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Summers *Speaks*

Lawrence H. Summers

In an exclusive interview, the Harvard professor takes on the subprime crisis, moral hazard, and Alan Greenspan's inflation forecast.

TIE: **This is the twentieth anniversary of *The International Economy* magazine. In some respects, this magazine really appeared in part because of some remarks you made at one of the conferences we held back in the 1980s. You stood up and commented on how there was a need for greater statecraft within the international economics community. Certainly statecraft existed then in the fields of national security and foreign policy, with magazines and think tanks offering the means for discussion, but not enough in the field of international economic policy.**

Summers: I do recall thinking that there was a space between the Henry Kissinger kind of stuff—geopolitics and negotiations—and Martin Feldstein stuff—regressions and models. It seemed underfilled.

TIE: **You've been involved as a policymaker in the G7 policy coordination process. How do you feel about where things are going today, and what changes need to be made? Should the system be restructured? Is it impossible to have G7 cooperation given so many new countries that aren't normally part of the inside club?**

Summers: We have two main challenges in terms of the coordination process. First, the G7 doesn't have the legitimacy or primacy as a steering group for the world economy that it once did. Everybody remarks that of the G7 countries, three already use the same currency and most will not be among the world's five largest

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economies a generation from now. We worked very hard at broadening the structure during my time at Treasury. We had a "proliferate-the-fora" approach to involving other countries with the APEC and Latin American Finance Ministers meetings, the New Arrangement to Borrow, and the various G22, G33, and ultimately G20 groups. The dialogue does seem to be in better shape because of those efforts, but the new fora don't have quite the prestige or influence of the G7 in its heyday. It was the right place to start, although some alternative group will probably be important for the future.

The second problem in the coordination process is much less discussed, and it's less a problem than an aspect of the situation. The central banks have become much more independent than they were in the 1980s, and the fact that they are is taken much more as a given. The European Central Bank doesn't quite have a political master, and the U.S. Federal Reserve and the Bank of England are much more independent, while the Bank of Japan is somewhat more independent. The concept of seven or twenty countries negotiating is less feasible than it once was with the bifurcation of power within countries. You can't really separate exchange rates from monetary policy. So what exactly is it you're coordinating? Independence has been on the whole a good thing because of the credibility and disinflationary benefits it has brought, but it has also complicated the coordinating process.

Judging not by the state of the process but by the outcomes, the global economy has grown more rapidly than we could reasonably have expected or any forecast we might sensibly have made twenty years ago when *The International Economy* magazine was launched. The U.S. economy has grown far more rapidly than we could reasonably have expected, and the degrees of cyclicality and inflation have been significantly lower. To some extent, a less-robust coordination process is like observing that surgeons have had less to do. That may mean fewer interesting articles for *Surgery Today* magazine, but it also represents a great deal of progress for the world.

***TIE:* Do you think because of all this prosperity and lack of cyclicality, we've become complacent? Maybe we won't be as prepared this time?**

Summers: Perhaps. I recycle a particular line every decade or so. In 1997, I said in Davos that the main thing we have to fear is lack of fear itself. The line had been sufficiently forgotten that I used it again in the *Financial Times* this past winter. There is a tendency toward complacency. And as we have seen in recent months yet again, complacency can easily become a self-denying prophecy if it leads to imprudent borrowing, lending, and spending decisions.

The current arrangements where the Fed is closely involved with big banks but much less involved with other institutions could create some pressures for a more corporatist, Japanese-style approach than I would be comfortable with.

The trick though is remembering that complacency is really an extreme manifestation of confidence, which is a good thing. I am not one who shares as fully as others the obsession with moral hazard. The mirror image of moral hazard is confidence, and we generally have an environment where there is confidence that contagion will be contained, that bank runs won't be allowed to spread, and therefore people can take risks they might not have otherwise. This is a major stabilizing factor for the global economy and probably also reduces the need for extremely expensive bailouts.

***TIE:* Good point. In fact, you could argue that blustering about moral hazard and then reversing yourself to bail out a troubled bank, like Bank of England Governor Mervyn King with the firm Northern Rock, discredit moral hazard.**

Summers: It's all very well to grumble about moral hazard, but five million American families own their own homes thanks to a more sophisticated mortgage market. There are plenty of predatory abuses that we should correct, but we need to be careful about succumbing to a sadomasochistic "We need pain or we'll become complacent" sort of world view.

