Adam Posen *Takes the Stage*

Just back from his three-year stint on the Monetary Policy Committee of the Bank of England, the new president of the Peterson Institute for International Economics sat down with TIE *founder and editor David Smick.*

Smick: Congratulations on becoming president of the Peterson Institute for International Economics. This appointment will go down in history as proof that nice guys actually do finish first. What changes do you have in store for the Institute at this point?

Posen: In the search to replace the retiring Fred Bergsten, I was in a sense the Board's continuity candidate. I promised them there would be no New Coke change for change's sake. We would stay the same size and be committed to the same values—pro-globalization, and intellectual honesty about globalization. Still, since Fred Bergsten and Pete Peterson founded the place over thirty years ago, we do need to adapt to a changing world. Let me list three ways I plan for us to do that. First, we have to reorient more globally. The Institute was always focused on Washington decisions, the actions of the U.S. government, and the United States talking to other governments. The action now is not just in Washington and not just happening in government. Markets matter. Non-governmental organizations matter. Part of my mission is to make the Peterson Institute more engaged both with stakeholders and with issues beyond just those that interest Washington.

The second adaptation is generational change. We have some wonderful scholars who make Peterson among the very top research institutions, but for a variety of reasons a number of them are retiring soon. This gives us an opportunity to refresh

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and restock. We've already hired a couple of exciting new people and promoted others. I'm hoping over the next three years to continue refreshing the senior staff.

The third way we need to adapt is to face the growing competition. Fred and Pete had the vision to create a specialized think tank back when nobody else was in this space. We're now one of many, including organizations that work directly on our issues. Our unique brand is intellectual quality while being relevant, but quality doesn't always come across in a blog or an op-ed. A big challenge will be to figure out what modes of publication and communication we should be using in the years ahead to get our research out. We can't just write a book and hope people read it the way perhaps we once could.

Smick: The Institute enjoys a well-deserved reputation for its fine analysis, but if there's one criticism—and it may be unfair—it is the relative lack of market experience on the part of the Institute's scholars.

Posen: It is fair to say it would be useful for us to have more market input. But I think the number of people who were both working in markets and being economically literate was much smaller when the place was started than it is now. So it's a little unfair to say that Fred and Pete missed the boat on that. I am hiring a couple of people who have direct market experience. Perhaps as importantly, I'm increasing the number of smaller meetings, forums, and interactions with market people—not just in pursuit of support, but also in pursuit of ideas and insights.

Smick: Did the Institute as a whole ring the alarm bell that the Great Financial Crisis was coming? I don't recall that being the case, but I could be wrong.

Posen: Our people, ranging in views on banks from Simon Johnson to Bill Cline, got some things right and some things wrong. I think Jacob Kirkegaard in particular deserves credit for correctly calling a lot of what happened in Europe. Joe Gagnon and I deserve credit for getting a lot of the monetary policy analysis correct in real time during the crisis. The broad optimism of our trade people—notably Gary Hufbauer and Jeff Schott—that significant protectionism wasn't going to result from the crisis, was borne out. And Fred, Anders Åslund, Nick Lardy, and Arvind Subramanian all called the at least temporary decoupling of Eastern Europe and Greater China from North American developments.

But that said, like almost everybody else, we were certainly too confident that something as bad as the global financial crisis wouldn't happen to the Western powers including the United States. We were too confident that financial liberalization was a good thing. Certainly financial liberalization versus the way things were in the 1980s was a good thing. But the extreme forms it got to by the early 2000s? Probably not. Give some credit to economists Joe Stiglitz and Raghuram Rajan and others who questioned the limits of excessive financial liberalization starting in the late 1990s. Like most, we took it for granted that more liberalization was better, or at least didn't question that assumption enough.

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Smick: Since the financial crisis, analysts have estimated that in response to the crisis, the world has collectively produced roughly $15 trillion in various forms of fiscal stimulus. In addition, the world's central banks have expanded their balance sheets by an estimated $5 trillion. Yet the global economy can't seem to get out of its own way. Witness the fourth quarter of last year for the United States, which may not be quite as bad as the headlines, but indicates the U.S. economic vehicle, if not moving in reverse, is moving at a painfully slow speed. Does this lack of a response to stimulus trouble you? There's always the argument that things might have been worse without the stimulus, but that's a pathetically weak fallback position for policymakers at a time of huge joblessness when average folks are suffering.

Posen: You raise several issues. First, in economic terms, did the stimulus have the desired impact, which is another way of asking how much worse would the crisis have been if we hadn't done it? To me the evidence is clear. We would have been much worse off in both the short term and long term if we hadn't enacted various forms of fiscal and monetary stimulus, and perhaps would have courted disaster.

