WHAT IS THE RIGHT MACRO-POLICY MIX FOR A SUSTAINABLE ECONOMIC RECOVERY?

Exchange of views between Larry Summers and Jacques de Larosière *

David Wright, Chairman, Eurofi

Our first session is about what the right macro policy mix for a sustainable economic recovery is, and we have two really outstanding people to discuss this. We have Larry Summers, who is the Charles W. Elliot University Professor and President Emeritus of Harvard University. He served as the 71st Secretary of the Treasury for President Clinton and the Director of the National Economic Council for President Obama, and before that he was the Chief Economist at the World Bank.

He will start and then he will be followed by Jacques de Larosière, who is the Honorary President of Eurofi, who has had most distinguished public service as the Director of the French Treasury, the Managing Director of the IMF, Governor of the Banque de France and the President of the European Bank for Reconstruction and Development. Thank you both in advance from all of us. May I turn it over to President Emeritus Larry Summers?

Larry Summers, President Emeritus, Harvard University; Former Secretary, US Department of Treasury

Thank you very much. It is a privilege to be with you. It is a privilege to be with my friend Hal Scott, whose work at the Harvard Law School does so much to make connections internationally with respect to financial services issues. I see Ken Bentsen, and I have pleasant memories of his time in Congress and our work together. I am particularly honoured to be in dialogue with Jacques De Larosière, from whom I have learned so much as we have worked together in various capacities for nearly 30 years. He has to be one of the supreme financial statespersons of our generation.

I must say that I have been driven by events to find myself with a prospective more like the perspective that Jacques frequently has than has been my usual experience. In general, I think Jacques and I have had productive dialogue and very useful exchanges of views over time. I certainly have listened to Jacques' views with great respect to my great benefit. I think there has been some difference in our orientation at most moments. I have, in general, being concerned with the maintenance of aggregate demand and with the adverse consequences of underutilised resources in a variety of respects. I have felt that debts can be managed, and I have felt that lower interest rates represented fuel for investment that was desirable, and I have therefore had a tendency to be supportive of expansionary policies that have tended to analyse the economy in relatively Keynesian terms.

Jacques has, I think it is fair to say, been more cautionary than I about fiscal excess and more concerned about the potential contribution of easy monetary policy to financial bubbles. He has had more concern about instability breaking out with a deep fear and recognition of financial authorities' first obligation to avoid inflation and a tendency to put more stress than I did on the insight that real problems cannot be addressed with a monetary solution but need to be addressed in structural ways. That difference in perspective has been with us almost since we met each other in the early 1990s. At times, it has led to substantial changes of view; at times, it has not led to important differences of opinion.

The United States has today embarked on an experiment of such sweeping boldness in both the fiscal and monetary arenas that I find myself, for the near term, very much with the kinds of concerns that my friend Jacques traditionally had. I have been warning for seven or eight years now about secular stagnation. I have believed and continue to believe that in the industrial world a whole range of structural changes has led to a situation where private saving naturally exceeds private investment at reasonable interest rates, and therefore we are going to have to accommodate ourselves to a rather different level of lower interest rates and more expansionary fiscal policies along various dimensions than we had been accustomed to.

I have to say that I could not have dreamt nor imagined that the United States would be entering into a new year when the employment rate was beginning at 6.3%, when the CBO was projecting that at year end the GDP gap would be in the order of 2%, when the gap between labour income and its normal trend level associated with the dislocations of COVID was in the order of 1.5%, when automatic stabilisers were operating, and when there was a substantial overhang of unspent private saving from last year that represented 3 4% of GDP in funds that people would have spent last year but were unable to. In the face of all of that, the United States has embarked on a fiscal programme worth 14% of GDP without a penny of long term intended public investment, intended fully as transfer payments. The Chairman of the Federal Reserve responded to this by saying that his greater concern was economic slack and social justice through the promotion of employment and that he regarded inflation as very much a secondary concern in the environment both because he suspected that inflation would remain below target and he expected that, if it were above target, that would be fine since it had previously been below target.

** This exchange of views took place on 11 February 2021 on the occasion of the webinar organised jointly by EUROFI and the Harvard Law School. This webinar was dedicated to "The implications of the US elections for financial services and the Economy: EU and US perpectives".*

I could not have imagined a Keynesian revolution on that scale. I think we will learn a great deal about how economies function from this kind of experiment. It is the essence of science that astronomers learn the most from supernovas, biologists learn the most from the most powerful microscopes and thermodynamics learn the most from environments in which extreme pressures are placed on gasses. It is always the case that, when you take variables out of their normal range, you are able to learn much more about relationships than you could previously.

