Unedited Transcript

Summers and Blanchard debate the future of interest rates

Olivier Blanchard (PIIE) and Lawrence H. Summers (Harvard University)
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Adam Posen: Hello, everyone, and welcome back to the Peterson Institute for International Economics, at least the virtual version. We're delighted today to be able to present an important debate or discussion on the critical macroeconomic issue of our day. What happens to the neutral rate? Or in other words, what happens to the trend rate of interest in the economy consistent with low inflation and stable growth?

This is also a question of whether secular stagnation will persist or not. We have today two of the leading policy macro economists of our era and academic economists of our era. Olivier Blanchard and Lawrence Summers. Both of them have been critical to the discussion of these issues.

It was Larry Summers who in 2015 reintroduced the concept of secular stagnation to the policy debate, aptly capturing the underlying issues of the period since the global financial crisis. It was Olivier Blanchard who has taken up the mantle on that and, starting with his American Economic Association presidential address three years ago, has pursued the fiscal policy implications were culminating in his newest book, Fiscal Policy under Low Interest Rates.

Just to remind everyone, not that it's necessary. Olivier Blanchard is the C. Fred Bergsten senior fellow at the Peterson Institute and also the Robert M. Solow, professor of economics emeritus at MIT. From 2008 to 2015, he served as economic counselor and director of the research department at the International Monetary Fund.

Lawrence Summers is the Charles W. Eliot University professor and President emeritus of Harvard University. During the past three decades, he has served in a series of senior policy positions, including as director of the National Economic Council for the Obama Administration and Secretary of the Treasury of the United States and of the Clinton administration.

He is also, I'm delighted to say, the vice chair of the board of directors of the Peterson Institute. Just to set this up, our colleagues are going to speak briefly each on the topic of where they see real interest rates trends going in the US. Are we still in secular stagnation and the world? And then after some exchange, we'll turn to the issue of inflation trends, and then we will go to question and answer.

Registered participants can submit a question over the Q&A function in Zoom. Just to set this up. Larry, in his comments at the American Economic Association this past January 8th was quoted as saying, “My guess is that will not return to the era of secular stagnation” after the current disinflation takes place. Meanwhile, Olivier published a blog on Peterson Institute on January 24th, titled Secular Stagnation Is Not Over.

The juxtaposition of these two money statements is what led us to convene this event. So, Olivier, could you take us through your thinking on why secular stagnation is not over? What's happening to the real economy?

Olivier Blanchard: Okay. Thanks, Adam. First, I think it's going to be more of a discussion than a debate, because I think Larry and I probably have more or less the same list. It's just a question of what weight we put on the various elements. What I've tried to put there is eight points, which I'm going to try to do in the seven minutes that you gave me making the case for a likelihood that will go back to lower rates and secular stagnation.

So, the first point is a fundamental fact, which is that there was something quite striking happening for the 35 years before COVID, which was this decline in real interest rates across the world, not due particularly to events such as the global financial crisis and so on, just very small, very steady. Clearly deep forces at work behind it.

And it would be surprising that all these forces have changed side and are going to revert in the opposite direction. So, I think we have to start from there. The second point, which is also obvious, is that the high rates today are due to a fight against inflation. If we had not had inflation, then I suspect the rates would be much lower.

But the point is, even today, when we're clearly at the height of the fight against inflation, and short rates may go up a bit more as Jake Paul said this morning. If I look at the 10-year rates, both nominal and real, basically, we're still in a configuration where the real rate is less than G, not by as much as before COVID, but the inequality still goes the same way. And I find this fairly striking.

You can do something better than looking at the 10-year rates. You can look at the OIS swaps and the inflation swaps and see what the investors expect, the rate one-year rate to be in 10 years and what they expect the rate to be in 10 years is 0.8%, which is clearly less than the expected growth rate in 10 years. So, I think even now we still don't have very high rates and r Minus g is still negative.

