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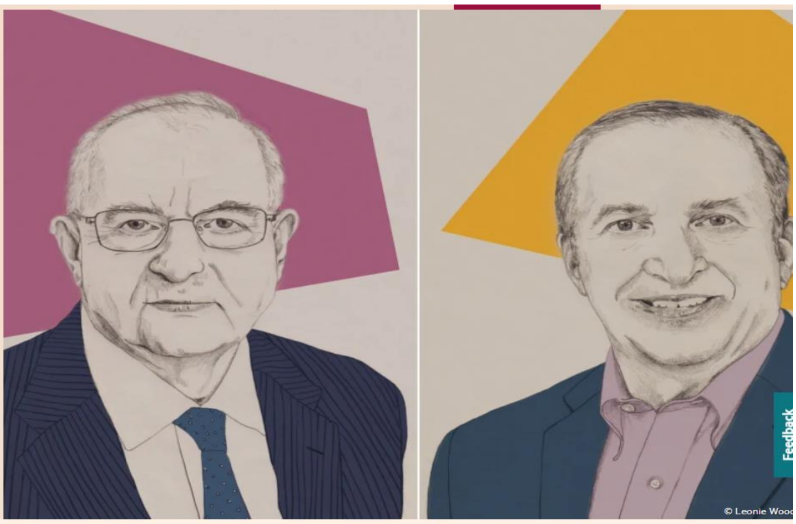
Larry Summers: 'I'm concerned that what is being done is substantially excessive'

Former treasury secretary criticises the scale of Biden's fiscal policy and warns it could lead to overheating and wasted resources



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This is part of a series, 'Economists Exchange', featuring conversations between top FT commentators and leading economists about coronavirus economic recovery

The world economy is struggling to escape the economic shock of Covid-19. During the worst of this pandemic, high-income countries provided a scale of fiscal and monetary largesse previously only seen in world wars.

Now, however, after the election of Joe Biden as president, the US is proposing to do more than double down on already generous support. Is what the US administration doing well judged or excessively risky?

For its proponents, the idea of "going big" is designed, among other things, to rectify the mistakes, as they see it, of the Obama administration of 2009. They want this to be seen as a transformative political moment. But Lawrence (Larry) Summers of Harvard has criticised the approach as the "least responsible" in 40 years.

Summers is an influential economist and policymaker on the US centre left. He won the John Bates Clark medal in 1993 and has been chief economist at the World Bank, Treasury secretary under Bill Clinton and head of Barack Obama's National Economic Council.

Summers has never been reluctant to court controversy as a thinker and policymaker. Notably, in 2013, he reintroduced into macroeconomic discussions the idea of "secular stagnation", first used by the Keynesian Alvin Hansen in the 1930s.

He used the label to explain the combination of a long period of easy, or ultra-easy monetary policy, with weak demand and disappointing growth. He then became the leading economist arguing in favour of less reliance on monetary policy and more on active fiscal policy.

Now, however, Summers — a Democrat with his party back in power — is criticising both the scale and direction of the administration's fiscal policies. Instead of applauding its boldness, he fears they will lead to significant overheating and waste of resources.

In discussion with Martin Wolf, the FT's chief economics commentator, Summers explains why the new approach might go disastrously wrong. He agrees there is a strong case for a more aggressive approach to fiscal policy. But policy still needs to be grounded in economic realities and priorities — and these ones, he insists, are not.

If Summers is wrong, it will matter little. If he is right, the hopes for a transformative presidency are likely to end in catastrophic economic and political disappointment. It is an immensely important argument.

Martin Wolf: Let's start with the current macroeconomic situation and, particularly, the legacy of Covid-19 and the arrival of Biden. His administration has already passed an enormous new fiscal stimulus of $1.9tn and is talking about a longer-term investment package of $3tn. Together, this is close to a quarter of gross domestic product.

You have been critical of these policies. Could you explain your criticisms? And how does this fit with your views on secular stagnation?

