THE BROOKINGS INSTITUTION

RESPONDING TO AN HISTORIC ECONOMIC CRISIS:

THE OBAMA PROGRAM

Washington, D.C.

Friday, March 13, 2009

PARTICIPANTS:

Welcome and Introduction:

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Featured Speaker:

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P R O C E E D I N G S

MR. BAILY: Welcome to Brookings. This is really a great occasion. My name is Martin Baily and I lead the Business and Public Policy Initiative here at Brookings. We're very fortunate that we had Christine Romer this week and now Larry Summers. It's a great pleasure and privilege. The format is I'm just going to give a short introduction, Larry is going to give his talk, and then he has agreed to take questions.

Larry earned his Ph.D. at Harvard and in 1983 at age 28 became the youngest tenured professor in Harvard's history. He was Chief Economist at the World Bank where he played a key role in designing strategies to assist developing countries. He then served as Under Secretary of the Treasury for International Affairs, Deputy Secretary of the Treasury, and then from 1999 to 2001 as the seventy-first United States Secretary of the Treasury. I was lucky enough to be one of his colleagues in the administration at least during some of those years.

After the Treasury he served as the twenty-seventh President of Harvard University, and until joining the Obama Administration he was the Charles W. Eliot University at Harvard. His research contributions which are pretty stunning were recognized when he received the John Bates Clark Medal, and when he was the first social scientist to receive the National Science Foundation's Alan T. Waterman Award for Outstanding Scientific Achievement. He's a member of the

Academy of Sciences and has published over 150 professional economics articles. Larry was also on the Board of Trustees at Brookings and served as Co-Editor of the Brookings Papers on Economic Activity. There is a line here that my speechwriter put in this introduction which quotes *Newsweek* as saying that Larry has a "rumpled, slightly sleep look of a professor who has been up all night solving equations." I guess I've just said that, but it doesn't really apply. You're looking very sharp, Larry, and we're delighted to have you here.

MR. SUMMERS: Martin, thank you very much for almost all of that introduction. It's better than we economists usually get as you well know, and it is a pleasure to be back in this room where I have spent so many hours over the years discussing macroeconomic policy in conjunction with my friend George Perry as part of the Brookings panel. Thanks to President Obama, my term as Editor of the Brookings Papers on Economic Activity is slightly reminiscent of President Harrison's term as President of the United States, but I hope all will agree in the end that my departure was for a somewhat better reason than his.

I want to talk this morning about our understanding of the roots of our current economic crisis, the rationale for the administration's recovery strategy, and connect that recovery strategy to the central objective of sustained and healthy expansion. Economic downturns historically are of two types that different not just quantitatively, but qualitatively. Most of those in post-World War II America and probably in most other countries have been a byproduct of the monetary authority's efforts to control rising inflation. But an alternative source of recession comes from the spontaneous correction of financial excess, the bursting of bubbles, deleveraging in the financial sector, declining asset values, reduced demand and reduced employment. Unfortunately, our current situation reflects this latter, rarer kind of recession. On a global basis, $50 trillion in wealth has been erased over the last 18 months. This includes $7 trillion in the U.S. stock market, $6 trillion in housing wealth. Inevitably these losses have led to declining demand with GDP and employment now shrinking at among the most rapid rates since the Second World War; 4.4 million jobs have already been lost since the recession began.

Our single most important priority is bringing about economic recovery and ensuring that the next economic expansion, unlike its recent predecessors, is fundamentally sound and not driven by financial excess. Without robust and sustained economic expansion, we will not achieve any other important national goal. We will not be able to project strength globally or reduce poverty locally. We will not expand access to higher education or make health care more affordable. And we will not be able to create opportunities for new small businesses to thrive, or most importantly, to raise incomes for middle-class families.

So today I come here to explain and discuss the rationale behind the President's Recovery Program and our strategy for long-term growth. Our problems were not made in a day or a month or a year, and they will not be solved quickly. But there is one ineluctable lesson of the history of financial crises: they all end. I am confident that with strong and sound policies the President has put forward and the passage of time, we will restore economic growth, regain financial stability and find opportunity in this moment of crisis to assure that our future prosperity rests on a sound and sustainable foundation.