***TIE:* Moral hazard is not something easily defined, because where is a fine line when it becomes an act being**

European Embarrassment

"At an international meeting a decade ago, I inquired innocently, "Could the Europeans here explain to me what happens if a bank in Spain gets into serious trouble? What are the respective responsibilities of the Spanish supervision authorities, the Spanish central bank, the ECB, and Brussels?" What followed was a brief embarrassed silence in which the Europeans looked at each other, then a chaotic argument among the Europeans, which ended without resolution but only a sense that they didn't want to air their linen in front of the rest of us. So I was left with the sense that, as so often happens in public life, harmony had been purchased at the expense of ambiguity. I think we're seeing some of the consequences of that ambiguity."

—L. Summers

geared to systemic or to special privilege? It's very hard to tell until after the fact.

Summers: Here's a question. What surprised you about former Federal Reserve Chairman Alan Greenspan's new book, *The Age of Turbulence?*

TIE: **We were surprised that he actually wrote the book. For someone like Greenspan, our view was that it's better to be always writing the book but never finishing it. Now everybody can choose sides. We're surprised at how hard it's been hit. As smart as he is politically, he didn't seem to anticipate that he was vulnerable on the issue of the subprime housing bubble. We think he anticipated some of the criticism and created a clever diversion by criticizing the Republican Party for their lack of discipline on spending and deficits. That diversion only worked briefly, however.**

We're also amazed that Greenspan hasn't used a more effective defense strategy over his responsibility for creating the housing bubble. Look at the period when the Fed reduced interest rates to one percent. The United States appeared to be following the same disinflationary path of Japan. The Fed had to make some very tough decisions with unintended consequences, one of which was a housing bubble. This bubble, frankly, is going to be very painful to a lot of people, but that's nothing like having a lost decade like the Japanese did, from which they are still trying to recover. Greenspan knew the United States had to get ahead of that train, and he acted accordingly. That's the case he should be making. The nature of this financial system means there are no simple moves. Everything has a tradeoff.

In addition, Greenspan gets absolutely no credit for his insight in the late 1990s that increases in productivity would allow unemployment to drop without stoking inflation. That insight probably gave this country a couple trillion dollars of additional wealth.

What do you make of Greenspan's forecast of inflationary danger by the year 2030?

Summers: I am somewhat more optimistic than my friend Alan Greenspan about the prospects for inflation over the next fifty years. The first edition of Paul Samuelson's textbook in 1947 showed a graph of the price level, not a graph of the rate of inflation, because the price level went up and down. The world experienced a terrible and quite universal episode of inflation in the 1970s and 1980s. But I look at the full variety of countries, including countries such as Brazil with very substantially populist governments that have maintained reasonably durable commitments to low inflation now in a variety of political environments, and I wonder whether the world's fairly disastrous abuse of fiat money in the post-Bretton Woods period may not prove to be a somewhat more historically isolated episode than Alan believes. Conversely, I see a greater risk that combinations of bad luck and bad financial policy will lead to significant parts of the world having a disastrous and protracted recession of the kind Japan suffered during the 1990s.

TIE: **How do you size up Fed Chairman Ben Bernanke's first handling of a crisis? Of course it's not over, but his coming in with a fifty-basis-point move on the discount rate brings up the whole question of his coming to terms with the Greenspan "put." To what extent is there now a Bernanke "put"?**

Summers: It's premature to make any definitive judgements. Certainly many of the worst sinners in the subprime lending business have gone bankrupt, and many more have lost large amounts of value. Those who mis-assessed the risks associated with a whole variety of securities have suffered very substantially.

There's no question that the Fed has been successful in adding confidence in a very difficult situation. In doing that, the Fed has probably created some expectation that in future difficult situations it will add confidence. That may lead to some increased risk-taking, but also to increased confidence and stability the next time there's an adverse shock.

This crisis leaves us with a very big question about what the tools are for regulating and providing finance when the equivalent of a bank run takes place with respect to a non-bank entity. That question is not satisfactorily resolved in the regulatory system of any country.

TIE: **Perhaps the financial system isn't quite sure where the safety net is, so these off-balance-sheet entities develop with too much confidence. Can you clarify this issue, taking into account your points about moral hazard?**

Summers: I don't think we have a single safety net. There's a constellation of policies; liquidity support to protect against bank runs guarantees to insure investors in certain institutions. Yet the need for regulation is inherently part of any modern financial system. Regulation and liquidity support need to be properly balanced against each other, and we do not have complete clarity about how that balance is to take place in the United States right now. There is certainly some indication that some institutions are systemically important enough to merit a financial response, yet these institutions are not significantly regulated before problems become apparent.