I do not know what will happen. My suspicion is that there is at least a real risk that the fiscal and monetary policy will prove to have been excessive and that inflationary forces, both in product and labour markets and asset markets, will soon become evident and that fiscal and monetary policymakers will face very difficult challenges that they will have to manage. An extreme pessimist would bring to mind the early Mitterrand experience in France in the early 1980s or the Lafontaine experience in Germany in the latter part of the 1990s. An alternative view would be that the world is importantly different and that we will see more elasticity of supply, more flexibility of policy and more insurance that needs to be taken out because of COVID. All of those things are possible, but I have to say that I am more surprised by the general orientation of policy and its seeming potential disproportion with my own reading of the economic statistics than at any time that I can remember.

David Wright

Thank you very much, President Emeritus.

Jacques de Larosière, Honorary President, Eurofi

Thank you very much. I am delighted to converse today with my friend Larry Summers. I have for him and for his thinking an enormous amount of respect, because he is a man who, in spite of the changing circumstances, thinks and thinks for himself. He has been my mentor over the years in many respects. The way he has characterised the differences in the approaches we both have on these issues is very fair, and I thank him for the generosity of his exposition.

Today's world is made up of paradoxes.

Global demand is weak, while investment needs are enormous and are not being realized, at least in Europe.

Interest rates have been very low for many years and non-residential productive investment has been declining.

So, let's try to put some order into these apparent contradictions.

Firstly, if aggregate demand remains weak, it is mainly due to structural factors which L. Summers has analysed masterfully: ageing, globalisation, technological advances, changes in labour market behaviour, leading to an overall saving surplus. This is where the debate on monetary policy and interest rates starts and where we see the nuances expressed by Larry.

We are told that in the face of excessive savings, we need fiscal and monetary policies that stimulate demand.

Let us pause for a moment to consider this apparent obviousness.

Monetary policy has been particularly accommodative for more than 10 years and interest rates have converged to zero. Public deficits have been booming and the public debt-to-GDP ratio has risen from 100% to 120% in the advanced countries within 5 years.

But what do we see?

Over the past 20 years, the stock of non-residential productive investment (without intangibles) has fallen from 14,4 % to 12 % of GDP in advanced economies which has been only partially offset by the rise in intangible investments which have risen from 4,3 % to 4,9 % of GDP.

What surprises me is that this statistic – which is one of the most significant in terms of global demand – is not highlighted more. And this collapse of productive investment has occurred despite historically low interest rates.

Let's continue this line of thinking. A strange hypothesis eventually emerged: What if it was low interest rates that contributed to lower investment?

"Absurd and nonsense" I will be told: if the financing conditions are easy and inexpensive, how could the investment be penalized? This is where the liquidity trap comes in.

Once again, Keynes was right. He was in favour of low interest rates, but not too low interest rates. Indeed, when they are too low, they deter savers from investing in long bonds and encourage them to either keep their savings in liquid form or in assets remunerated because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of non-growth emanating from zero interest rates, are turning away from productive investment in favour of share buybacks and speculative opportunities.

What I just said is not a confabulation. This is confirming a study carried out last year on the development of the financial part of household savings in Europe: over the past 10 years, we have seen a massive increase in the purely liquid part of household savings (notably overnight bank deposits). And this, of course, before the Covid crisis (*see figure 1*)

For sure, this research is European and may be less verifiable in the United States, where investors are less risk-averse than in Europe and more interested in the opportunities offered by Wall Street. So, I don't pretend that my interpretation is universal. But if it is correct in Europe, we should give serious thought to the problems posed by current monetary policy.

This is all the more so as the role of banks in financing the European economy is much more marked than in the United States (3/4 in Europe, ¼ in the United States). The profitability of banks is penalized by zero interest rates. This penalty is all the more pronounced in Europe as interest rates are lower than in the United States.

So there is a problem in Europe: is it possible that the mantra that we have been taught for 20 years is not adequate? Could it be that slightly higher rates could boost the morale of European companies and steer savings towards productive investment?

