The Prophet

Lawrence H. Summers:
"I did not expect so much inflation so soon… we are looking at real grounds for concern going forward."

TIE *Founder and Editor David Smick interviews Larry Summers, the former Clinton Treasury secretary, top Obama economic adviser, and Harvard president. Summers' recent accurate inflation forecasts have drawn attention from many market participants.*

TIE: **The New York Federal Reserve recently upped its inflation forecast. A sizable number of FOMC members in their public statements are also sounding a lot more concerned about the recent rise in inflation. You were way out front in your inflation forecast. For example, at the beginning of this fiscal year, U.S. Treasury Secretary Janet Yellen predicted 2 percent inflation by year end. We are of course way beyond that now. The argument that the inflationary outbreak is all transitory seems increasingly less convincing. What convinced you to take this public stand? A lot of people in the Democratic Party weren't very happy with you. But then I am reminded that you did the same thing with Fannie and Freddie years ago. They were a major Democratic Party fundraising base but you took them on anyway, accurately predicting a coming crisis. Is this your new public policy role now—to say courageously what needs to be said, even if it is unpopular?**

Summers: I try to call them as I see them, especially when I'm not in government. Ultimately, everybody's interests are best served by the most open debate.

I was surprised by the complacency surrounding inflation early this year. It seems to me that if you did very elementary calculations of the output gap, the size of the fiscal stimulus, the multiplier, the extremely expansionary monetary policy, and the savings overhang, you reach the conclusion that aggregate demand was going to run very hot relative to even optimistic views about supply. Frankly, I did not expect so much inflation so soon. We are looking at real grounds for concern going forward.

TIE: **Where does China fit into your global forecast? Will Chinese and other supply bottlenecks continue? The Chinese economy seems to be slowing. I'm not ready to utter the word "stagflation," but to what degree does the role of China play into your outlook for U.S. GDP growth, interest rates, and inflation in 2022?**

Summers: China is a major source of uncertainty for itself, and for the global economy. Some years ago, I predicted mean reversion in Chinese growth rates. There has been less mean reversion than I would have expected. Looking at Evergrande and what it signifies for the Chinese real estate sector, which is hypertrophic relative to the Chinese economy, and looking at the demography, rising protectionism, and the increasing extent of state control, I am concerned about China's economic prospects. Potentially, that will have significant consequences for global commodity markets, and for many emerging markets for whom China is an important export destination. Ultimately, it is a negative factor for the U.S. economy. I think the forces coming out of China look to be, right now, more deflationary than stagflationary.

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TIE: **Talk a bit more about your China worries. Upper-middle-class Chinese families for so long bought one or two extra properties as an inflation hedge. But that situation is at risk of unwinding, particularly if consumer demand weakens further and credit conditions contract under President Xi Jinping's new inward policies. Will a Chinese real estate collapse be the tripwire of the global economy?**

Summers: I am quite concerned about what could emanate from China. In mechanical models, it's not so easy to go from adverse events in China to major global consequences. But then again, it was even harder in those kinds of mechanical models to trace huge linkages from, for example, the Thai baht or the Indonesian rupee to the global economy in the late 1990s. And that is what we saw.

Problems in China are a major source of global risk. Other sources of uncertainty are another pandemic or a

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President Bill Clinton *with Treasury Secretary* **Robert Rubin** *(right) and Treasury Secretary nominee* **Lawrence Summers** *(left) after announcing Summers' nomination on May 12, 1999.*

A Foolish Mistake

I've been very clear that I think the combination of the stimulus packages at the beginning of the year that totaled $2.8 trillion were a consequential macroeconomic policy error. The argument I made that has gotten more attention is the concern about overheating the economy, given that the size of the stimulus substantially exceeded any reasonable estimate of the size of the GDP gap by a substantial margin.

But the other argument I made at the time was that there was a finiteness to fiscal space—because of what both markets and politics would tolerate. Absorbing so much fiscal space while doing so little in the way of public investment would be a mistake that we would regret.

—L. Summers

mutation of the coronavirus that is significantly more lethal and transmissible, and also a generally extended level of asset valuation. If my suspicions are right that long-term interest rates are substantially too low for the current settings of policy, then there is the risk that the market wakes up to that reality with consequences for bond, stock, and real estate markets.