The second issue is at least as important. Politically, are our system and globalization sustainable given how miserable the recovery has been? That's a very troubling question. For unemployed youth, whether in the United States or Spain or for that matter in North Africa, recession and unemployment do lifelong damage to their incomes. We can agree that unemployment, particularly youth unemployment, is a really bad thing in ethical and political as well as economic terms, but there is a limit to how much it can be reduced using the macro tools of stimulus. It's a real challenge. If one wanted to be pessimistic about the United States, that's the place to start.

I push back against that claim because not all bubbles are created equal.

Smick: If you go back to 1973 when energy prices quadrupled, since then the real wages and salaries of Americans have stagnated. In the past decade or so, both Presidents Bush and Obama pushed through enormous amounts of fiscal stimulus, yet wage and salary growth has remained relatively stagnant. The situation has been helped along by more ample government support. Yet you get the feeling something's fundamentally wrong with the U.S. economy. Is the problem that technological breakthroughs have not been as economically transforming as perhaps they were for previous generations?

Posen: I completely agree that the income development for most Americans has been dispiriting and unsatisfactory. But a number of countries that were supposedly not like the United States have ended up in this state. In Germany, real wages stagnated for a decade and inequality rose, too. There are a couple of exceptions. Until the crisis, the situation was actually getting much better in Spain. But that was an exception, and maybe part of the problem was they couldn't sustain being an exception.

Smick: One argument too is that the political/economic system's response to this wage and salary stagnation has in effect been to tolerate a series of bubbles. First came the dotcom bubble, then the real estate bubble of the financial crisis. We may now be facing a monetary bubble as another means of trying to bring about a more dramatic improvement in incomes. In the end, don't bubbles burst because the underlying fundamentals are not strong enough to support asset prices?

Posen: I push back against that claim because not all bubbles are created equal. The internet bubble had much different effects than the real estate bubble. And the bubble in the United States had much different effects than the bubble in Ireland. This idea that everything that happened, not just the crisis, was because of a macro bubble flies in the face of the evidence that there were long periods for a lot of countries with no bubble, and yet income stagnated there, too.

You have to look at other causes. One is that the size of the world labor force doubled at the low-skill, low-wage end by bringing China, Eastern Europe, and parts of India into the global economy. This put huge downward pressure on some wages. I believe strongly that having five hundred million Chinese and a couple hundred million Indians and Latin Americans rise out of abject poverty over the last twenty years while the vast majority of Americans are probably slightly better off than they were, in real terms, is a triumph for humanity. But that does not allow us to deny the wage impact of the process.

The second cause is there basically was a corrupt capture of a big chunk of our political and financial system where a lot of legislation, regulation, and corporate decisions were directed toward maximizing the benefits for the few people in charge of financial firms at that particular time. We used to lecture other countries about that, yet the United States, United Kingdom, and Japan have all shown evidence of such capture in recent years. That's not the full story, but you can't tell the story honestly without at least acknowledging that's part of it. When you think of corruption, it's not literally everyone taking bribes, but rather the cult of the CEO or the transactions mania of the derivatives dealers. It corrodes.

Smick: The Republicans call that "crony capitalism" and argue that such cronyism has infiltrated the entire government stimulus arena. Witness the Solyndra fiasco. But if there is an area where both parties were captured by this cult of corruption, it is in the area of financial liberalization. Agree?

Posen: Definitely. Some specific things in the tax code and in deregulation were more due to Republicans than Democrats in the United States, but the vast majority of people who were running economic policy under President Clinton and running Democratic Party policy even in opposition also believed in extreme financial liberalization. Among economists, it was a combination of an honest intellectual mistake—we got it wrong, including me. Certainly a lot of my colleagues here at the Institute and elsewhere in the profession have recognized this intellectual mistake and are trying to get past it. And while most of us weren't literally bribed, it's nice to be invited to give speeches at nice places where you tell people what they're doing in the financial sector is good for the world.

Smick: Let's go back for a moment to this issue of bubbles. Former Clinton and Obama adviser Larry Summers points out that one of the near-impossible tasks for central bankers is to identify asset bubbles. In recent decades central banks have had a pretty poor track record. In 1996, then-Federal Reserve Chairman Alan Greenspan famously argued that the U.S. stock market had reached bubble-like conditions. He said the market had reached "irrational exuberance." As Summers later noted, that was a bubble "that wasn't" and the subprime/real estate bubble turned out to be the

bubble "that was." I'm concerned today listening to the central bank chatter. At the recent Davos meeting, for example, officials were preening. The level of hubris was astounding. Given the complicated nature of the global financial system, wouldn't this be the time for some humility and caution, especially from a crowd that for the most part missed the call on the financial crisis?