It may change sign in the next few months, but looking forward, I think it is negative. The third point is about psychology of markets. I think that we all have a very hard time thinking about what happens beyond the horizon and markets traditionally, when there has been an inflation environment and a high interest rate environment have had a hard time thinking about where we are once this fight is won.

So, I went back and looked at the 1980s. And basically what you find is that the [inaudible 0:06:14] 10-year rate was much, much higher from 82 to 85 than the exposed some of the one year rates. Now, clearly there's a spread, but it was higher by basically 2.5%. So, think markets have a hard time just turning the page, thinking about what happens later.

So, in that way it may be the right rate is even lower than that. The fourth point is you cannot trust investors in markets fully. You should listen to them. They know a lot, but you really have to look under the hood. And that's what Larry and I have done for quite a while, which is what other factors which are behind the steady decrease in rates.

And I think the analytical framework is very clear. It had to come from a combination of high saving, high supply of funds, low investment, low demand for funds and high demand for safety, leading to very safe rates. I think that we're thinking is the only way to think and that's the right one. Now, think it is fair to say maybe Larry disagrees, but that we didn't identify the culprit.

And there are good reasons to think that all these factors have played a role. But exactly which role we don't know. So, what you have to do in thinking about the future is think about each one and see where it goes. So this takes me to the to the fifth point, which is the resilience of current demand, the fact that the Fed really has a hard time slowing down the economy.

And you could see this as indicating that basically there is more aggregate demand than there was structurally more aggregate demand than there was before. And therefore the interest rate which is needed is going to be higher. And the question is, where does this resilience come from? My sense is it's due to special factors. It's due to the excess saving, which has been the result of fiscal policy over the last few years.

People have a lot of money to spend and are spending it. It is due to pent up demand for cars. There's enormous pent up demand for cars, so I don't read anything in the fact that the resilience of demand is an indication that we're going to have higher rates in the future. Let me now go briefly to each of the remaining three points.

So the sixth point is about private saving. So I think the reason why private saving played a big role pre-COVID was the increase in the life expectancy, which led to longer retirement, more need to save. So life cycle saving and higher income, which allowed more and more people to basically save a bit in a precautionary life cycle.

I think that will continue. One should look a bit more into it. There is going to be a fairly large decrease in fertility in emerging and in developing countries. That on the face of it might lead to lower saving. But think, for example, when you think about the Chinese, they relied on kids as basically the insurance for old age. I think they now have to rely much more on themselves and therefore saving.

So I think they don't expect any major change. Within that point, there's the issue of public dissaving and I think Larry may come back to it, which is maybe we're going to have much more debt than we used to have, and higher debt means a higher equilibrium interest rate. Now, two things -- striking thing is that as a result of the very large deficits, you might have expected a very large increase in debt relative to, say, 2019.

It has been small largely because inflation has eaten quite a bit of the nominal debt. So there's not a big change in terms of where we are compared to where we were. But looking forward, I surely worry about the budget process in the US and the fact that we may have much higher debt in the future. It is broken. It is worrying. I'm not worrying about the European Union one where I think there'll be fiscal consolidation, but clearly if there was a lot more debt, then this would lead to higher neutral rates for five years, ten years out.

Let me move to the last two points. The next one is demand for safety. It clearly has increased for various reasons over time. But full regulation is a big one. It forces financial institutions to hold liquid and therefore safe assets. I don't see any change there. So let me get to the final point, which is investment. So investment was weak pre-COVID and was one of the reasons why interest rates were neutral rates were low.

And the question is, is it going to be the same in the future? And I think there that's where Larry and I think are probably struggling to decide how important that is. You can think of a number of reasons why investment would be higher. The first one is maybe we have entered a period of high TFP growth due to AI and so on. This would lead to higher g, higher r, ambiguous about r Minus g, but that would be a change that could happen.

I think we keep predicting it. Larry has shown that from decade to decade it's very hard to predict, but it could happen. The things which are more likely to happen, reshoring, reshoring basically means building a plant where you actually already had a plant somewhere else so it could lead to more investment and that would again, increase the rate.

