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Larry Summers *Exit Interview*

TIE: **Let's start with China. The Chinese government is hinting that it plans to spend another $1.5 billion on new technologies. Housing and retail spending, the preoccupations in the United States, are not part of that spending. In the meantime, China's military has been engaged in a lot of bravado. How do you size up this brave new world?**

Summers: President John Kennedy died believing that Russia would be richer than the United States by 1985. Every issue of the *Harvard Business Review* in the early 1990s contained some joke or allusion to the effect that the Cold War has ended and Japan and Germany have won. Ezra Vogel's 1979 book *Japan As Number One* was a bestseller. But none of these prophecies proved to be correct. In fact, looking at the history of growth rates in all countries, the correlation between growth rates in one decade and growth rates in the next decade is remarkably low. Extrapolative forecasting is perilous.

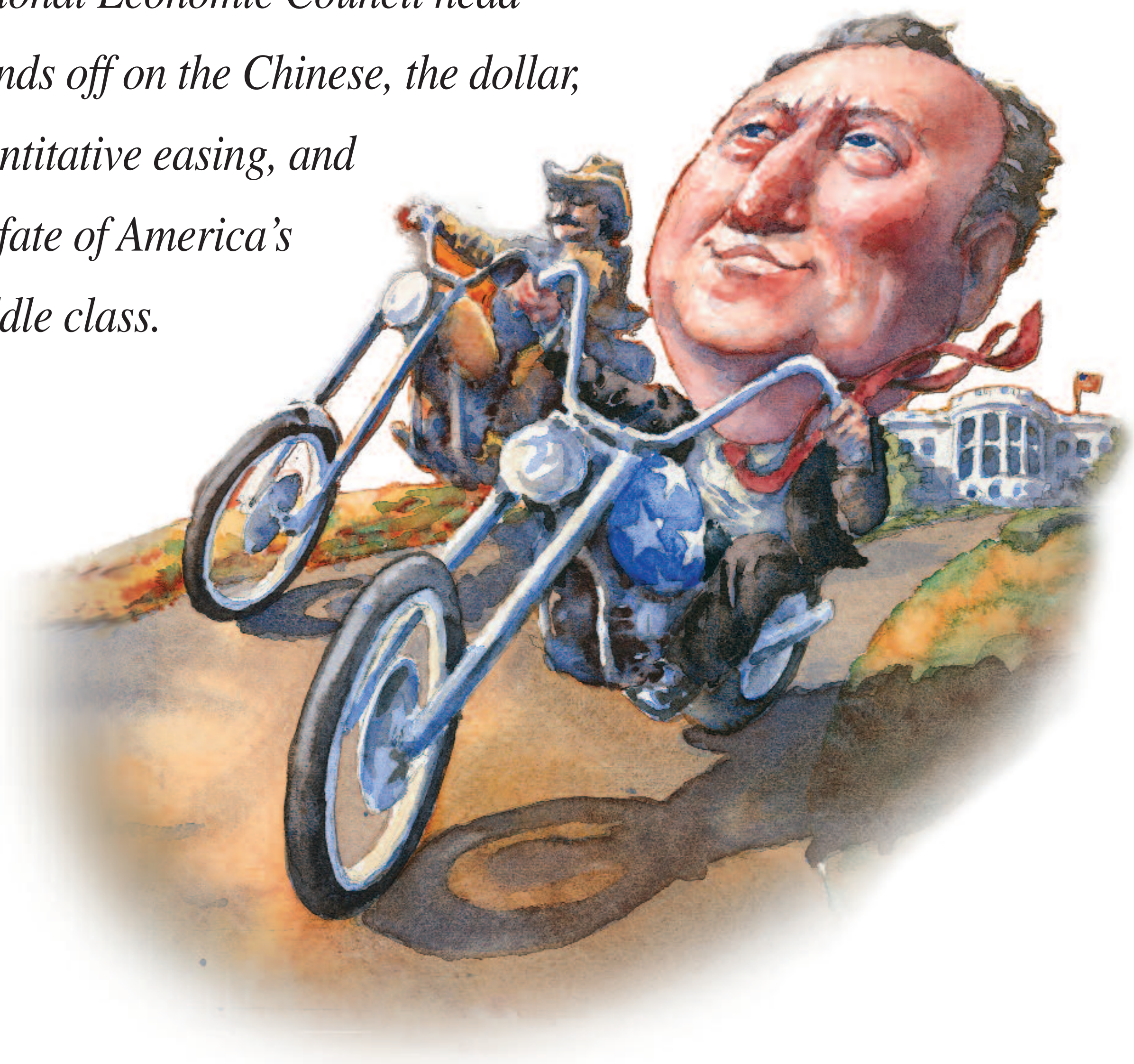
If concern about China leads the United States to strengthen our education system, invest more heavily in research and development, and contain our borrowing, then it could be very constructive. At the same time, it is easy to exaggerate what is happening in China. The average Chinese citizen is not nearly as rich as an average American was even two or three generations ago. The Chinese government is riding a tiger given all of the changes that are underway in that society.