Posen: I was at Davos for the first time this year and spoke on one of the first panels which dealt with monetary policy. The first words out of my mouth were that central bankers should be a lot more humble now than they were in the last decade. The challenge is not just identifying bubbles, but successfully popping them without destroying the economy—which has proven very difficult.

Smick: *Financial Times* columnist Martin Wolf perhaps put it best with regard to a monetary bubble. He said it's the exit strategy that's the difficult thing. I was taken by the recent statement by the just-retired head of the Danish central bank, Nils Bernstein. He said the great unknown is what central banks will do after half a decade of quantitative easing now that there already appears to be a shortage of qualified collateral. Agree?

Posen: I was an economist on the staff of the New York Fed in 1995 and 1996 when Greenspan and then-Fed Governor Larry Lindsey among others started to think the stock market was in a bubble. I remember Greenspan's "irrational exuberance" speech. The fact was, all the jawboning and even interest rate increases didn't pop the bubble. And we have lots of examples from around the world where central banks have tried to raise interest rates to pop bubbles and it didn't work. Now a bunch of central banks are trying macroprudential means and supposedly that's going to allow them to pop bubbles. I'd prefer regulation to try to prevent behaviors that may lead to bubbles rather than leave it up to central bankers to hubristically decide when the bubble exists, how much is enough to pop it, and whether they have the guts to do it. This is what I mean about humility. I would prefer to overdo it on structural reforms in the financial system, rather than increase the discretionary burden on central bankers.

Smick: With the goal of better protecting the taxpayer, who seems to be the fall guy when things turn sour for the bubble masters.

That's a very troubling question.

Posen: Exactly. Protect the small saver and protect the flow of credit and try to reduce the range of issues where it's up to the central bankers to be smart and brave. Even as a former central banker, I don't have confidence that we could be any smarter using so-called macroprudential instruments—and not just be smarter but be tough at the right time—than we are using interest rates. I'd rather make rules ahead of time.

The other thing I said on that panel at Davos was that even though central bankers overrated themselves and oversold their ability in the 2000s, we shouldn't doubt or throw away the few things they do know how to do well. This is part of the problem when everyone gets so upset about so-called unconventional monetary policy or exit strategies. People understandably are quite skeptical of, if not angry at, central bankers. The anger is deserved. But it's like getting annoyed with the doctors who haven't cured cancer. That doesn't mean they don't know how to set a broken leg. There are some things central banks know how to do. For example, central banks know how to raise rates to stop inflation.

Smick: Assuming they have remained independent, which in some cases is debatable at this point. The conclusion I saw coming out of Davos was a great concern that governing elites are now vulnerable. In some cases they are under outright attack, which is producing a more short-term and reactive approach to governing.

Posen: I think the major central banks will remain independent. Everybody's made a big deal about the examples of Arthur Burns and the lack of independence of the Fed in the 1970s, and political influence on the decisions of the Bank of England and Bank of Italy around that time. It's all true. But before the 1970s and since the early 1980s, we've seen decades and decades of if anything contractionary-biased monetary policy in the major central banks. You can say that's because central banks were on the gold standard. But that doesn't explain the last thirty years and even the gold standard was no more absolute than anything we're doing now. Countries exit and enter the gold standard. The gold standard wasn't what caused central banks to be tough. The central banks adhered to the gold standard because they were tough and chose to be. People are legitimately disappointed and upset with central banks, but as markets and as voters, they're doubting too much. Look at the European Central Bank and what ECB President Mario Draghi's done over the last couple of years. It's hard to argue that they've been eager to provide easing. Look at Japan, where the Bank of Japan didn't want to do much until very recently after years of deflation.

Smick: What do you make of economist Nouriel Roubini's view of the monetary situation? Dr. Doom paints a frightening picture of quantitative easing. He predicts that over time,

quantitative easing will produce "zombie banking, zombie corporations, and zombie households." He talks about the unintended consequences, particularly if central bankers bungle their exit strategies. Former Bundesbank President Axel Weber believes central banks are woefully naïve about these unintended consequences which include fanning fiscal and regulatory complacency among governments and households, and risking a potentially dangerous global race to the bottom in currency devaluation while also potentially producing destructive asset bubbles. You have argued that the risks are minimal. Why are these folks wrong? Could the central bankers of Club QE end up the suckers in this emerging global drama—the fools who created the perception that they have cornered the market on the understanding of financial risk?

