutions to be good at recognizing and puncturing bubbles is unrealistic.

I have an intermediate position. On the one hand, I think that the danger is lowflation, stagnation, and slow growth. I've been reluctant to push for central banks to tighten because that runs the risk of extra unemployment and setting off a deflationary tide.

On the other hand, there are risks associated with very low rates as people lever up and chase yield. That's why I've been a strong advocate for more of the burden of stimulus coming on the fiscal side than on the monetary side. There may be places where that's not easy. Our notion of debt capacity needs to be very different, however, in a zero interest world rather than in the world we came from. Why should this be the moment of the lowest rate of public investment—zero in net terms—in the United States since World War II?

Smick: What about a bipartisan deal? Entitlement reform (for those retiring in ten years and beyond) in exchange for infrastructure spending. Wouldn't such a grand bargain potentially produce a kind of paradigm shift with a change in global perceptions? Suddenly, it would be clear globally that in the United States a new bipartisan consensus had emerged to solve problems. In 1981, Ronald Reagan achieved a paradigm shift with his handling of the air traffic controllers union. To the surprise of many, the confidence of the leadership of a bloated U.S. corporate sector to be able to restructure soared. Wouldn't a grand bargain potentially be a similar confidence booster?

That raises the risk of a cycle where emerging markets pull the industrial world down and, in turn, the industrial world pulls emerging markets down.

Summers: I'd rather see a broad-based investment agenda that included much more public investment and infrastructure, and also embraced a set of measures directed at regulatory and tax reform that would promote private investment on a substantial scale. The right priority now is increasing the rate of growth, and that depends on increasing the rate of investment. Entitlement reform is still an important issue, but in light of the progress we've made bringing down the rate of health care costs, it is a somewhat less urgent issue than it appeared to be four or five years ago. I would rather see us deal with a rising debt-to-GDP ratio by raising the denominator, instead of painful measures to shrink the numerator.

Smick: If the next President, Republican or Democrat, called you in January 2017 for advice about America's low rates of productivity growth, what advice would you give him or her? Business startups by young people (outside of Silicon Valley) have hit an all-time low. Why is this and can this situation be reversed? Or is productivity growth being inadequately measured? Are the fundamentals of the economy actually better off than we think?

Summers: My best guess is we've been underestimating the rate of productivity growth. We calculate productivity growth in airlines, for example, based on the total number of passenger miles flown, but a lot of that has changed. Routing is more convenient than before. You check in much faster using your cell phone than you once did. You have wireless internet during the flight in a way that you never had before.

Not only are we underestimating productivity growth, but we're probably underestimating it by more than we used to. For instance, sectors such as health care where we know we underestimate productivity badly are a larger share of the economy than they once were.

That said, we're not doing as well as we could in growing the economy. We're very short on public investment in infrastructure, which contributes to congestion, which contributes to transportation problems, which contributes to the United States being a less attractive location for investment.

We are short on basic investments in science and technology. James Watson discovered the structure of DNA when he was twenty-seven. Albert Einstein created the theory of relativity when he was twenty-five. The average age for a researcher at the National Institutes of Health to get his or her first grant is now forty-two. We can do much more on the public sector side to invest in research.

We've also got substantial issues on the private sector side. In too many areas, there's too much of a presumption of prohibition and not enough of a presumption of permission, and it takes too long to get the necessary approvals to take a business to substantial scale. It is a huge cost on the economy.

Immigration reform is probably the single most important issue that could raise the underlying growth rate of the economy. If we were prepared to take more high-skilled immigrants from Asia, it would be a substantial shot in the arm for the economy. The Congressional Budget Office, which always estimates that any given policy will have a small behavioral impact, estimates that immigration reform alone could add half a percent a year to the GDP growth rate.

You can argue for any of a number of corporate tax reforms. But $2 trillion in corporate profits is being held outside the country in order to avoid taxation. With everybody continuing to anticipate some reform will pass in the next couple of years that will reduce the tax rate on bringing that money home, that money stays out of the country. Bringing some clarity to the corporate tax reform debate is a very high priority for stimulating investment.

And over the longer term, you have to address the fact that this is likely to be the first generation of Americans since George Washington that is not better educated than the generation of Americans now leaving the labor force. So I would recommend public investment in infrastructure, public investment in science, regulatory reform, tax reform, immigration reform, and for the very long run, increases in education quality. Those would be the priorities if the next president wants to increase our rate of economic growth.

Smick: But if productivity is being underestimated, then is inflation actually lower than official estimates with real interest rates higher than current measurements? And if so, what does it mean for the concept of secular stagnation? Why the need to tighten monetary policy, regardless of the near-term tightening of labor markets?

There's an important opportunity for Europe to respond to the various challenges associated with refugees and security with concerted European action drawing on the credit of Europe taken as a whole.

Summers: I agree with your thrust here. If inflation is now understated more than in the past, productivity looks less aberrant. Yet, if inflation is well below 2 percent, it is hard to see why the Fed should be tightening. Equivalently, if inflation is increasingly understated by conventional price indexes, then one would expect measured real rates to decline.

Smick: Are you worried about the possibility of another financial crisis? Eighty percent of today's IPOs are unprofitable when brought to market. In 2013 and 2014, U.S. corporations had 50 percent more debt than in 2006. More than 70 percent of this new debt is only B-rated. Some analysts think today's situation is similar to the situation in 1999 just before the dot.com crisis.

Summers: The essence of 2007 was not overvalued markets. It was declining markets, and declining values of assets that were held with very great leverage. If IPOs were to collapse, most of the people who are holding those IPOs are not holding them with very great leverage. I don't think most of the corporate debt that is being issued is being held with very great leverage. I am more worried that the economy will drive the financial sector down than I am that the financial sector will drive the economy down. ◆