Defense spending, we were in a mode where we thought of fighting very differently from the way it's happening in Ukraine. Fighting in Ukraine implies much higher levels of defense spending, and that could lead to a fairly substantial increase in defense spending. But again, if it's financed partly by debt, would lead to a higher rate. And let me get to what I think is maybe the crux of it, which is green investment.

If we're serious about the fight against global warming, it's going to require high investment, which is likely to be partly financed by debt. The numbers are uncertain, but you need basically something like gross investment of 2 to 3% and net investment because there will be less investment in brown energy of 1 or 2%.

If this happens, which I hope it does, then this would lead to a higher rate. On that, I would not expect to return to the low, very low negative rates of pre-COVID, but I would expect r to remain below g, which for many issues is the important question. So I've gone very fast. I'm sure Larry has all kinds of rebuttals, but I'll let him speak. Thank you.

Larry Summers: As Olivier said, I think we probably come down in somewhat different places, but I don't think we have fundamental differences, and there's a lot of commonality in how we think about the problem. I think the first question is what do we think we're disagreeing about and what do we mean when we say the era of secular stagnation is or is not over?

And I tend to think of that question by saying, will real interest rates be meaningfully greater than the half a percent that the Fed has currently identified, the neutral real interest rate as being. And Olivier tends to frame that question by comparing r with his best guess of g, which is probably some number a little less than two. So, if the number ends up being one-and-a-half, I'm calling that a substantial move away from the pattern of the post-financial crisis.

And Olivier's calling that his books are less than g condition still holds, and so there's secular stagnation. So, some of the disagreement between us is semantic on how we would make those definitions. And I guess I would make the point that r was less than g for lots of the 1960s and lots of the 1950s, and those would not have been thought about as times of secular stagnation, where there were chronic lacks of demand that fiscal policy had to fill.

So that's the first aspect of where we're coming to somewhat different conclusions. On the question of where the neutral rate is going to go, I think the fact that the Fed has raised rates by more than 400 basis points actually, and 550 basis points in expectation during which period expected inflation has certainly not risen and may have come down.

And the economy has not slowed nearly as much as most people would have expected it to slow has to affect one's Bayesian prior, either in the direction of thinking that the neutral rate is higher. Some of what's making the neutral rate be higher may be temporary, but there's no reason to think that all of it is temporary or to effect one's view in the direction that the IS curve is steeper than one had supposed.

That is, that demand is less interest sensitive, in which case, if on net, as I'll discuss in a minute, there's less saving or more investment, the necessary increase in the interest rate to offset that will be greater pointing towards higher neutral real rates in the future. So, then we come to the questions of how to think about risk seeking, saving and investment. Respectfully, I think my friend Olivier is uncharacteristically confused on the subject of the risk aversion aspects.

I would read the fact that the spread between the earnings price ratio and interest rates is at an epic low, and that other kinds of empirical estimates of the equity risk premium are, if anything, abnormally low, not abnormally high. And that the same thing is true with respect to credit spreads and that the same thing is true with respect to multiples on real estate as suggesting, if anything, the market is acting like there's low risk aversion, not like there's high risk aversion, and that ceteris paribus means higher safe rates.

And those are kind of long run measures, not short run measures. So, insofar as there's a judgment to be made about risk premiums as an aspect of this, I would think that it points in the direction of higher rates, not lower rates. With respect to saving, I'm not sure that I would take Olivier's treatment of the life cycle model as quite definitive. I think there is also some merit in Charles Goodhart's positions.

Olivier emphasizes that life expectancy is going up, which ceteris paribus would increase saving. But I would note that actually the trend towards rising life expectancy has slowed substantially, that what's relevant is life expectancy relative to retirement age, and that after a long change, the when it was going the other way, the labor force participation of older people is significantly trending upwards in the United States.