There is always a seductive appeal to technology and public infrastructure. In the 1950s and 1960s people talked about the Moscow subway system in the same way that they talk about Chinese high-speed rail today. Whenever I hear about Chinese high-speed rail, I remember that the Shinkansen bullet train in Japan was built in the early 1960s. It may be fast, but it's not actually twenty-first century technology. It's very easy to overestimate our problems, and even easier to underestimate the political, environmental, financial, and societal transformational problems that China faces.

At the same time, history as far back as Athens versus Sparta cautions about rising economic powers. The United States is often cited as a benign example, but that's probably not how people feel in the Philippines, Cuba, Colombia, and in a number of other parts of the world. Relations with China are going to require a great deal of understanding and accommodation in both directions. We in the United States tend to be better at asserting the universality of our values than at accommodating the interests of those who see the world quite differently than we do. Usually, hoping for the best while preparing for the possibility of much less is a good idea. It will require a lot of discussion and mutual trust on both sides to prevent the worst outcomes from materializing. No question, when historians look back a couple of hundred years from now, the relationship between the United States and China is more likely to be the major story than either the end of the Cold War or anything that happens with the Islamic world.

TIE: **In the United States and Europe, elites have done everything they can to prop up bank balance sheet values, usually at taxpayer expense. Even in**

The Obama Administration's retiring National Economic Council head sounds off on the Chinese, the dollar, quantitative easing, and the fate of America's middle class.



China, the situation is building to where the government may have to bail out the banking system. Did Clinton political advisor James Carville get it wrong? He said that if he believed in reincarnation, he would want to come back as the bond market. Maybe he should come back as a Wall Street banker. Looking back several decades from now, do you think elites will be seen to have put the livelihoods of middle-class workers in jeopardy by attempting to prop up asset values that were unsustainable?

Summers: Whatever's happening in other countries, it needs to be emphasized that in the United States, the government got back all the money it put into the banks and earned for taxpayers a very good return. U.S. taxpayers are going to have to pay less in taxes than they would have if the government hadn't made those investments in the banks and the automobile companies. Taxpayers are not financing the bailout in the United States.

TIE: **Looking at it from the Federal Reserve's standpoint, the top twenty Wall Street banks enjoyed access to the Discount Window and were able to borrow for next to nothing. The small- and medium-sized financial firms—the job producers—meanwhile were starved for capital.**

Summers: But it's crucial to separate when taxpayer money is being transferred to elites and when it isn't. And the current perception in the United States is of much larger taxpayer transfers to elites than, in fact, took place. There really weren't taxpayer transfers to elites.

That said, concern about the middle class is increasing around the world. One crude theory of politics is that outcomes depend on the preferences of the middle class, and when the middle class thinks they have more to fear from a rich elite then they tend left, and when they think they have more to fear from their money being taken away and given to the undeserving poor they tend right. In 2008, the middle class felt they had more to fear from money going to elites and that contributed to the election outcomes.

My late Harvard colleague Sam Huntington talked about the rise of the cosmopolitan elites. There's a concern within countries that business leaders are more citizens of Davos than citizens of their particular country. To win support, global integration is going to require more credible demonstration that globalization doesn't mean local disintegration.

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The difference between efforts that cost the government money and ones that don't is going to turn out to be a very important distinction. As you well know, the profits earned by the Federal Reserve System have never been higher. The thinking that recent economic recovery programs are a straightforward cost on taxpayers is thus misleading. Nevertheless, as the connection between governments and elites becomes closer, the question of the legitimacy of government is going to become more real.

TIE: **Compare the average annual U.S. growth rate since the year 2000—about 2.6 percent—with the rate from 1945 to 2000, which was 3.4 percent. The difference is only 0.8 percent. While that sounds like a small difference, it accounts for the loss of ten million jobs. Americans therefore are witnessing an underperforming economy with big equity markets fueled by unprecedented central bank liquidity. So if you own a big stock portfolio, everything is wonderful. If you are strictly a middle-class wage earner, you're in trouble. Is this system politically sustainable?**

Summers: The challenge for this country over the next decade will be what happens to middle-class incomes and middle-class families' sense of well-being. Statistics say that U.S. middle-class incomes have stagnated in real terms, and they're right. But it's worth looking beyond those statistics. In terms of durable goods like television sets or refrigerators, or in terms of clothing or even food, there has been real progress.