How should we think about this crisis? One of the most important lessons you learn in any introductory economics course is about the self-stabilizing properties of markets. When there's an excessive supply of wheat, prices fall, farmers gross less, people consumer more, the market equilibrates. When the economy slows, interest rates fall. When interest rates fall, more people take advantage of credit, the economy speeds up and the market equilibrates. This is much of what Adam Smith had in mind when he talked about the invisible hand. It is what people have in mind when they talk about the self-equilibrating forces of the market or use the metaphor of a thermostat to describe how a market functions.

However, it was the central insight of Keynes's General Theory that two or three times each century, and now is one of those times, the self-equilibrating properties of markets break down as stabilizing mechanisms are overwhelmed by vicious cycles, as the right economic metaphor becomes not a thermostat but an avalanche, and that is what we are confronting today.

Consider the vicious cycles. Declining asset prices lead to margin calls and deleveraging which leads to selling, further declines in asset prices, perpetuating the cycle. Lower asset prices mean banks hold less capital. Less capital means less lending. Less lending means lower asset prices, and the cycle perpetuates. Falling home prices lead to foreclosures which lead home prices to fall even further, forcing more foreclosures, forcing losses in the mortgage sector, forcing reductions in lending, forcing housing prices further down. A weakened financial system leads to less borrowing and spending, which leads to a weakened economy, which leads to a weakened financial system. Lower incomes lead to less spending, which leads to less employment, which leads to lower incomes. And I could go on. These are not processes that are self-correcting.

To put the point a different way, an abundance of greed and an absence of fear led some to make investments not based on the real value of assets, but on the faith that there would be another who would pay more for those assets. At the same time, the government turned a blind eye to these practices and the potential consequences for the economy as a whole. Bubbles were born, and in those moments greed begets greed and the bubble grows. Eventually, however, the process stops and reverses; prices fall, people sell. Instead of an expectation of new buyers, there is an expectation of new sellers, greed gives way to fear and this fear begets fear. This is the paradox at the heart of financial crisis.

If in the last few years we've seen too much greed and too little fear, too much spending and not enough saving, too much borrowing and not enough worrying, today our problem is very different. It is this transition from an excess of greed to an excess of fear that President Roosevelt had in mind when he famously observed that the only we had to fear was fear itself. It is this transition that has happened in the United States today.

What is the task of policy in such an environment? While greed is no virtue, entrepreneurship and the such for opportunity is what we need today. We need a program that breaks and reverses the vicious cycles. We need to instill the trust that allows opportunity to overcome fear and enables families and businesses to again imagine a brighter future. And crucially, we need to create confidence without its leading to unstable complacency.

While the economy is falling far short today, perhaps a trillion dollars or more short, we should never lose sight of its potential. We are the most productive workers in the world, the great universities and capacity for innovation, an incredible amount of resilience, entrepreneurship, and flexibility, and the most diverse and creative population of any economy in the world.

One striking statistic suggests the magnitude of the opportunity that is before us in restoring our economy to its potential. Earlier this week the Dow Jones Industrial Average adjusting for inflation according to the Standard Consumer Price Index was at the same level as it was in 1966 when Charlie Shultz, Art Okun and George Perry were helping to preside over the American economy. While there are many ways that one could question the precise details of this calculation, that the market would be at essentially the same real level as in 1966 when there were no PCs, no Internet, no flexible manufacturing, no software industry, our workforce was half as large as today, and our capital stock was a third as large as today, will be regarded as some as suggesting the presence of the sale of the century. For policymakers it suggests that the magnitude of the gains from restoring confidence and sustained economic growth.

The prospect for producing recovery and harnessing these opportunities will depend on the choices we make now. Toward this end, the President is committed to an approach that moves aggressively on jobs, on credit, on housing, thereby attacking the vicious cycles I just described at each of their key nodes. In this effort, he has insisted that we guided by the recognition that the risks of overreaction are dwarfed by the risks of inaction.

The first component of the President's program is direct support for jobs and income, to engage the multiplier process in favor of economic expansion. Increases in income lead to financial repair which supports further increases in income. Rising employment will lead to rising spending which leads to further increases in income and employment. The Recovery and Reinvestment Act is the largest peacetime economic expansion program in the country's history. It will inject nearly $800 billion into the economy, three-quarters of it within the next 18 months. The Council of Economic Advisers' estimates suggests that it will save or create 3-1/2 million jobs. At the same time that it creates jobs for people who need them, it will do work that the nation has needed for a long time. Doubling renewable-energy capacity in the next 3 years, supporting middle-class incomes, modernizing 10,000 schools, and making the largest investment in the spine of our economy, the nation's infrastructure, since Dwight Eisenhower's Interstate Highway System some 50 years ago.