Posen: People fantasize that monetary policy is far more important than it actually is. If you're making a speech where you want to avoid angering banks or don't want to get into the details of regulation, just say that everything's bad because the monetary policy is too loose. And the speechmaker can always assert the existence of unforeseen and unintended consequences. It's just a bizarre way to think about serious issues. After discussing all the reasons why central banks are overrated and less able to control the economy than we previously thought, and how the problem with quantitative easing is that it doesn't seem to have had as large an effect as we thought or hoped it would, then how do you get all these side effects? Especially by just asserting with no empirical evidence.

Smick: I suppose these critics would say it is possible for a policy to be less than effective in completing its mission while still producing dangerous unintended consequences. My role here is to be the honest broker, to present the views of both sides. I must say that members of Club QE often resort to a distracting straw man when presenting their arguments. Their favorite straw man is the charge that quantitative easing is inflationary in the short term. But people in the markets know it would be very hard to have a big bout of inflation as long as today's weak labor market situation continues. The question is whether quantitative easing is helping cause a big run-up in the price of equities and commodities that carries with it significant risk because, again, the fundamentals of the economy aren't strong enough to support the market surge for very long.

The one thing that keeps me up at night is the thought that we've really hit a lasting technological slowdown.

Posen: That's a really important question. But it's just a variant of a question that investors, traders, and business leaders have to address all the time, which is whether prevailing market conditions reflect fundamentals, or do they reflect some arbitrage or selling opportunity? But that need to decide is not created by central bank behavior, nor by monetary loosening. It's a sideshow. The issue really facing policymakers is: What will it take to get all the money sitting on the sidelines back into risky assets? That's ultimately what determines whether the current commodity and equity prices are based on fundamentals or not.

Smick: The United States is in a special position. We can attract the world's capital. We're the least-ugly person in the ugly person contest. With the world awash in newly created money, doesn't that mean the Fed may be able to maintain its current policies for some time with no serious downside?

Posen: We're winning the least-ugly contest in part because potential competitors have chosen to keep themselves ugly. No one seems to want capital inflows, which is an ongoing systemic issue.

Smick: It's very hard to argue against one of your major conclusions: that austerity policies by themselves are counterproductive. They've been disastrous. Just ask the Greeks. The austerity policies have made geopolitics the great unknown of the global system. The question now for policymakers is whether they should do nothing or take further risks with even greater fiscal stimulus, monetary stimulus, or both.

Your recent position on Japan is most interesting because of your influential work on the subject more than a decade ago. Today you argue that Japanese Prime Minister Abe's new fiscal stimulus will be a mistake because it will add to the long-term cost without addressing Japan's real problem: a return to deflation and a (previously) overvalued exchange rate.

You say that the case for continued deficit spending in Japan ended by mid-2003 because from 2003 to 2007, per capita real income growth was the same in Japan as it was in the United States (averaging 1.8 percent annually). Yet in this issue, economist Rick Katz argues (p. 32) that this is a misreading of the data. During 2003–2007, Japan was recovering from the five preceding years of disaster when per capita GDP actually shrunk by 0.4 percent. So Japan's performance during the 2003–2007 period was simply an unsustainable post-slump bounce. That's why U.S. per capita real

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income was 17 percent higher than in 1997. By contrast, Japan's per capita income was only 5 percent higher.

Katz also suggests that Japan's 2003–2007 recovery was clearly unsustainable because with real wages dropping and interest income shrinking for the elderly, Japan could not depend on vigorous consumer demand. Instead, 40 percent of its GDP growth was derived from what was clearly an unsustainable trade surplus. Another 30 percent came from growth in investment tied to exports.

How is Katz wrong?

Posen: You covered a lot of ground there so there's a lot of errors you also cover. On the growth side, I think Katz and others are telling the play without Hamlet. Actually, they're telling the playing without two Hamlets. First, you could make the case that a lot of growth in the United States—perhaps not 1997 to 2000, but 2003 to 2007—was a bubble based on real estate speculation, financial market expansion, and overborrowing. And so the sustainable potential growth of the United States was exaggerated. By comparison, Japan over that period saw a great deal of growth and it was all in productivity because there was certainly no rise in real estate prices or in working population.

Smick: Wasn't it really export-related at a time when Japan's trading partners were complaining about yen manipulation?

Posen: Some of it was export-related. But remember, the export share of GDP in Japan is smaller than for almost any other major economy. And over this period for the most part, the yen was strengthening. So it wasn't export-related because they were manipulating the currency (which failed in 2003). Real wages were dropping, but that's true in Germany as well. It's a question of what you use as your basis for comparison. I'm not saying the Japanese economy was ideal, but that whatever fair comparison you take they did as well.