TIE: **In this issue of *TIE,* we are concentrating on the subject of sovereign debt. Can you comment on the link between America's sovereign debt as a percentage of GDP and the performance of the ten-year Treasury bond? Time and again, the debt load has jumped yet long bond yields until recently either stayed stationary or dropped. Quantitative easing no doubt played a role in this outcome by distorting a traditional market signaling device. But now rising U.S. Treasury ten-year bond yields reflect a concern for the future. What is going on in your opinion? Are sovereign debt ratios largely irrelevant to bond yields short of a series of supply shocks that damage the supply chain? Or does debt matter? Sooner or later, aren't interest rates and price levels affected? Or is that old-school thinking?**

Then again, if, as some of your critics maintain, in the New Economics the level of U.S. sovereign debt has little or no bearing on the level of U.S. interest rates or the efficiency of the economy (productivity), why not increase the level of U.S. public debt to 200 percent of GDP? Why not 500 percent? Why not unlimited public debt if the effect on the real economy is nil? The same could be asked about the size of the U.S. Federal Reserve's balance sheet and the level of quantitative easing.

Summers: You've raised a lot of issues there. Let me comment on some of them.

My view is that the fundamental reason why real interest rates are low is a set of structural changes in the global economy that have taken place over the last generation. Slowing population growth has meant less demand for new housing investment or new business investment to equip a growing workforce. Increased saving has led to rising inequality as redistribution takes place from lower savers to higher savers. Changing technology—whether it's investment banks, hotels and offices, malls being converted into warehouses, or vast amounts of computing power being contained in $600 cell phones—means a reduction in the demand for capital. This

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A Bad Idea

I think of quantitative easing as the Fed issuing reserves which are essentially floating-rate government obligations and buying longer-term government instruments. I'm not sure why that is a good idea. Everybody else in the economy is turning out debt. For the Fed to turn in the debt of the government of the United States, at a time of unprecedented uncertainty and remarkably low long rates, seems to me a quite odd decision. I wish tapering had already begun and I hope it will play out before too long.

—*L. Summers*

OFFICIAL WHITE HOUSE PHOTO BY PETE SOUZA

President Barack Obama *(right) meets with his economic team, including National Economic Council Director* **Larry Summers.**

is a world where cutting-edge growth technology companies such as Apple and Google face a major business problem with what to do with all the cash they are generating.

This is going to be a very low interest rate world where savings is chronically strong relative to investment. It's going to be a world where there is pressure on governments to fill the demand gap by spending and accumulating debt.

From my perspective, deficits are not a random choice of policymakers. They are a reflection of structural forces that are driving wedges between private savings and private investment. To say that low interest rates coincident with large deficits means that deficits do not impact interest rates is as foolish as saying that high death rates and hospitals tend to go together and to conclude that hospitals are killers. The reality is that the deficits are a natural kind of response of the system to the forces that have produced low interest rates.

We need to recognize this as we formulate fiscal policy. Whatever the exact merits of the celebrated Maastricht criteria—a 60 percent debt-to-GDP ratio and a 3 percent deficit ratio—these criteria were formulated at a time when German nominal interest rates were in the 9 percent range and German real interest rates were in the 5 percent range. Now, when nominal interest rates are a little bit negative, and real interest rates are significantly negative, is a moment for potentially very different thinking about fiscal policy.

Woke Central Banking

The climate today is of more woke central banking, where central bankers give speeches about challenges not proximally related to inflation or unemployment such as climate change, and reject the idea of preempting inflation in favor of the idea of waiting until inflation is firmly established. These things threaten a return to the kind of psychology that prevailed in the 1960s and 1970s and contributed to excessive inflation.

—*L. Summers*

ECB President
Christine Lagarde

If my suspicions are right that long-term interest rates are substantially too low for the current settings of policy, then there is the risk that the market wakes up to that reality with consequences for bond, stock, and real estate markets.

Whatever one regarded as an appropriate budget target in the day of 3 or 4 percent real interest rates in the United States, in the days of ten-year index bonds trading in the minus-1 percent range, we need to think differently about appropriate fiscal policy. Does that mean that we can run ever-expanding debt-to-GDP ratios? No. Does that mean that higher deficits will have no impact on interest rates? No. Does that mean that there's some insight in modern monetary theory that we have all missed? Surely no. Making economic policy requires understanding the world that we live in, and that world has changed in important respects.