Already its impacts are being felt. It may retain 14,000 teachers in New York alone, and cops and teachers and public employees across state and local governments. It will for most American workers within the next several weeks be felt as withholding schedules are adjusted resulting in higher take-home pay. Already several hundred-thousand workers are benefiting from continuing unemployment insurance benefits and health benefits that would otherwise have been unavailable. And contracting is already underway for tens of billions of dollars in infrastructure projects that otherwise would not have taken place. It is too early, surely too early to accurately gauge the broader impact of the President's program, but it is modestly encouraging that since it began to take shape, consumer spending in the United States which was collapsing during the holiday season appears according to a number of indicators to have stabilized.

The second major portion of the President's strategy is the Financial Stability Plan. It is directed at addressing the vicious cycles associated with deleveraging and credit contraction. A strong flow of credit is necessary because factories need it to buy equipment, stores to stock their shelves, students to attend college, consumers to buy cars and businesses to meet their payrolls. The President's approach rests on two pillars that reflect the diversity and complexity of the U.S. financial system. The first is provision for a trillion dollars or more for financing, for purchasing mortgages, student and small business loans and other financial instruments through the TALF program or what is now called the Consumer Business Lending Initiative, the government-sponsored enterprises in the mortgage area, and the public-private investment facilities that Secretary Geithner will be detailing in the weeks ahead. Reactivating the capital markets is essential to restarting nonbank lending which accounts for nearly 40 percent of the lending in the American economy, for establishing realistic asset valuations so that markets can function, and enabling banks to divest toxic assets when they judge it appropriate or economic conditions make it necessary.

The second pillar of our program is assuring that our banking system is well capitalized and in a position to lend on a substantial scale. This starts with accurate assessment. The stress tests now underway will enable a realistic assessment of the position of each different institution and appropriate responses in each case to assure their ability to meet their commitments and to lend on a substantial scale. As the President said in his Joint Address to Congress, when we learn that a major bank has a serious problems, we will hold accountable those responsible, force the necessary adjustments, provide the support to clean up their balance sheets, and assure the continuity of a strong, viable institution that can serve our people and our economy.

As a result of government interventions in financial markets, key credit spreads are already substantially narrower than they were last fall even in the face of a stock market that has declined as well. There are some indications that the expectations of future actions have been a positive in reducing credit costs in a number of key areas. It is our hope and expectation that further support for capital markets, transparency with respect to the condition of banks and infusion of capital into the banking system will create virtuous circles in which stronger markets beget stronger financial institutions which beget stronger markets, leading ultimately to financial and economic recovery.

These two measures together address most of the vicious cycles that I spoke about. But the third component of the President's recovery strategy is addressing the housing market. A vicious cycle of foreclosures leading to declining home prices, leading to rising foreclosures, leading to declining home prices and problems in the mortgage market must be contained as it is at the heart of our economic crisis. Through direct intervention using GSEs to bring down mortgage rates and make possible refinancing for credit-worthy borrowers who have lost their home equity as house prices decline, and through setting standards and providing significant financial subsidies for measures directed at payment relief to prevent foreclosures we are achieving several objectives. Housing wealth and its contribution to expenditures is being maintained, and critically, lower mortgage rates mean more income for consumers and function like tax cuts in support of consumer spending. Depending on market conditions, the administration's program may save American households more than $150 billion over the next 5 years.

Taken together, these steps to support incomes, increase the flow of credit and normalize housing market conditions address each of the vicious cycles that is leading to decline. With the passage of time they will permit the normal processes of economic growth to reengage, rising incomes and employment, greater credit flows, increased spending, a stronger U.S. economy and a stronger global economy. They will also reinforce crucial cyclical dynamics that people often lose sight of at moments like this one. For example, about 14 million new car sales a year are necessary on average for replacement of vehicles and to accommodate a rising population growth, yet car sales are now running at an annual rate of about 9 million. New household formation requires something like 1.7 million new housing units a year, and yet housing starts are now running at about 400,000 a year. Once the inventory is worked off, investment will increase. Historical experience suggests that rapid inventory decline such as we have observed in recent months is followed by increased production to rebuild inventories.