So then comes the question of whether they're just playing catch-up. That's the other Hamlet that's missing. From 1997 to 2001, the Japanese government and the Bank of Japan were busy beating the Japanese economy over the head. They kept raising taxes and threatening to tighten the interest rate. They didn't engage in any meaningful quantitative easing. Once they got to zero interest rates they kept threatening to raise them, and they did briefly. And then they let the banking situation get out of control. So when you say catch-up, that misrepresents the case. The second the Japanese government and the Bank of Japan stopped killing the economy in 2002–2003 and Prime Minister Junichiro Koizumi and Economic and Fiscal Policy Minister Heizo Takenaka cleaned up the banking system, the economy did well. And neither unemployment nor inflation moved much, so that also doesn't seem like mostly catch-up. That's my interpretation of the situation.

Smick: How much weaker today does the yen need to become? Some analysts argue that for Japan, currency depreciation is unlikely to be the new panacea. After all, when Japan spent $320 billion intervening throughout 2003 and the beginning of 2004 to try to keep the yen from strengthening against the dollar, the yen actually strengthened by nearly 10 percent. The yen rate is determined by global markets, not in the offices of the Bank of Japan.

Some argue that the problem with companies such as Panasonic and Sony is not a strong yen but the nature of their product line in an extraordinarily tough and competitive global market. How confident are you that the Bank of Japan's new monetary policy, involving a 2 percent inflation target and a weaker yen, is going to turn things around?

Posen: It's similar to the United States, where suddenly the dollar depreciated some, and combined with some wage movements, the manufacturing sector came back—not all the way, but part of the way. In Japan, the bulk of Japanese industry and the part they're good at—autos, heavy machinery, optics, some electronics, and engineering—these are things that with the yen at ¥90 to the dollar are competitive. Other industries such as shipbuilding and low-value-added electronics probably have left Japan forever.

Smick: The product supply chain for large parts of Japanese industry is pretty global.

Posen: Like any other major economy, Japanese business has had to adapt. Talking about the yen, I agree that in 2003 and the first quarter of 2004, sterilized intervention by the Ministry of Finance in Japan demonstrated for once and for all that sterilized interventions generally don't work. Exchange rate intervention needs something from the monetary policy side to back it up. I think the yen will probably stay around where it is at the time of this interview which is about ¥91, or maybe go a little lower. I'm confident the Abe regime and the new Bank of Japan leadership are going to do some truly expansionary domestic monetary policy and that will have a side effect of preventing yen appreciation. Will it depreciate much further? Trying to predict short-run foreign exchange movement is a mug's game.

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Wherever it goes, if the Bank of Japan directly intervenes in a visible way by buying dollars, that will probably end pretty quickly. The G-7 is clear on that. But if the yen stays where it is and continues to weaken some as a result of straight-up aggressive monetary policy on the part of the Bank of Japan, that to me should be sustained and unchallenged politically.

Smick: My sense is the Japanese are panicked right now. They're desperate because they sense that militarily they're vulnerable to China. They look and see that the Chinese may not be able to produce the kind of growth levels the public has gotten used to, and they think Japan is going to be the great scapegoat, for starters feeding tensions in the South China Sea over the Senkaku/Diaoyu Islands. There appears to be in Japan this intense and growing desire, if the LPD retakes upper house in July, to rewrite the constitution to allow the country to remilitarize. But the coalition in power right now is fragile. So they have to show economic progress in coming months. And that's why they really need to get that yen down quickly and anything else to get the economy moving. Agree?

Posen: It's several things. They're going to keep the yen down. They're doing fiscal stimulus, some of which will work short-term. And they will be doing domestic monetary stimulus. I agree that they're frontloading everything to try to make sure this is a good-looking recovery ahead of the upper house election this summer. And I agree that a major part of why the Abe government and a large portion of Japanese decision makers are finally doing something about the economy is because they're worried about the national security side. They're worried about China.

Smick: Let's move to another part of the world. The Bank of Canada's Mark Carney, who will become Governor of the Bank of England this summer, has proposed nominal GDP targeting to force central bankers to be more aggressive at stimulating growth. Can you elaborate on your recent criticism that such an approach would be a serious mistake?

That's not a genuine argument for why the British economy's doing so badly; "the data is lousy" is not an explanation.