Where middle-class incomes have fallen heavily behind are healthcare, childcare, and, until very recently, housing. This is why President Obama felt that addressing the problems around health care had to be done at the beginning of his presidency. We need job creation, and that's why infrastructure continues to be an ongoing priority, not a countercyclical one. The group that's having the most difficult time is men who didn't go to college and who expect to work with their hands. By supporting infrastructure development, we can help that group.

TIE: **How about the middle classes of China and Europe?**

Summers: If you ask the Chinese how they were living when they were children, they will say that no society has ever made as much progress. On the one hand, people generally expect their children to live much better than they do, but on the other hand there is acute resentment toward elites who lack legitimacy.

In Europe, there's a growing uneasiness about the future of an aging society. This is coupled with both a lack of acceptance of austerity in the countries that are in the most financial trouble, and failure to understand why it should be the responsibility of ordinary Germans to deal with whatever happens in Greece, Portugal, and Ireland.

In many ways, European integration seems to be one of mankind's more noble endeavors, but many ordinary citizens view integration as a project by the elites for the elites. Going back to the debates about the European constitution, there's been a real public legitimacy gap in Europe. But throughout the world, the question of confidence in institutions is becoming increasingly important. The more complicated the world becomes, the more it needs institutions even though the world finds itself with less and less confidence in those institutions.

TIE: **How about the monetary mechanism in the United States? The Fed has engaged in a second round of quantitative easing, the so-called QE2. A lot of people hope it will produce some kind of a wealth effect. While QE2 may be a clever idea, is the jury still out on whether the policy produces some negative unintended consequences?**

Summers: Credit flows require both borrowers and lenders. In the early stages of the crisis, there was clearly a problem with lenders being unable to lend even to creditworthy borrowers. It appears now that the larger problem in lending is on the demand side rather than on the supply side. The evidence is in the extremely low level of interest rates in credit spreads, and in the failure to invest even by those sitting on large amounts of cash earning a zero percent interest rate. It's common sense that you don't expand your restaurant or hire new waiters if your existing waiters are sitting around with no customers to serve. At this point, the problem is less with the monetary transmission mechanism than with a lack of effective demand to borrow.

Then there are bubbles. Bubbles lead to excessive optimism, excessively high prices of assets, and excessive creation of those assets, whether they're factories or houses or shopping centers. Bubbles then lead to excessive borrowing against those assets. When a bubble bursts, you are left on the one hand with an excess supply of assets sitting empty, and on the other with an excessively indebted set of asset holders. After a bubble, there is a very high desire to save in order to restore normal balance sheets, and no desire to invest because of the large number of assets sitting empty.

The normal economic mechanism for bridging excessive saving relative to investment is a decline in interest rates. But you can't jump very far out of the basement, and interest rates can't fall from zero. Thus, the mechanism doesn't really work to restore the economy. I've been an advocate for fiscal discipline throughout my career. Reducing deficits in the 1990s was part of what drove the economy forward. But in the current circumstance, where the private balance had swung into massive surplus, an upwards adjustment in the government budget deficit was appropriate. Only by getting demand going in the economy—so people would to see their office building start to fill up and see that existing workers had too much to do—could you start to engage the forces of expansion.

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***TIE:* Isn't it true that the wealth effect on the asset side is the only hope of those pushing quantitative easing, simply because the employment challenge is so enormous that anything short of a monstrously large monetary stimulus is doomed to fail? Some analysts argue that reducing the U.S. unemployment rate from 10 percent down to 5 percent would traditionally require a 400-basis-point cut in interest rates. With short-term nominal rates in the basement, the Fed to match that level of stimulus would need to do $4–$6 trillion in bond purchases.**

Summers: If the multiplier of a policy instrument is relatively low, it's never entirely clear whether that's an argument for not using the policy instrument, or for using it on a larger scale. It's certainly true that Taylor Rule calculations suggest that interest rates could be—if it were possible—minus-3 percent or even minus-5 percent. And no one thinks that $600 million in quantitative easing corresponds to a reduction in interest rates of anything approaching that magnitude. I understand the view that QE2 will be relatively ineffective, or that it will be inflationary. But I don't see how it could be both. If QE2 does not meaningfully affect the credit process, then it is hard to understand how it can be inflationary. The greater risks in the current environment are more on the side of doing too little to assure that the recovery is rapid and normal conditions return, than on the side of making the mistakes of the 1970s and running into an excessively inflationary environment.