With regard to the Fed's balance sheet, I think there is some confusion here going back to an earlier era when the Fed did not pay interest on reserves. I think of quantitative easing as the Fed issuing reserves which are essentially floating-rate government obligations and buying longer-term government instruments. I'm not sure why that is a good idea. Everybody else in the economy is turning out debt. For the Fed to turn in the debt of the government of the United States, at a time of unprecedented uncertainty and remarkably low long rates, seems to me a quite odd decision. I wish tapering had already begun and I hope it will play out before too long.

But it's important to understand that the size of the Fed's balance sheet is really one component of what is an overall national decision about the maturity structure of the debt. And a maturity structure of the debt that has to be held by the marketplace. What I think has received too little

Continued on page 76

Continued from page 13

attention in the commentary is the reality that while the Fed has been buying securities at an unprecedented rate, the government has also been issuing them at an unprecedented rate. What really should be relevant for markets is the net stock of duration that it has to absorb, which I think by most measures has gone up rather than gone down.

TIE: **Some analysts suggest the global supply shocks are not likely to go away any time soon. Others suggest $100 or $120 oil is coming, perhaps by late in 2021. Is there a chance that the U.S. economy will hit a fiscal cliff in 2022—and that policymakers will regret having passed out the stimulus checks so soon because of issues relating to fiscal space? The economy, having been shut down, was already rebounding. Will we someday regret firing off this particular ammunition to consumers so soon?**

Summers: I don't have a view on oil prices and where they are going. I do have a view that we're likely, with demand growing faster than potential output for the next few quarters, to encounter a rising number of bottlenecks. I am less optimistic than many that labor shortages will ease. So far, my pessimism about the demand-supply balance has been fully warranted. We'll have to see over time what comes next.

I've been very clear that I think the combination of the stimulus packages at the beginning of the year that totaled $2.8 trillion were a consequential macroeconomic policy error. The argument I made that has gotten more attention is the concern about overheating the economy, given that the size of the stimulus substantially exceeded any reasonable estimate of the size of the GDP gap by a substantial margin.

But the other argument I made at the time was that there was a finiteness to fiscal space—because of what both markets and politics would tolerate. Absorbing so much fiscal space while doing so little in the way of public investment would be a mistake that we would regret.

Does that mean that there's some insight in modern monetary theory that we have all missed? Surely no.

It is already true that there would be more political space for the vitally important investment that President Biden contemplates as part of his Building Back Better agenda if we had absorbed less fiscal space at the beginning of the year. Contingencies could arise down the road where we would regret not having more fiscal space. So certainly I believe that the long-term investment program now under discussion in Congress should, to whatever extent it is enacted, be fully financed by revenue increases. I do have a concern about the using up of fiscal space.

Deficits are not a random choice of policymakers. They are a reflection of structural forces that are driving wedges between private savings and private investment. The reality is that the deficits are a natural kind of response of the system to the forces that have produced low interest rates.

On the other hand, I think that truth is very often near the center, and many of my friends who have a more deficit hawk perspective may underestimate the significance of the low real interest rate world in which we now live in terms of the federal government's debt-carrying capacity.

TIE: **You were part of the team in the 1990s under President Bill Clinton that brought about policies that helped lead to budget surpluses. At the same time, the economy experienced extraordinary growth in productivity gains. The view then throughout the G-7 industrialized nations was that the surpluses helped instill investor confidence. That confidence helped provide the foundation for the productivity bonanza. Yet in recent years, some scholars argue that the productivity gains were largely unrelated to fiscal policy. They were the result largely of advancements in technology that would have come about had Bill Clinton, Bob Rubin, and Larry Summers not existed. What's your response to the revisionists?**

What I think has received too little attention in the commentary is the reality that while the Fed has been buying securities at an unprecedented rate, the government has also been issuing them at an unprecedented rate. What really should be relevant for markets is the net stock of duration that it has to absorb, which I think by most measures has gone up rather than gone down.