Posen: The attractions of such an approach to monetary policy, as I understand them, are twofold. If you think what you're currently doing is ineffective, you're willing to believe that making these so-called pre-commitments has an independent effect on policy. You hope this gives you another tool. The second attraction is that it's a way of allowing you to say growth or unemployment are part of your goals, and you want to keep policy loose until you recover some of what you've lost on that front.

Those two reasons are attractive in principle. But I find verbal pre-commitments of monetary policy to be nonsense in practice. There is absolutely no evidence that verbally committing to a nominal GDP target would make any positive difference. In the United States and United Kingdom, for example, the Federal Reserve and the Bank of England did, relative to the size of their economies, essentially the same amount of quantitative easing over the last four years. Yet as I pointed out at the Fed's Jackson Hole conference this year, the Bank of England Monetary Policy Committee explicitly never made a commitment from one meeting to the next. And all the econometric evidence says that quantitative easing had essentially the same effect in both economies.

The Riksbank—the Swedish central bank—went to great lengths under the leadership of Deputy Governor Lars Svensson to pre-commit and be transparent, and to talk about interest rate rules and paths. As has been documented (including by Svensson), sometimes this pre-commitment had the opposite effect on markets and expectations of what they were intending. The same for Bank of Canada, in fact. This pre-commitment thing—to me it's grasping at straws. We spent decades arguing that central banker talk was cheap, so I don't understand why everybody suddenly thinks it would matter.

The practical aspect of a system of nominal GDP targeting is that you say you want to go back and catch up with this growth that was missed. It's a worthy goal. But GDP numbers are revised constantly. And how much you catch up is completely arbitrary depending on what date you choose to catch up from. I don't even understand how a nominal growth target functions compared to an inflation target.

And suppose the United Kingdom has been experiencing really low growth for various reasons, then suddenly announces perhaps a 4 to 5 percent nominal GDP target. You're basically announcing higher inflation for a time since it will not immediately lead to real growth, absent actual policy measures. And for all my position as supposed super dove in my time at the Bank of England, the reason I was dovish was that I made the call that when inflation spiked up, it would come back down. I had faith the inflation target would anchor expectations versus temporary shocks. It wasn't because I wanted higher ongoing inflation. It was because I made a forecast that frankly turned out to be closer to right than the other forecasts.

I'm worried that if the Bank of England or another central bank suddenly announced that it wanted inflation to average 3 percent or 4 percent, it would get what everybody has warned against for years which is a jump in inflation with no particular benefit to anybody.

So I'm worried that if the Bank of England or another central bank suddenly announced that it wanted inflation to average 3 percent or 4 percent, it would get what everybody has warned against for years which is a jump in inflation with no particular benefit to anybody. That is what a nominal GDP target would deliver, to my mind. And if a small open economy's government is the only one to announce a higher *de facto* inflation target, I worry exchange rates would overshoot and raise inflation further.

Smick: Why do you think the U.K. unemployment rate has performed in such a mysterious way, contrary to all the rules?

Posen: That's a really profoundly scary question. I can't figure it out either. I've been struggling with it. To me, that's the biggest question about the United Kingdom economy right now. For roughly three-plus years we've had growth in private sector employment and you've also had decent retail sales in the United Kingdom. And those are things we actually measure, unlike GDP. They are not set by government or rules, but by millions of individual decisions by consumers and by thousands of individual decisions by employers. Somehow private sector employment and retail sales have been rising, not at a great clip but probably consistent with a one-plus percent GDP growth rate rather than the zero or negative rate we've been seeing in the official data.

Until six months ago, I hoped the data would be revised, things would pick up, and then the puzzle would shrink. That hasn't happened. Many, including some of my former colleagues at the Bank of England, have now sort of reasoned backwards, saying that if the data are coming in lousy, it must be the truth. But that's not a genuine argument for why the British economy's doing so badly; "the data is lousy" is not an explanation.

Smick: What's really going on behind U.K. Prime Minister David Cameron's whole European Union in-or-out referendum? Politics?

Posen: My sense is it's purely shortsighted politics. First, he's scared by the attacks from the right wing of his party and the threat of London Mayor Boris Johnson moving up. Second, he doesn't want to fight the next election on the state of the economy, because the state of the economy's lousy. To me it's really that straightforward, which is sad. I'd like to think that something else was behind a move that big, but frankly I think that's all it is.