It is tempting to suppose that as some argue the focus of economic policy at a moment like this should be solely on achieving economic recovery. We believe that that would be setting our sights too low. It would be in a real sense irresponsible because we have just been reminded of the dangers of policies that produce short-term, bubble-driven growth instead of durable and sustainable growth. To a sobering extent, the events of the last 18 months remind us that our experiences of rapid growth in the United States have been associated with asset price inflation, unreasonable extensions of credit to both the household and the business sectors. It was housing and mortgages in the last few years before this recession, and certainly we saw bubbles in the technology sector and beyond in the late 1990s. Bubble-driven growth is problematic because of disruption and dislocation affecting those who took part in the bubble's excess and those who did not. It is not entirely healthy even while it lasts. Between 2000 and 2007, a period of solid aggregate economic growth, the typical working-age household saw its income decline by nearly $2,000. The decline in middle-class incomes even as incomes of the top 1 percent skyrocketed has a number of causes, but one of them is surely rising asset prices and the financialization of the economy that reached an apex when the financial sector accounted for fully 40 percent of all U.S. corporations in 2006.

Confidence today will be enhanced if we put measures in place that assure that the coming expansion will be more sustainable and fair in the distribution of its benefits than its predecessor. That is why the President has priorities that go beyond the immediate goal of containing the downturn and promoting recovery. An overhaul of our financial regulatory system is one such priority. In little more than two decades, we have seen the stock market crash of 1987, the savings and loan scandals, the decline of the real estate market, the Mexican crisis, the Asian crisis, LTCM, Enron and long-term capital. That works out to one big crisis every 2-1/2 years. We can and must do better. There is room for debate about how regulation should be enhanced, but not I suggest about whether we should stay with the status quo. Treasury Secretary Geithner will be laying out the administration's approach in some detail in the coming weeks and the President is eager to take this issue up with his fellow leaders at the April G-20 meeting.

The discussion can get pretty technical pretty quickly, but some things are common sense. Regulatory agencies should never be placed in competition for the privilege of regulating particular financial institutions. Globally the United States must lead a leveling-up of regulatory standards, not as has happened all too often in the recent past trying to win a race to the bottom. No substantially interconnected institution or market on which the system depends should be free from rigorous public scrutiny. Required levels of capital and liquidity must be set with a view toward protecting the system even in very difficult times. And there must be far more vigorous and serious efforts to discourage improper risk taking through transparency and accountability for errors.

An additional requirement for financial stability is that the government's own finances be stable. When I left Washington 8 years ago there was an active debate about how we would conduct monetary policy and federal financial affairs in the absence of federal debt when it had all been paid back. That is one issue that off the policy agenda.

I would hope that all of those who participate in the debate over this year's budget whether they agree or disagree with President Obama's priorities will share his commitment to truthful and realistic budgeting and to a criterion of fiscal sustainability that ensures that once the economy has recovered, the ratio of the nation's debt to its income stabilizes rather than continuing to grow. If through these reforms growth in the coming years is not to be driven by asset-price inflation induced consumption, other engines of growth must be identified. These forms of growth should be sustainable and shared by the majority of American households. Stronger exports are one such foundation for sustainable expansion. That is why along with strengthening financial regulation the President will be focused on the global growth strategy at the G-20. Priorities will include spurring demand around the world and assuring that this global credit crunch does not as credit crunches have in the past unduly burden emerging markets. These are issues of great importance for the American economy, but for the global system as well, at a time when 2009 is likely to be the first year of negative global growth since the Second World War.

But moving away from foreign-debt-financed growth is only one component of ensuring a healthy expansion. An additional component is addressing our health care system. It is I would suggest no accident that the period of the most rapidly rising wages in the last generation for middle-income families was the 1990s when health care cost inflation was relatively well controlled. Our ability to produce competitively in the United States will be enhanced if we contain health care costs. We are all very focused and rightly on the automobile companies. It bears emphasis that in some cases their largest supplier is not a parts company, but Blue Cross and Blue Shield. Containing health care costs can keep the economy sustainable, and so also does improving quality and access. A study was done at Harvard while I was there. It calculated that of all the hypertension in the United States, only about 1 in 4 cases was well controlled. In half the cases it was undiscovered, and in half the cases where it had been discovered it was not under satisfactory control. This means children will never grow their grandparents and it means the huge costs for treating strokes down the road. By investing in our health care now, we can make our economy as well as our people healthier. We will also, given the exponential trends in this area, increase confidence in the ultimate stability of the nation's finances.