Larry Summers: I'm going to focus on the American policy path and not talk about where responsibility lies for that path. I think, in important respects, it lies with the Republicans and with those on the more extreme left of the Democratic party.

If you look at the economy at the beginning of this year, prevailing forecasts were that Covid would reduce wages and salaries to American households by $20bn-$30bn a month, with that figure declining over the year. So, that would be a $250bn-$300bn hole in wages and salaries over the course of the year.

So, I look at this hole and then I see $900bn of stimulus in the December package, $1.9tn of stimulus in the recently passed package and $2tn in the savings overhang, which is also likely to be spent. I see the Fed with its foot on the accelerator as hard as any Fed has ever done.

I see serious discussion of trillions of dollars more in fiscal stimulus, along with the explanation that this latest package is not temporary Covid relief, but a harbinger of a major transformation in social policy, which suggests that at least some of it will be continued indefinitely.

So, I look at that dwindling hole. Then I look at expenditures that aren't hard to add into the multiple trillions, and I see substantial risk that the amount of water being poured in vastly exceeds the size of the bathtub.

That could manifest itself, as a much smaller period of excess did during the Vietnam war, in rising inflation and a ratcheting-up of inflation expectations. It could, as has often happened, manifest itself in the Federal Reserve feeling a need for a sharp and surprising increase in interest rates, and the subsequent deceleration of the economy into recession.

It could manifest itself in a period of euphoric boom and optimism that leads to unsustainable bubbles, or it could all work out well. But, it doesn't seem to me that the preponderant probability is that it will work out well. So I'm concerned that what is being done is substantially excessive.

How does this square with my earlier views on secular stagnation? I looked at the global economy and, indeed, at the US economy during the pre-Covid period and what I saw was that, at near-zero real interest rates, there was a quite substantial gap between private savings and investment, driven by demography, cheap capital goods, inequality and technology.

That substantial gap meant a deflationary tendency, one towards sluggishness and for savings to flow into existing assets and create asset bubbles. So, I felt that savings absorption was a central macroeconomic problem and the order of the problem was 3 or 4 per cent of GDP at very low interest rates that themselves carry substantial risks.

Martin Wolf

Joe Biden’s $1.9tn package is a risky experiment

Now, when we’re talking about fiscal stimulus totalling 14 per cent of GDP in its first round, when we’re also talking about extraordinary monetary measures, structural effects of Covid — notably a large savings overhang — it seems to me that we are way overdoing the requisite response.

I always thought of economics as a quantitative field and when I hear people talk about why this is the right thing to do, they say things like “we really need to go big”, or “the 2009 stimulus was too small”.

It seems to me one needs to link the scale of the problem with the magnitude of the response. I look at the response and I look at the scale of the problem and I can’t see how it adds up.

There’s not much argument that the 2009 stimulus, in retrospect, was too small. It was 4 to 5 per cent of GDP over a couple of years, so it was 2.5 per cent of GDP in the first year, against a gap that was 6 or 7 per cent of GDP and growing, so it was perhaps a third or half of that gap.

Today’s stimulus is above 10 per cent of GDP in the face of a gap that is 3 or 4 per cent of GDP. Relative to the gap, this stimulus is already of the order of five or six times as large as in 2009. Not even the most extravagant critics of the 2009 stimulus have suggested it should have been six times as large.

I would say one other thing. In 2009 there was an important argument in which the people who were, in general, more progressive in their beliefs stressed that — in addition to responding to the macroeconomic situation — it was essential, in Rahm Emanuel’s phrase, “not to let a crisis go to waste” and take advantage of this opportunity to do deep structural things.

That’s why, in the 2009 stimulus, there were important investments in electronic medical records, new green venture capital and research-type measures, extending broadband and infrastructure repair and investment. What’s striking about today is that all of the trillions of dollars — all of it — does not include a penny directed at building back better.

I could have been comfortable with a headline figure well in excess of $1.9tn if it had been a large-scale, multiyear programme of public investment responding to our deepest societal concerns. But that’s not what this is.