***TIE:* No postwar U.S. recovery has performed well without housing leading the charge. Yet housing is still in the basement. Statistics show that if a person borrowed to buy a house within two years of the peak, because of negative equity in the house, that person can't refinance even if rates are attractive.**

Summers: The Obama Administration put in place a set of programs, though nothing as rapidly as we would have liked. The HARP program through the Federal Housing Administration was directed at exactly at that problem—financing for people who had met all their obligations but whose mortgage was currently underwater.

But the challenge is deeper. We have a substantial inventory of unused homes. It's not clear that if we somehow found a way to get more houses built before that inventory was worked off, it would be an especially good thing to do. I'm hardly Austrian in my outlook, but building more of what's already in excess supply as a countercyclical tool does not seem like nearly as good an idea as trying to encourage energy efficiency investments in existing houses.

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Traditional economic thinking puts too little weight on qualitative change as distinct from quantitative change. People always talk about excess capacity and they're right. Despite three personal computers in our basement, I still bought an iPad because it was able to do different things. Solving the housing situation is going to be difficult. But we should look at spurring investment in areas where qualitative improvement is possible.

I was struck by the extent to which the U.S. bonds were a flight-to-quality asset even in a global financial crisis in which the United States was at the epicenter.

***TIE:* Banks have a lot of inventory on their balance sheets with foreclosures and so forth. Are you concerned at all about accounting forbearance? One of the reasons the inventory stays on bank balance sheets is the failure rates—the banks don't want to write it off until they are earning profits. Wouldn't getting inventory off the balance sheets and into the market help clear this process and make housing more affordable?**

Summers: You raise an important point. We put a lot of emphasis on raising capital ratios in banks. However, a number of the institutions that failed were reporting terrific regulatory capital almost on the brink of their failure. I hope over time we will look carefully at our measurement concepts for regulatory capital as well as our levels of regulatory capital.

***TIE:* If the German people end up backstopping the European sovereign debt problem, presumably the Bund (ten-year government bond) will take a hit and interest rates will rise? Will there be a contagion effect with U.S. Treasury rates?**

Summers: I could argue both sides on that issue. You could argue the inflationary effect, but you could also argue a flight to quality develops if there used to be two quality assets and now there's only one.

***TIE:* What about the dollar?**

Summers: You have to hold something. That's the explanation I've been giving for years for why gold's done so well. There is no alternative currency to buy. It's implicit in the way you're talking about it to judge what the impact will be, because the extent to which Europe has difficulty will tend to reduce demand relative to supply of global credit markets. This will tend to lower interest rates, which will tend to raise uncertainty premia, which will raise interest rates, which will tend to lead to a flight to quality to the United States, which will tend to reduce interest rates, and so on.

It's pretty difficult to work out what the impact of developments in Europe will be, but one possibility is that complexity in Europe raises uncertainty which leads to a flight to quality. I was struck by the extent to which the U.S. bonds were a flight-to-quality asset even in a global financial crisis in which the United States was at the epicenter. And in a financial crisis where the United States is not the epicenter, I would expect the flight to quality and safety to happen on an even more pronounced basis.

The alternative view would be that if Germany signals in some unambiguous way that the European debt situation is going to be resolved in a manner easier than expected, then some of the uncertainty premium may come out of interest rates and you may have less flight to quality.

***TIE:* The Chinese have just announced that Chinese overseas corporations no longer need to bring back capital, which is another way of saying the Chinese will no longer be big buyers of U.S. Treasury securities. What are the implications of this decision? Will the Fed be forced to become the big buyer in the Treasury auction the way it performed during World War II? Is there a chance of an inflationary effect? How about a crowding-out effect from such policies?**

Summers: I see a very different situation in a substantially demand-constrained liquidity trap economy. Many of the traditional shibboleths about prudent policy don't really apply in that context. That's why John Maynard Keynes's book, *General Theory of Employment, Interest and Money,* was so important. At the same time, Keynes's book was actually a specific theory of a depressed liquidity-trap economy. As we succeed in the United States in normalizing conditions, then the normal laws of economics regarding inflation, interest rates, and confidence can come back very quickly. As MIT Professor Rudi Dornbusch used to say, things in markets and economies take longer to happen than you think they will, and then they happen faster than you thought they could. That was a good thing to remember as imbalances built up before the crisis, and I think it's a good thing to remember now.

***TIE:* Thank you very much.** ◆