And I would note that a large part of what matters in the life cycle is the ratio of, um, older people to younger people, dis-savers to savers, which for reasons relating to fertility, is going substantially up. So insofar as the life cycle considerations are controlling, I think they are substantially ambiguous with respect to saving. I think Olivier underestimates the fiscal risk. He cites the CBO forecast as suggesting a 10-year increase of about 20 percentage points in the debt to GDP ratio.

Those forecasts assume a 10-year interest rate of below 3% in the out years and a steady state Fed funds rate in the 2.5% range. So in many ways they are assuming the conclusion. If the interest rate were three and one half percent, 118 would become 130. I think it is overwhelmingly likely that far less than 100% of the Trump tax cuts will be repealed in 2025, and that potentially adds another 10% of GDP to the debt to GDP ratio.

I think that it is hard to look at the headlines and not think US national security expenditures are substantially increasing. And in times when we have cold wars versus we don't have cold wars, those movements can easily be 3% of GDP. An extra 1% of GDP would be another 5 to 10% on that debt to GDP ratio. So I think it's not hard to imagine that Olivier's 20% should be doubled.

There is total room for debate and no convincing econometric estimate on the impact of a change in the debt to GDP ratio on interest rates. But three basis points for every 1% of GDP, I think, is a pretty good rule of thumb. And that would then get you 100 basis points, not to mention the probably comparable impacts of larger flow deficits on the level of interest rates.

With respect to investment, I think we will have more green investment and if we don't have more green investment, we will have more brown investment. I think the rate of obsolescence of the capital stock is increasing for resilience related reasons. It's in the wrong place for IT superseding related reasons. So I think the volume of investment is not likely to be down.

And I am mindful as I think about this and it's hardly a conclusive consideration that if Olivier and I were alive in 1943 and practicing economists because Olivier may have been alive or close to alive in 1943, we would have for sure been worried deeply worried about secular stagnation and a return to depression after the Second World War, because all the smart Keynesian economists were quite convinced that that was going to happen.

And it proved to be wrong, in part because the buildup of assets and the change in habits that took place during World War Two proved to be more durable than people had expected. And so I would be a little bit more skeptical about a return to secular stagnation. But again, I don't think Olivier and I are very far apart.

If the real interest rate got into the general range of 2% most of the time as measured by the Fed funds rate, I would not call that secular stagnation because it would have been not like anything I was talking about in the pre-pandemic period. And Olivier would say we were still in a kind of r near g, r less than g world. So I don't think our disagreements are terribly fundamental.

Adam Posen: Darn. We were obviously hoping for bloody conflict. Olivier, do you have anything passing for a rebuttal, be it on Chinese life cycle hypothesis or on 1940s asset accumulation?

Olivier Blanchard: Let me again, so many points that we could discuss. I think, again, the way we think about things is very similar. It's just a question of magnitude. I think the resilience of, of current demand is indeed not a puzzle, but an important question. Is it just due to the fact that IS curve has become steeper, permanently, in which case Larry would be right? Or is it special factors? And as I've said, think special factors are probably playing a role.

The excess saving probably plays a very major role. On the risk aversion of the equity premium or the inverse of this, which is the liquidity discount, I think that is right that something has happened, which is given the increase in real rates, the stock market should have decreased a whole lot more, and it has.

And so the question is the equity premium has become much smaller. Or put another way, the liquidity discount has become much smaller. I do not know, again whether this is structural or it's just the inability of the stock market to really fully take into account the increase in rates. That again, is an open issue that we need to think more about. On --

Larry Summers: Olivier, it’ll be a long run -- this is the only time where we analytically have a have a fairly fundamental disagreement. I think if you looked in general at the trend in the equity risk premium or the trend in credit spreads, it would, if anything, be coming down. And that would be a factor explaining why other things equal, interest rates should be going up.

So that's why I never thought when the issue was to explain why rates were low, I never found any of the safe asset shortage, any of the change risk premium stuff that your MIT colleagues pushed as an explanation never seemed connected to me. So, I don't know how important any of that is, but I think it's very hard to make that be the definitive factor pointing towards interest rates falling again from now.