Smick: At the recent Davos meetings, European Central Bank President Mario Draghi was being congratulated as a hero because of the belief that the eurozone financial crisis is over and happy days are here again. To what extent is this a reflection of a real turnaround or simply of financial traders in attendance ecstatic at, for now, the narrowing of eurozone interest rate spreads and the market's bounce from the dramatic monetary expansion? And has this monetary expansion already begun to have the effect of halting the reform efforts that were underway in the peripheral countries? After all, the eurozone debt crisis can be defined as a series of policy "breakthroughs" over several years in which officials congratulated themselves only to find months later that the spreads widened back out. In the meantime, the populist war against the eurozone's governing elites grew in intensity.

Posen: My gut tells me what we are seeing in Europe is the reverse of the Herbert Stein Law (which is: "If something cannot go on forever, it will stop.") Actually, misery can go on a lot longer than you would think possible. To give credit, my colleagues Fred Bergsten, Anders Åslund, and especially Jacob Kirkegaard were all ahead of the curve on the political economy. In varying ways for varying reasons, they all said, "You Americans think the minute unemployment in Europe rises there is going to be fascism in the streets and the parties in power are going to get booted out. That's not going to happen." They were right on that call.

Let me be clear. That it is for now politically sustainable doesn't mean that this is a good outcome in either economic or political terms. It just means that between the memories of the world war and for some countries of Soviet occupation, the lack of a good intellectual alternative, the fact that young people who are unemployed don't tend to vote, and the fact that there is still a reasonably generous welfare state in most of these economies, you can have a system that performs pretty badly for a long time without seeing any influential political reaction. Without the political reaction, among policymakers, then the kinds of things that I and others had been advocating for the European Central Bank that President Draghi finally did last summer—have the ECB guarantee against a panic in the government bond market—picks up the other pieces of tail risk. So it seems there are not going to be political riots that matter for policy and market purposes for now, even if they do express a lot of unhappiness.

Smick: Certainly the Europeans, particularly the Germans, are influenced by "history" in their efforts to preserve monetary union and the euro. But isn't a large reason that Greece is still in monetary union and no one's talking about Spain and Italy leaving and the eurozone cracking up is that the powerful German export industry cannot afford to have the system crack up? If Greece and some of the others were to leave the eurozone, the euro would sooner or later soar. Germany's exports would become less globally competitive. Germany has no problem pressuring the periphery countries to accept the pain of reforming their systems. But when all is said and done, the Germans are not going to allow anyone to leave the currency union if at all possible.

Isn't that why Chancellor Merkel has looked the other way and let ECB President Mario Draghi intervene in the bond markets? Maintaining the eurozone is essential for Germany. But is it essential for the peripheral countries? I'm not sure. The peripheral countries staying has kept the euro from strengthening more than it has. But the level of unemployment in the periphery, particularly youth unemployment, is astounding. In the old days these countries would have revalued their currencies long ago. Now they are trapped with few options and with hollowed-out banking systems ill-equipped to engineer any type of significant recovery. At the end of the day, doesn't the mountain of sovereign debt remain, not to mention the continuation of huge disparities in competitiveness throughout the eurozone? For the eurozone, fundamentally the more things change, the more they stay the same?

Posen: I don't think you're way off. But rarely does anyone do something for only one reason. And very rarely does the result of policy come out of any one person's plan. Clearly there is an element where German exporters have done exceedingly well by having the internal European market lock in overvalued exchange rates for several of their trading partners and then weaken the euro relative to where it would be if the deutschmark was on its own. There's no question about that. But there's no question as well that the history of World War II does matter, as does European idealism and institutional inertia. The kind of ongoing bargaining you were talking about between Draghi and German Chancellor Angela Merkel and others was part of the game.

My colleagues Fred Bergsten, Anders Åslund, and especially Jacob Kirkegaard were all ahead of the curve on the political economy.

I give Draghi a lot of credit. My concern throughout most of 2011 was not that I thought Draghi had the wrong intent, but I was worried that he and Merkel were pushing it too close to the brink. They were driving hard deals and risking things getting out of control. In hindsight, they seem to have gotten what they wanted. I would not have taken the gambles quite as far as they did. Frankly, even if I knew how they were going to turn out, I do not believe that the amount and pace of pain that was inflicted on some of the peripheral counties versus incurring bigger losses in the German-Dutch-Austrian banking system was the right call. But you've got to give Merkel and Draghi credit that they got most of the things they wanted. The eurozone didn't break up and the market panic was temporary. You can't say it's all just a German plot to depreciate the currency. I think that's part of it, but only a part.