It transfers to state and local governments that don’t have any new budget problem, according to the latest figures. It’s paying people, who have been unemployed, more in unemployment insurance than they earned when they were working. It’s giving cheques to families in the 90th percentile of income distribution.

It doesn’t seem prudent on resource allocation grounds, as well as being problematic on macroeconomic grounds.

MW: Assume you are correct. So we get huge excess demand in the US. One plausible consequence is a widening of the current account deficit, possibly associated with a large rise in the dollar as monetary policy is driven to tighten. This could, given the scale of borrowing around the world denominated in dollars, be followed by the sort of debt crisis we saw in the early 80s.

Should we be thinking about such international ramifications of the programme you’re discussing?

LS: I very much share your apprehensions. The reason I haven't articulated a fuller set of views is that I find myself ambivalent between two adverse scenarios.

One is what I would call the Reagan deficits scenarios — a temporary boom, rising current account deficit, increased protectionism, a strong dollar and magnification of the debts of others.

The other risk is what I would call the pre-Bretton Woods scenario or the Carter administration scenario, in which the sense that a country is printing its currency indiscriminately, in conjunction with the substantial accumulation of debt, leads people to be more reluctant to hold it.

I guess if I can see a plausible scenario for a very strong dollar and for a very weak dollar, it's logically possible that the forces will balance themselves, at least over time. Of course, Latin America's experience would suggest that the pursuit of reckless policy could lead to a scenario like yours, followed by a currency collapse.

There's a term I coined when I was in the Treasury, iatrogenic volatility. Iatrogenic illness is when you go into a hospital and you catch an infection there. Iatrogenic volatility is when policymakers, whose role is to stabilise markets, destabilise them with their actions.

I think there is a risk of that taking place. But I don't have the conviction to predict in what direction and with what timing it will happen.

MW: Let's suppose I were [Treasury secretary] Janet Yellen. Her argument might be that this stimulus might create some excesses in the short-run. But that will be a temporary shock.

We believe — she might say — that the elasticity of labour supply in the US is actually much greater than you and most other economists believe. We will pull a large number of workers into the labour force. This will pull up wages. That will squeeze profits, which will be fine, because profits are very high.

Yes, maybe, inflation will get up to 3-3.5 per cent but the Fed will look through that and expect a return to lower inflation. And, our future spending plans — this $3tn, or whatever — are going to be covered by taxes. You are far too worried about something we need to do to give confidence back to Americans, jolt us out of the Covid-19 recession and improve the conditions for many workers who have given up.

Why would you say this is wrong?

LS: I'd make these points.

First, no one was advocating a programme of this magnitude last December. This was not anyone's economic analysis. So, the argument might be right — but it was not an argument anyone had come to before it became politically expedient.

Second, there's much discussion that suggests you can't measure the GDP gap but, gosh, employment is 10m people lower than it might otherwise have been, so there's got to be enormous slack.

As a rough calculation, if employment is 10m people short, that's about 6 per cent of the labour force and, it appears, those who are not employed have wages of perhaps 60 per cent of the average worker. In terms of the shortfall in effective labour input, you're at 60 per cent of 6 per cent, which is about 3.6 per cent.

So, in employment terms that gets you to just about the same gap that you come to in terms of more traditional estimates. You also don't see the Fed or others substantially revising upwards their estimates of potential GDP.

Third, the view that this is only temporary expenditure sits uneasily with two other things that the proponents like to say. One is that this is a new era in progressive policy, with a different attitude towards government and public policy, and that there's a lasting legacy of structural improvement.

That would suggest that the spending was going to continue over some very substantial interval, in which case relying on its transience may not be such a good idea, even before you get to the question of future spending and investment.

The other thing that Paul Krugman and others who have defended this programme argue is that households are going to save part of the money that's provided to them. I, too, think it's likely that half this money will be spent this year and a quarter of it will be spent next year and the year after.