Of course, what I have just said might not be of great interest to American economists: their country has an extremely strong stock market and economic agents are less sensitive to interest rates because of their natural tendency to move from bonds to equities. In addition, the United States issues the world currency, which gives it some leeway to finance its deficit.

So, I ask the question: rather than being satisfied with a paradigm of low growth in Europe, isn't it time to ask the fundamental question: «what if zero interest rate monetary policy was not the right recipe to revive the global economy?

I have heard recently a Chinese economist, a professor at Peking University, say the following: « A too accommodating monetary policy raises many objections:

- Our economies need investments: to finance them we must encourage instruments with sufficiently high returns to cover the risks involved.
- Using monetary policy to stimulate the economy inevitably leads to inflation of financial assets and thus increases the danger of a crisis».

The profound truth of the real world is that a well-functioning economy is always based on work and normal returns on savings and therefore interest rates freely defined by the markets.

I will be told that, for all the secular reasons we know, the "natural» interest rate is declining. That's certainly true. But what is not said is that monetary policy plays a major role in lowering rates. It is so true that when the market anticipates the start of a rate hike, central banks immediately buy billions of securities to discourage this trend.

Of course, I am aware of the effects of this approach on sovereign securities markets. But monetary policy should not be at the service of the fiscal sustainability of States (fiscal dominance). Markets must play their role and not be entirely dictated by central banks.

Or should the wartime Accord between the Fed and the US Treasury be revived and sustained worldwide?

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Even if the above does not convince the leading monetary thinkers, there remains an unescapable issue: that of financial instability which Larry was kind enough to refer to.

The Financial Times has recently reported that "the riskiest borrowers in corporate America are making up their largest share of junk bonds sales since 2007.

From the start of 2021, more than 15 cents of every dollar raised in the US high-yield bond market have been issued by groups with ratings of triple C or below".

And I would add that, according to a gauge of cross-asset complacency from JP Morgan, investors are feeling the least fearful and most complacent since the dotcom bubble.

This sounds familiar and should be taken seriously by those who feel comfortable with present monetary expansion.

David Wright

Thank you both so much. Hal, do we have a little time for a quick comment from either Larry or Jacques? Do we need to move on?

Hal S. Scott

Let us maybe give each of them a couple of minutes to respond.

Larry Summers

I have found, as I expected to, Jacques enormously thoughtful. Jacques, if you would be able to forward me a copy of your remarks, I would be grateful, particularly for your statistics on what happened with respect to global investment. I think I am saying something Jacques would agree with, but the latter 60% of my remarks were heavily devoted to the policy response to Covid in the United States and possible excesses of the policy response to COVID. Jacques' remarks, if I understood them correctly, were in a sense more deep, long run and structural. He addressed issues that we were grappling before there was Covid and that we may well be grappling with in the aftermath of Covid.

Jacques raises a very profound issue, which in the language of my classroom economics would be the question of whether the IS curve in fact slopes downwards, i.e. whether it is in fact true that declines in interest rates do contribute to increases in aggregate demand or, through the various mechanisms he describes, in a context like Europe whether they actually reduce aggregate demand. I have considerable sympathy with Jacques here, and indeed I have a manuscript that I have been working on that raises questions about the impact of interest trades on aggregate demand in the way he described. Jacques makes an important point, which I have been aware of but have focused on insufficiently and will focus on more in the future, having to do with the distinction between the bank centric European system and the less bank centric American system in the transmission mechanism of low interest rates.

There is a challenge I would put to my friend Jacques, though. If one accepts his view about interest rates, if one accepts his view about the perils of central bank financing of the long end of the bond market, if one accepts his views about excessive fiscal indebtedness, what is the source of the energy that will lift these economies that are in something of a deflationary situation? Perhaps his focus is Europe, and his answer is a significant further decline in the value of the euro, but that is something that is not going to be entirely welcome internationally. So the question I would put to my friend Jacques would be, presuming that we are somehow past Covid, where is the energy going to come from? Is he confident about the efficacy of the structural reforms that he has long favoured?

Jacques de Larosière

Thank you. In a nutshell, you have presented the different approaches between us in a very clear and lucid way. I would add two remarks, however. First of all, yes, it is true that I am more geared on structural reforms than Larry is in his statements, but I will remark that the absence of structural reforms for some 40 years, which I have observed in my own country for instance, eventually creates conjunctural problems. If you have an economy that is less productive and less competitive, if you have an absence of supply side reforms, eventually you get into lower growth. In order to offset low growth, you get into more stimulative policies, which themselves have financial drawbacks and compound the balance of payments. That is one general remark.