There's also considerable evidence that regulation with heavy emphasis on mark-to-market pricing can easily induce pro-cyclicality. And there is the concern about whether satisfactory tools exist for providing liquidity as distinct from guarantees when the problems lie in non-bank institutions. One of the important risks in the current system is that it creates some incentives toward turning major banks into public utilities which are asked to cooperate with the Fed in responding to broader problems in the financial system. One needs to stay very far away as a general matter from encouraging policy lending. The current arrangements where the Fed is closely involved with big banks but much less involved with other institutions could create some pressures for a more corporatist, Japanese-style approach than I would be comfortable with.

TIE: **How worried are you about the fact that in Europe, there seems to be a separation between the roles of monetary policy and the roles of bank supervision and bank regulation?**

Summers: I am worried but not surprised. At an international meeting a decade ago, I inquired innocently, "Could the Europeans here explain to me what happens if a bank in Spain gets into serious trouble? What are the respective responsibilities of the Spanish supervision authorities, the Spanish central bank, the ECB, and Brussels?" What followed was a brief embarrassed silence in which the Europeans looked at each other, then a chaotic argument among the Europeans, which ended without resolution but only a sense that they didn't want to air their linen in front of the rest of us. So I was left with the sense that, as so often happens in public life, harmony had been purchased at the expense of ambiguity. I think we're seeing some of the consequences of that ambiguity.

TIE: **We agree. Let us ask you something on a broader topic. The industrialized world economy has benefited from several decades of cheap commodity prices, including oil. With this explosion in globalization as China and India continue to develop, we're seeing commodity prices going through the roof. The world's excess saving economies—including the oil producers—are in a situation that clearly looks like it's leading to tensions with the industrialized world. They are establishing sovereign investment funds with the desire to purchase hard assets. Do you see this leading to an unraveling of the whole globalization model?**

Summers: I'd offer several observations. First, there's a consistent tendency to underestimate the impact of real interest rates on commodity prices. When real interest rates are low, it always seems like a good idea to keep your commodity in the ground and let it appreciate. So to an extent I think is underestimated, commodity prices will tend to track the behavior of real interest rates. We've had abnormally low real interest rates in recent years. I wouldn't be certain that we will have a high commodity price environment forever. To some extent, the move toward a more knowledge-based economy has made commodity prices less central than they once were to the overall economic performance of industrial countries.

The second observation is that the whole set of issues surrounding sovereign wealth funds is going to require very extensive attention. It is difficult to know just where the bright lines should be drawn, but it would be a great irony and not a happy one if we were to see large-scale cross-border renationalizations over the next decade because sovereign wealth funds or central banks with large accumulations of reserves chose to make direct investments in hard assets with control rights rather than indirect portfolio investments. I don't look forward to the day when international diplomacy includes requests for tax breaks for the companies in one country that are owned by the sovereign wealth fund of another country. On the one hand, it is a mistake to abuse the concept of "strategic" in order to provide protection. But equally it's a mistake to assume that governments are just another investor if they're investing hundred of billions of dollars and if their broad geopolitical interests are not in harmony with the country in which they're investing.

TIE: **China appears to be experiencing a bubble. Has there ever been a bubble that didn't burst?**

Summers: We only call it a bubble in history if it did burst. For example, in the fall of 1996 when Alan Greenspan used the term "irrational exuberance," the Dow was in the 6,000s. That was a declaration of a bubble that wasn't. There was a quite high degree of confidence in many quarters that the dollar was a bubble deeper into the 1980s than proved to be the case. Many observers expected some deceleration in Asia to take place more quickly than it did before the Asian financial crisis.

If you asked whether there ever been significant prophecies of doom that didn't come true, certainly there have been people for twenty-five years now who have been very worried about very damaging hard landings from the dollar, but whose fears have not materialized.

International monetary history records dozens of instances of exchange rates that were held too fixed for too long, with substantial adverse consequences at the moment when the exchange rate had to let go. I am aware of no convincing example of a fixed exchange rate that could have been maintained but that was instead adjusted prematurely, and for which there were adverse consequences. Looking at the tendency toward very fixed exchange rates in many of the emerging market countries, I worry that mistake will be made again, though to be fair we have much more experience with countries where the exchange rate should be devalued than revalued.

TIE: **Where do you see the situation with global imbalances going at this point?**

Summers: The classic concern with respect to imbalances is that a situation develops where people are both trying to take money out of a country's banks and trying to sell its currency. And the central bank can't both add liquidity to help the banking system and the economy and reduce liquidity to maintain currency stability. Those are the situations where imbalances become most serious. The United States is much closer to a situation of that kind now than it has been at many other moments of concern about imbalances.

TIE: **We're not sure though how many eurodollars and pounds are being pumped out there either.**

Summers: Right. To what extent this is an American problem or a general problem or an English-speaking country problem is not entirely clear.