Olivier Blanchard: Okay, falling again. I'm not asking for. I'm just asking them to remain in the low level they were before a bit higher. But you have to take my MIT colleagues seriously and actually it's a belief which goes beyond MIT. But that as we know that we've been discussing this issue for ten years and you're more a saving investment guy than a demand for safety guy.

But there's a variety of views on that. I think clearly the uncertainty is at the discussion of investment. And think on that defense spending, I mean was struck, I look at how much of GDP was spent on defense spending during the Korean War, it was 14%. During the Afghanistan war, it was 7%. And now we're at 3%.

And so this we thought of wars as we just send a few people with high technology and they do the stuff. And it's clear that in Ukraine we're learning that we may need many tanks, many planes and so on. And so the notion that defense spending could increase from 3 to 5 in an unpleasant geopolitical environment seems to me to have some probability.

On green investment, what's actually interesting is actually investment in energy at this stage is very weak. And the reason is that if you are thinking of brown energy, you're very reluctant to do it because you don't know how long it's going to basically be in existence and allowed. And on green investment, there's so much uncertainty about the rules of the game.

The size of a carbon tax, the subsidies, but actually there is relatively little green investment. So that the sum of the two is actually at this stage is lower. I suspect it will change and I hope it changes. And if it changes and it changes on a substantial scale, that would be good and would lead to a high neutral rate. But exactly what will happen here is very uncertain.

So on investment, I agree that kind of a standard deviation then to be technical about it is fairly large. And then there's a scenario in which it will be higher and maybe even higher than G4 and I lose on both definitions. But don't expect this to be to be likely.

Larry Summers: Just to make a couple very quick points. One, we have a kind of terminological issue, which is, I think, of defense spending as impacting the federal deficit and that impacting the level of saving. So when I think about it and that points up what I think we agree on, which is if there is a substantial increase in defense, it makes a difference whether it's paid for with taxes or not. And think of that as being on the savings side.

If one believes, and I am inclined to, the estimates of the stimulative effects of the administration's tax credits, which point towards, I have heard thinking suggesting that those tax credits will end up costing 2 or 3 times as much because take-up will be much greater than was suggested in the initial estimates. And if each dollar is stimulating $2 or $3 of extra spending as the administration is arguing, you are getting to quite substantial volumes of investment.

And the last thing that I would say is I think we have both maybe misled the audience slightly by our total focus on the US. And I think we probably agree that the real interest rate was kind of a global phenomenon. And then there were deviations between countries that were associated with who was exporting and who was importing capital. And presumably the US would have a lower neutral real rate if it was a closed economy, because it would need to have -- did I give a sign wrong? It would have a higher neutral real interest rate if it was a closed economy because it wouldn't be losing demand to the rest of the world.

Adam Posen: Well, and it also would it also wouldn't be getting capital from the [inaudible 0:34:34].

Olivier Blanchard: Yeah, exactly. It's getting a lot of capital.

Adam Posen: Time is flying by. So can we stick for a minute on Larry's welcome discussion of globalization? So we've gotten a couple questions on the chat. I mean, the first one coming off of -- sorry, I can't read his name -- is how much does the US action essentially determine the real interest rate versus it's a global average? How much does Chinese behavior determine it? I mean, I'm not asking for exact percentages here. And obviously, you think US matters more than others, but just in your sense, how divergent can these R-stars be? Can we --?

Olivier Blanchard: It's clear it's a global market, right? Because if you thought of the US, European Union, Japan's closed economies, I think each of them would have had a very different path of R-star. It is a fact that capital flows which makes them much closer to each other. So I think we have to think about well determinants.

So indeed, when Larry said we're focusing too much on the US, that's wrong. For example, the discussion of fiscal policy in Europe is very different. And although I worry very much about the US, one, I do not worry about the European one or if I worry, I worry about them contracting too much. When you're looking at the numbers, you really have to think of a world as fairly integrated, not totally. Japan has a lower rate than others and so on, but there's clearly a lot of global forces at work.