Smick: You have argued that if you examine the data, often countries with the highest levels of debt do not have the highest interest rate premium. By the same token, countries with low levels of debt pay relatively high interest rates. To what extent is America's public debt a risk? Do you buy into the Rogoff-Reinhart thesis that the United States is approaching a danger zone with its debt? If the debt is not a serious problem as economists such as Paul Krugman maintain, why not double or even triple the level of federal debt as a means of restoring levels of domestic demand that might lead to full employment and reduce income inequality? Shouldn't President Obama and Senate Majority Leader Harry Reid (D-NV) go for broke and propose \$2–\$3 trillion more in stimulus, including massive infrastructure spending? Why not \$5 trillion to get the job done if the level of debt is irrelevant?

Posen: As I've been trying to argue recently with the Bank of Japan, it is rare if not unheard of for a big country with its own currency to hit a wall on debt. This particularly applies to the United States, with its dollar the global currency, and itself a major military power. Frankly, the United States has plenty of room to increase taxes if it really has to pay its bills. So it is very unlikely the United States will go splat against the wall any day soon.

The issue is that there are still costs to having too much debt even when you don't have a crisis. One is that debt crowds out spending public money on things that work to help youth unemployment or work to decrease inequality. And debt crowds out (to a much lesser degree during recessions) spending in the private sector. The most important reason for a country like the United States not to have too much debt is resilience. If the United States were to suffer a triple disaster like the one that hit Japan, or another Superstorm Sandy, or if there were some sort of global depression as in 2007–2009, with money in hand policymakers could respond without hesitation. It's the idea of a rainy-day fund. So even if you don't think the debt is going to lead to imminent collapse, you want to be responsible about it.

And that's why, as I argue with Japan, as well as for the United Kingdom or the United States, the key thing is that you want to try to be sure you're consolidating and paying down debt in good times as much as you're drawing up debt in bad times.

So when will the United States be on a good enough trajectory that, balancing the risks, it's a good time to cut back some on stimulus? I have friends and colleagues who argue for more stimulus now because the United States still has low interest rates and relatively high rates of unemployment. I'm not going to say they're obviously wrong. But my gut assessment is we've started a weak but decent recovery, and while the unemployment rate has unfortunately done permanent damage to the labor market because we didn't act strongly enough the first year or two, we're not as far away from full employment as some people think. I worry that we do need to have more of a rainy-day fund, more resilience there. And I worry about policymakers cutting it too close without humility.

So I make the judgment call that, if I were in charge, a slow but steady consolidation would be the right way for the United States to increase its resilience. It's been a messy process, but I believe we're going to get to mid-2013 and there will be a 2.0–2.5 percent of GDP shrinking of the U.S. structural deficit spread out over 2013 to 2025. That's pretty good. Your definition of the structural deficit depends on what you think the growth rate of the economy is and other factors, but roughly speaking it's somewhere between 3 percent and 4 percent in the United States. We will not have done what the United Kingdom, Spain, or Latvia did, probably wisely, and we will have ended up making some moderate progress on the deficit without prematurely cutting off the recovery. That to me is a good balance.

Smick: So you agree with Larry Summers' idea for dealing with debt? Tackle entitlements and other areas of the budget that only go into effect in the long run, but send a powerfully positive message to markets now that Washington is getting its fiscal house in order. And don't do anything in the short run that would risk killing the economy. Makes sense.

Posen: Call me naïve, but I think we're going to look back at this outcome and say how the hell did we get here? The bottom line's going to be that we will have done something with the situation as Summers and former OMB Director Peter Orszag and others have argued. You're not putting on the brakes prematurely, but you're making a clear commitment to future consolidation. Even if we do have the full-on sequester, it won't be anywhere near as bad as if we had gone over the full fiscal cliff. The actual deal likely to emerge will in macro fiscal terms be similar to that of the sequester. Finally, for the first time in years, state and local government budgets are going to be moving in the up direction because of the real estate market timing. On net, there's going to be fiscal drag but not too much. We're doing a set of down payments. We're making progress without killing the recovery. Between tax increases and spending cuts, again I'd choose more tax increases and less spending cuts than are likely to emerge from this process, but not all one or the other. Compared to some of the mistaken fiscal policies going on around the world, this is pretty good.

Smick: Final question. What's the one thing that keeps you up at night?

Posen: The one thing that keeps me up at night is the thought that, as proposed by Robert Gordon and Peter Thiel, among others, we've really hit a lasting technological slowdown. The theory is unfortunately rather persuasive to at least consider.

If it's true, then all these things we've talked about—income inequality, stagnation of the average people's incomes, youth unemployment—they all just get worse indefinitely. And on the national security side, the gap between the United States and other possible competitors is going to shrink even faster over time. This is what keeps me up at night, but there's no simple contingency plan for it.

Smick: That's a great—but rather disturbing—answer. Thank you very much. ◆