TIE: **How do you size up the free trade consensus in the United States? And to what extent will global warming become a factor in trade discussions? The Germans are talking about spending 800 billion euros over the next thirty years on global warming. Will global warming efforts become a kind of a new industrial policy, the next great stimulus of domestic demand?**

Summers: On trade, the lessons are pretty clear that more open markets in the vast majority of cases contribute very strongly to better economic performance. Nothing in the experience of the last decade suggests otherwise to me. It is true that widening income inequality is becoming a central economic problem in the United States and to a lesser extent in the industrial world. And that is going to require a much more energetic response than the standard adjustment assistance that tends to accompany advocacy of free trade.

If the income distribution in the United States were the same today as it was in 1979, the bottom 80 percent of the population would have about $670 billion more, or about $8,000 per family. And the top one percent would have about $670 billion less, or about $500,000 per family. Relative to numbers like that, a $3 billion trade adjustment assistance program looks very small. We need to think in a much more comprehensive way about income distribution, the progressivity of taxation, the enforcement of tax laws, and the benefits of public spending if we're going to maintain broad support for the legitimacy of the system including the ability to maintain open markets.

With respect to global warming, it is very hard to know which way it will move. In no other public policy issue that I've been engaged in has the gap between the rhetoric and the concrete action been as large. While there is tremendously visionary rhetoric about the complete transformation of economies and the like, the reality is that all of the discussions of global warming have to date resulted in only very small differences in patterns of energy use relative to business as usual. While Europe is doing much better than the United States or other parts

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of the world at meeting the kinds of targets embodied in the Kyoto Protocol, that is largely because of events involving de-emphasis on coal in England, Germany, and Russia which were driven primarily by domestic factors rather than by global warming concerns.

The future for emissions reduction is much less clear. If the European Union was not able to impose penalties on countries that failed to meet budget deficit targets, with all the history of comity and cooperation that existed in Europe and all the direct control that governments have over their finances, it is going to be profoundly difficult to reach enforceable agreements. Emissions are much harder to measure than budget deficits and, because they depend upon overall economic performance, are actually much less subject to public control. While I have no doubt that the science is entirely clear about the very large risks of unchecked accumulation of greenhouse gases, and while there is increasing rhetorical and political commitment in many countries, I think that the task of reaching viable international agreements is a formidable one that many underestimate.

There is a strong tendency in political life to respond to political difficulty by simultaneously lengthening the horizon and escalating the strength of the commitment. When I hear politicians talk about reducing greenhouse gases by 50 percent relative to benchmark by 2030 or 2050, I sense this tendency making itself felt. It would be much more impressive if meaningful actions were undertaken that would change patterns of energy use through either taxes or regulatory instruments with measurable impacts three or five or seven years from now.

There hasn't been enough reflection yet on the interactions between the global warming issue and international trade. The point is frequently made in the United States that it is not fair for the United States to take on binding commitments with respect to greenhouse gases if other major countries do not take those commitments. There's certainly some force to that argument. But there is a stronger related argument that if such commitments are undertaken by the major industrial countries and not by other countries, there's the prospect that they will not have any effect on the overall level of greenhouse gas emissions because the production of energy-intensive goods will simply migrate to the countries that are not constrained. When that happens, the targets will perhaps be met from the industrial countries, but the reductions in industrial country emissions will not represent reductions in total global emissions, so they will be ineffective. The world has so much difficulty now enforcing codes on subsidies or measures of protection. How is it going to undertake the formidable task of looking at the overall structure of energy economies and judging when there are unfair subsidies?

TIE: **Larry, maybe you were right all along years ago when you were so criticized at the World Bank for your views on comparative advantage.**

Summers: As has been the case at several points in my career, those thoughts could perhaps have been expressed in a more felicitous way.

TIE: **One final question: Are you supporting a candidate in the Democratic primary? And how do you size up the economic, trade, and financial positions of the three major Democratic candidates?**

Summers: There's a great deal that can be improved on in the economic policy of the last seven years. More needs to be done to restore the kind of fiscal health that we had in 2000. A more cooperative posture needs to be taken with respect to the rest of the world. The needs of middle-class families have not been central in the setting of economic policy over the last seven years in the way they were during the Clinton years. And we've had important shortfalls in a variety of public investment areas despite all the increases in domestic spending. Can it possibly make sense with the life sciences revolution we're having that there's substantially less grant money available for young biologists today that there was two years ago? And if anyone thought that the failure to build the levies in New Orleans was an isolated accident, the bridge collapse in Minneapolis should have convinced them otherwise. We can do much better as a country, and the differences between the Democratic candidates are probably small compared to the differences between any of them and the Republicans.

TIE: **Thank you very much.** ◆