Adam Posen: So let me follow up on that. And we have a question from Charles Steindel relating to this, which is how much does de-globalization to whatever extent that's occurring, arguably because of security challenges as much as anything else -- diminish that integration in a meaningful way, but also affect R-star, affect the neutral rate?

I mean, there's a lot of discussion of how it might increase inflation. And I've argued it will probably decrease productivity. But what do you think is the channel, if any, from de-globalization to R-star.

Larry Summers: I wrote a paper with Lucas Rachel on neutral real rates and the like just before COVID. In the course of that paper, what we discovered was that if you look at the flow of capital from the developing world to the industrial world. In aggregate, it was never substantially different from zero. So it could change at some point. But it is not the case that the countries that we might deglobalize from, like China, were in aggregate a major source of capital.

If Ben Bernanke's savings glut had been a permanent phenomenon of Asia, exporting capital to us and then it went away, you would expect that to be an important channel through which the neutral real rate would rise. I don't think it has been a large channel. The Chinese current account surplus went from 10% of Chinese GDP to close to 0% of Chinese GDP years ago.

So I think my main answer would be that there probably isn't a large set of capital flows effect from deglobalization because I don't think deglobalization is going to deglobalize between the United States and Europe and Japan very much.

That there is probably some effect of the kind we both mentioned that if you can no longer use your factory in another country or you no longer trust your factory in another country, you have to build a new factory. And so that operates to raise investment and that operates to increase neutral rates a bit, but not an enormously large effect, in my view.

Olivier Blanchard: Just one word. I would say that the deglobalization in goods and there is deglobalization in financial sector. I think that main effect is likely to be about goods and reduction in imports and exports doesn't have any obvious implications for net exports or capital account. So I don't see this as a major determinant of future R-star.

Adam Posen: Very good. So we've been playing up till now in the real space. But of course, you framed all this as what happens after the current disinflation. So maybe starting with Larry, we could have some reflections on where you see trend inflation going and whether some kind of inflation risk premium going forward or change in Fed regime or inflation target going forward would have an effect on the secular stagnation outcome. Or are they totally separate?

Larry Summers: There's some semantic questions here. I think if the question is what's the what's the average level of interest rates going to be? I think if you think higher, there's going to be more inflation and you don't think it's going to have substantial real effects. You think there's going to be higher nominal interest rates and maybe you think there's going to be a bit higher risk premium.

And I don't know how you want to use that with respect to the term secular stagnation. I think whatever you thought about long term inflation prospects in 2018 or 2019, it's hard for me to see how you shouldn't have a view that expected inflation is higher now. Simply the fact that you had several years of inflation that would have seemed inconceivably high to people in 2018 has to widen the aperture of their consideration for the future.

The fact that half the academic economists who propound on this, not including me, think that the Fed should de jure or de facto raise its inflation target to 3% has to lead you to think there's a greater chance that that will happen de jure or de facto, and that will mean more inflation.

The 2% inflation target has sort of morphed from being a ceiling that we were trying to reach to being an average that we hope to attain over time to being a floor that we hope to touch at the trough of an inflation process. That evolution, it seems to me, has to lead one to think that expected inflation is going to be higher than whatever one thought before.

To the extent that you think the economy is more naturally rigid and more are going to be held back by rigidities, there's more of a case for using inflation as a kind of grease and lubricant. So all of that leads me, whereas I would have thought, pre-COVID, that inflation was likely to average two because there was a substantial chance that it would spend long intervals below two over the subsequent ten years.

I think today my expected value of inflation would be 2.5 or a bit larger given the tail risk of 4 or 5. And given that, I'd assign a very low likelihood to it being well below two. So if you take a 1.5% to 2% real rate, a 2.5% inflation rate and some risk and term premium, you're sort of looking at short rates running in the four range on average and longer term rates if traditional spreads reassert themselves running 100 basis points above that. So four and five.