The second point is this one. In the United States, monetary policy works rather well, because when you reduce interest rates to close to zero – not completely zero but close to it – you have an immediate offsetting mechanism which pushes up shares on the equities side, and therefore the economy is stimulated by the fact that shares are being bought by investors. In Europe, it is different. People are more sceptical about shares. They feel the risk is substantially higher in shares, and therefore you do not have the transmission of low interest rates going into dividend creating instruments. I think we have to understand the difference in investment behaviours in Europe and in the United States. However, I very much appreciate the openness of Larry, which is for me extremely important for the reasons I set out at the very beginning. Thank you.

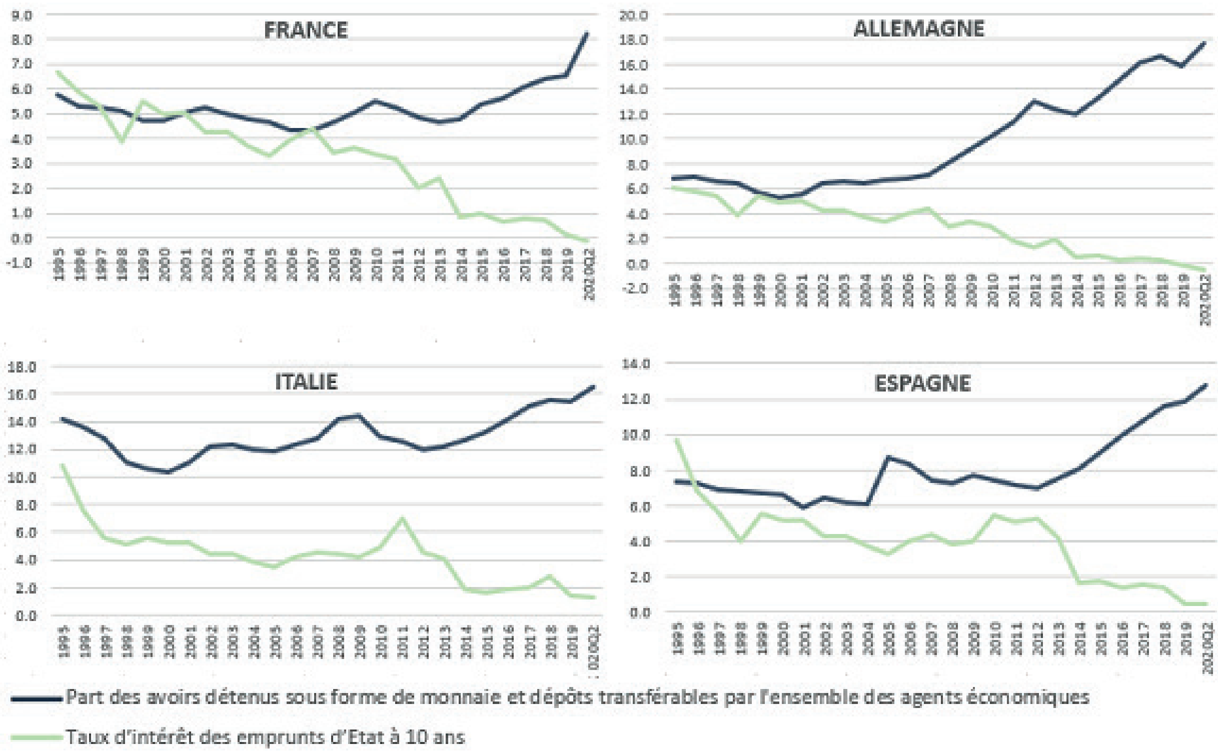
To sum up, I answer your question: the "energy" will come from two things:

- Restoring normal remuneration on long term investments and savings (growth has never been observed in an environment of zero interest rates)
- Reforming structural deficiencies that hinder production

Hal S. Scott

Thank you, Jacques and Larry. I could listen to this for hours. It is too bad that we have limited time, but I think even in this limited time we have benefited tremendously from both of your remarks, and I want to thank you very much for being with us.

Figure 1. Evolution of liquid assets held by economic agents and sovereign interest rates



Source: Eurostat, Thomson Reuters, calculs OEE (Observatoire de l'Epargne Européenne)