Yet, you still have to ask what is the magnitude of the fiscal stimulus and what is the magnitude of the cumulative gap over the next several years? It is hard to make that arithmetic work out even over that period.

There is a serenity that, yes, inflation may rise for a time but it will return and expectations will not become unanchored. Of course, when it's explained that the Fed has an entirely new paradigm, that this is an entirely new paradigm of fiscal and social policy, it's a bit hard to understand why expectations should remain anchored.

So, we're seeing an episode that I think differs both quantitatively and qualitatively from anything since Paul Volcker's days at the Fed, and it stands to reason that would lead to significant changes in expectations.

Let me put it in a different way and it's sort of ironic. The bet that we can do this is a bet on secular stagnation being even more true than I had supposed. For this to be right, the long-term demand gap has to be far larger than I had imagined.

I don't think that, until recently, the principal criticism of my views on secular stagnation was that I was very much underestimating its force. So I find it not a preponderant probability.

MW: The implication of your view of the macroeconomics would seem to be that taxes have to be raised permanently because the administration's ambitions are for permanent increases in spending, some of it on investment but quite a bit on current spending. If you were asked how should we raise the taxes to pay for this, what would you advise them to do?

LS: I have written for years in favour of increased public investment. An additional point that I think is under-appreciated is that whatever values you have, the reality is that a larger fraction of our population is going to be aged in the future and the relative price of things, like education and healthcare, has also increased very dramatically relative to the price of things like television sets. This means the public sector has to be bigger, to deliver on the same values.

The fact that we have more inequality, that support for opportunity and redistribution are central fiscal responsibilities and that we're moving into an increasingly dangerous world with more international obligations, mean that whatever you thought the right share of government was 20 years ago, you should favour a substantially larger one today, unless your values have changed. And I do.

So, yes, the US would definitely be better off with a larger government and that is going to require larger taxes. I think the administration is entirely correct in its view that the place to begin looking for higher taxes is with those who have been most fortunate over the last decades.

The measures that I would favour would be, first, a very substantial increase in the tax-enforcement effort.

Second, there were very substantial and inappropriate excesses in the Trump tax cuts. Even the business community didn't ask for a reduction in corporate rates to 21 per cent. A serious programme of corporate tax reform could surely raise over $1tn over the next decade.

Third, a variety of changes associated with capital gains tax would raise $0.5-1tn.

In all, I think one could raise close to $4tn over the next 10 years with measures that would be desirable in terms of having a more just and more level tax system, and that's where the conversation should start.

Ultimately, I think society is going to require larger revenues and it is going to be necessary and appropriate to raise taxes, not just on the top 1 per cent of the population but more broadly.

And I think that would be the right thing to do, even if there were not macroeconomic concerns over overheating.

MW: Finally, a long time ago, we used to associate the Republican party with a "balanced budget" view. That has clearly gone out of the window. Is the same thing now happening to the Democrats? Is the implication of your analysis that no political force in America nowadays wants to offer fiscal rectitude?

LS: Imputing a tradition of serious fiscal concern to Republicans has been wrong for 40 years. Republicans have been deficit hawks whenever Democrats have wanted to spend money on helping people who are disadvantaged. And then going back to the Reagan tax cuts, through the Bush tax cuts and the Trump tax cuts, whenever there was an opportunity to cut taxes for high-income people.

In the 1990s, substantial amounts of business investment were being inhibited by high costs of capital. So I pushed the idea that bringing deficits down and crowding in private investment was an attractive growth strategy.

In the context we've had for the last decade, when cost of capital was not a meaningful constraint on investment, one needs to think quite differently about deficits. So, I don't think anybody should believe the things that were believed in 1993, because the world has changed in important ways.

But, in many ways, today's situation is a bit like the 1960s. It was then hoped that the laws of economic arithmetic could be suspended and that it would all work out. That experiment didn't work out well for Lyndon Johnson, economically, and it didn't work out well for the Democratic party, politically. I think there is a significant risk that something of the same kind will happen today.