Adam Posen: Thank you, Larry. Olivier, any notable differences of opinion or prognostication?

Olivier Blanchard: Yeah. On the last numbers, I was very happy when he said when basically he forecast inflation around 2.5% on average. That I agreed with. Now, on the rates at 4.5, that goes back to what the real rate will be and that's a previous discussion. But again, it's more a discussion than a disagreement. Let me make a few points.

The first one is I think there is no question that if there was no past. Absent the contact, it would make a whole lot of sense to have 3% as the target inflation. And I don't think any economist can argue against this. The back of the envelope with your computation. But suppose that we had had a target of 1% more higher and that nominal rate, all things equal, had been 1% higher when we had to decrease them. We will have a 1% more space to do it. That's roughly what we got from QE.

So in a way, if we had had 1% more, we are let’s say, exaggerating, we could have done have done away with QE. And in my book, this would have been great. I mean, there are reasons to do QE and complications, but we're not talking about insignificant changes. So we understand why 3% is better than two, both with respect to the room for monetary policy and the adjustment of what negative prices and so on.

Just a footnote, I had argued in the past for 4%. I've concluded that it's too salient and then people start taking into account it complicates the job of a Fed, of the central bank in general. So I've come down from 4 to 2 as a gesture of goodwill. Now, this being said, context is everything and I fully --

Adam Posen: You've come down from 4 to 3, not two to.

Olivier Blanchard: Oh sorry, 4 to 3. So same mistake as Larry getting the sign wrong earlier. We sometimes speak too fast. Thank you. Yes. Because if it was two and then think this would be the headline news in my part of the field, three is the right number. I think it's completely right for central banks not to want to have that debate now.

The credibility of the anti-inflation stance is at stake. I think it would be very, very difficult to keep the credibility and saying, well, we're going to stop at three. So I think they should probably not say never, but they shouldn't talk about it. And they should say there will be a time when this is desirable.

At the same time, I think that people like me who have no responsibility whatsoever can actually discuss the issue, but understand how they are going to take a strong stand against discussing the issue now. So this is a normative stuff. The descriptive stuff. I think Larry has it more or less right.

We're going to go down and before going from 2 to 3 was going up, now we coming down to three. When we're at three, the question will arise of what should the Fed do? And if we had three and the economy is about okay, and the Fed says, well, we have to go to two, and unfortunately, for this, we have to increase rates and slow down the economy further. I suspect there will be a debate.

We might by chance just get all the way to two and then have a discussion there. But it's likely that we get around two degrees is very low from there. And then there's a discussion, is it really worth getting 1% less inflation with maybe not a recession, but at least to slow down. So I think there will be a lot of discussion.

I wouldn't be surprised if the Fed said, okay, you've convinced us. Let's go to three. I suspect what the Fed will say is, well, let's have a range between 2 and 3. Let's not go too fast. Let's see where things go and that we end up, you know, with 2.5, which was the number that Larry had. But it will happen. This is a discussion which we guess in a year from now will be on the table. And we have to think about it now.

Adam Posen: Normatively. Larry, do you agree with that, that that's what the Fed should do in a year from now, assuming that's broadly where we are?

Larry Summers: Yeah. I think I mostly am not quite where Olivier is for a combination of reasons. First, I am much less impressed by the efficacy of getting real interest rates really low and negative. I am not sure that it stimulates very much investment. I am not sure that any investment that firms would do with a -3% interest rate that they would not do with a -2% interest rate is very valuable or worthwhile social investment.

I think the risks of various kinds of perpetuation of zombie firms and creation of financial bubbles are better. So the idea that monetary policy should be the only stabilization instrument and we should be focused on being able to use it to extreme seems off to me. And so I'm not nearly as persuaded as Olivier and many other people are of the efficacy of the higher inflation to get around the zero lower bound, point one.

Point two, I am much more concerned that, given the discussions of the price index and all of that I think are is easy to see as price stability. And I think that gets harder as you start moving towards three a level where price is double in a generation. That seems harder to me to call price stability.