An equally important engine of recovery can be investment in reducing our energy vulnerability and our contribution to climate change. That's why the Recovery and Reinvestment Act provided for doubling renewable energy and weatherizing 75 percent of federal buildings. It's also why the President's budget points toward strong action to implement a market-based cap-and-trade system after the growth recovers. Let's be realistic. Sooner or later we'll have to reduce our dependence on foreign energy and contain our carbon emissions. Thinking about this issue, I was reminded of Ben Bernanke's doctoral thesis written about 30 years ago. The basic argument of Bernanke's doctoral thesis was that if you think energy prices will be low, you will buy one kind of boiler. If you think energy prices will be high, you will buy a different kind of boiler. If you don't know what will happen to energy prices and you think you'll find out soon, you don't buy any boiler and you don't invest at all. There's a message here about the importance of certainty and the importance of resolving the cap-and-trade issue in a rapid way. There's another benefit as well. As many enlightened business leaders have recognized, the confident expectation that pricing policy will discourage carbon use in the future will spur a whole range of green investments in the present when our economy can benefit from all the investment it can get, and in the long run we believe this can create jobs on a substantial scale. We can choose to lead these industries with all the commensurate economic, political and environmental benefits or we can choose to lose out on these jobs and opportunities.

Finally, America's education system may not be directly implicated in why we have a recession now in 2009, but it is surely the case that improving education is essential to the long-run growth of the economy and to ensure that this growth is shared, lifting up more families who get the opportunities afforded by a better education and expanded access to college.

And I must say as a former college president, of all the arguments that were made in the course of the discussion of the fiscal stimulus Recovery and Reinvestment Act, the one I found most difficult to understand was the claim that somehow increasing Federal assistance that enabled students to go to college in the midst of the worst recession in 40 years had nothing to do with stimulating the economy.

Apart from any moral aspect, apart from any long-run aspect, isn’t it good to stop families from selling their houses to send their kids to college?

Isn’t it good to enable families to spend their incomes without sacrificing their students’ education?

And as the father of two college-age daughters, I can tell you there is very little danger that any assistance that finds its way into their hands will be saved and not spent, quite frankly.

I’ve spoken in the language of economists and economic policy, the language of the Brookings Institution -- budgets and prices, capitalizations and interest rates. That’s because I believe what the commitment to this institution is, that there is no substitute for careful analysis in setting economic policies. But as we debate these concepts, we must always keep in mind that our economic policies affect real lives and that economic problems cause real pain. The decisions we make as a country will determine whether children will look to their parents with pride when they come home from work or fear that their home will be lost, whether families will experience the prosperity that this nation is capable of producing or the disruption and dislocation that too many have found instead.

President Obama inherited an economic crisis. It is not a crisis he sought or created, but it is one that, under the President's leadership, I believe we are answering.

We are embarked on what I believe is the boldest economic program to promote recovery and expansion in two generations. No one can know just when and how its positive effects will be fully felt. No one can predict with precision when this crisis will be resolved. But I am confident that in its resolution lies enormous opportunity for both Americans and the United States of America. We can and we will emerge more prosperous, strong, wise and better prepared for the future.

Thank you very much.

(Applause.)

MR. BAILY: Thank you. Thank you, Larry.

Larry has agreed to take some questions. And, if I may, can I toss the first one at you?

The two concerns that I hear most are, number one, that restoring the financial sector needs to be the number one priority, and people are not kind of reassured yet that it is. Now you spoke to that, but you also talked about health care and climate and so on.

And a second related concern, and again you spoke to that a little bit, is what are the specific steps that are going to be taken to deal with the financial crisis? There seems to be, you mentioned that, that Tim is going to lay out those, but there seems to be a bit of hesitation there, and one wonders is this because the price tag is so big. Nobody wants to own it. Or, is it just a matter of time? Are we being impatient?

Can you speak to those concerns a little bit?

MR. SUMMERS: Gosh, Martin, I'm really glad to let you ask the first question.

MR. BAILY: I thought you would be.

MR. SUMMERS: Look, I think the first thing to say is at a crucial moment during the campaign it was proposed that one of the presidential