Summers: I don't think there's any question that the fiscal and economic performance in the 1990s was a consequence three things. First, the direct positive impact of budget deficit reduction and reducing the cost of capital spurred investment, including investment in research and development and in information technology. Second, the greater confidence that came with the removal of a very substantial debt overhang operated to strengthen the animal spirits of business leaders and to push people to both invest and spend more, which created the confidence that is behind a buoyant economy. And third, in 1990 a set of investments that had been made over a long period of time by both the public and private sectors in, for example, the internet—which started as a DARPA project—came to fruition. All three of those elements contributed to the substantial success.

It would be foolish to suppose that if macroeconomic policy management had been unsound and costs of capital had remained very high we would have seen the kind of performance that we saw. But I have always said that no matter how well the dials of fiscal and monetary policy are twiddled, ultimately a country's prosperity depends upon the work of its people and the strength of its businesses. That is certainly true of the United States. So it would be very wrong to claim total credit for fiscal policy or monetary policy in explaining our prosperity during the 1990s.

TIE: **Tell me I'm wrong, but our policy community seems so cavalier about the effects of higher inflation on average working families. Doesn't this all come down to a wager? The models we used to predict future macroeconomic conditions, including inflation, are not very effective. So if the inflation bet goes wrong, there is huge risk to the little guy. Wage earners will take the hit big time even as asset owners will continue to ride the escalator to new highs. To what extent do central bankers play too much to the interests of elite asset owners over the little guy, furthering inequality? Is the central bank world too enamored of Wall Street's interests?**

Summers: The currently fiscal/monetary mix, in which we have very easy monetary policy that we pursued between 2011 and 2019, had a larger positive impact on the crisis than it did on real wages. That has contributed to the growing polarization in American society.

We Democrats make a serious mistake in neglecting inflation. It was inflation that was important in contributing to the election of Richard Nixon in 1968, and crucial in contributing the election of Ronald Reagan in 1980. Inflation is perceived as harmful for the little guy, and as a sign that government cannot control its appetite.

We did enjoy very substantial prosperity in the 1990s. It was related to the sense that there was absolute respect for the independence of the Fed, that the Fed was focused on price stability, and that the policy of the Treasury was the recognition that a strong currency was in our national interest.

The climate today is of more woke central banking, where central bankers give speeches about challenges not proximally related to inflation or unemployment such as climate change, and reject the idea of preempting inflation in favor of the idea of waiting until inflation is firmly established. These things threaten a return to the kind of psychology that prevailed in the 1960s and 1970s and contributed to excessive inflation.

Because we remember those events, I'm confident we will not repeat the mistakes on the same scale. But I see a disturbing set of parallels to the hubris with respect to expansionary policy that developed in the 1960s and early 1970s.

TIE: **Finally, recent polls show an American youth that has lost confidence in democracy and capitalism while believing the future will be one of doom and gloom. Depression is rampant. Suicide rates are soaring. As an educator, are the polls too pessimistic? Put another way, do you agree with Warren Buffett that America's best days still lie ahead? Or are the hate, division, and dysfunction probably unsolvable in our lifetime? What do your students tell you?**

Summers: I'm ultimately an optimist. I believe in the power of self-denying prophecy.

Look at American history. It's a history of jeremiads—of people worrying about the best days being behind us, and our power having collapsed. In 1991, the joke was that the Cold War was over and Japan and Germany had won. Before that, we worried about the crisis of the national spirit that was proclaimed by President Carter in 1979, and about the rearrangement of the constellation of forces that President Nixon and Secretary of State Henry Kissinger believed was necessary in the aftermath of Vietnam. We worried about the missile gap, and the widespread belief John Kennedy proclaimed while running for president in 1960 that the Soviet Union would surpass the United States economically. Even going back to Patrick Henry in 1792—he fretted that the spirit of the American revolution had already been lost.

We are a country that benefits greatly from our capacity to become alarmed about our future. There can't be any certainties, and the alarm is not unjustified, but I suspect that historians will look back at the traumas of this moment and they will again see that anxiety and alarm called forth things that were new and better.

Trees don't grow to the sky. The American story will at some point not be a story of continuous progress, but I think we've got a while to go. I would rather be playing the hand of the United States with all its problems than playing the hand of any other major country in the world right now. ◆

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