And in the current context, I think there is a certain vagueness in the conversation, but there seems to be an idea that we bring inflation down to some level and we decide that that's what the right level is and then we discuss what that number is.

But I assume that after you bring inflation down to level X, what happens after that is if things work as you want and the economy is recovering and going strongly, inflation accelerates a bit. And so I think that if you say we're going to declare victory at the end of the tightening cycle with 3% inflation and we're not going to push further and maybe we're even going to start to ease after a lag, then you're kind of asking for three to have been a four.

And then I think you're on a much more slippery slope. So I would prefer a strategy of quite strongly sticking with two and recognizing that there's a bit of ambiguity around just how fast you'll get to two. I think that there's probably some room for the reintroduction of the opportunistic disinflation concepts that were present some years ago.

But if I was counseling the Fed from an external academic perspective, trying to nudge things in a more dovish direction. I would be talking about opportunistic disinflation rather than talking about raising targets. For the same reason, Olivier said. I wouldn't recommend that the Fed right now be talking about anything except getting to 2%.

Olivier Blanchard: Can I come in just with a rejoinder? Again, I have the same sense as Larry that IS curve is actually quite steep before now and later. So that monetary policy is a tough tool to use. You have to use a lot. And there's a lot of uncertainty. And one of the themes of my book is fiscal policy should play a much more active role in the economy slowing down and the policy rate goes to zero, then clearly fiscal policy has to help, but it probably has to help much more generally.

So actually, Larry and I have written at least one paper on some automatic stabilizers. I think, yes, 1% more is useful, but it's not the magic solution. We just have to think about using fiscal policy much more actively, even when we're not literally at zero.

Adam Posen: So picking up on that, Olivier, to go to you guys for one last round as we're almost done. From what you both said early in the conversation. There seems like a pretty good chance we haven't put a number on it, but a chance that the r Minus g gap shrinks a lot or possibly changes sign. Not a done deal, but seems well within the bounds of Larry's worldview and at least within the bounds of Olivier's worldview.

How does that change the fiscal? Advice, policy advice you're giving about activism or about doing things slowly. And putting yourself stretching it a little bit, how reactive should fiscal policymakers be to a change in r Minus g sign? I mean if it happens for one year, we don't care.

But in practical terms, how long does it have to be changed that you start wanting to change the regime or change the values? If both of you could just say a few words since you've written so much on fiscal policy, both of you, how would a world of higher interest rates positive r Minus g change things?

Olivier Blanchard: Well, positive r Minus g means that the dynamics are much, much less attractive. So that if you want to think about fiscal space, there is much less fiscal space. And it has to be the message. And even if r Minus g is negative now, but you put some probability on it changing sign more or less permanently in the future, then you take this into account and you realize that these are good times today, but it's going to be tougher. So I think the implication is you're much more careful with fiscal policy, obviously. I mean, that's a trivial answer. But think that that's the right one.

Adam Posen: Okay. Anything beyond the trivial on that, Larry, or is it a trivial question?

Larry Summers: Jason Furman and I suggested a couple of years ago before -- I think it was after COVID, but before Biden. But it was when people thought the interest rate was going to be zero till 2024. That a reasonable concept was that if the real interest burden of the federal debt was below 2% of GDP and not rising rapidly, that probably you were in a reasonable kind of place.

And if you were seeing the real interest burden, get past 2% of GDP or on a trajectory to that, you should probably be significantly worried. That may not be precisely the right criterion because it's about r much more than it's about g, so it was kind of in the context of the United States. By that standard, if you think the United States is headed to 1.5% real interest rates and 130% debt to GDP ratio, you would think you were headed for some substantial issues that needed to be addressed.

I certainly think from here, if we do anything that we don't pay for, we are almost certainly making a mistake. If we fail to budget for the fact that there will be contingencies that none of us see and that on average they will be bad, they will involve outlays or lost revenues, that would be a mistake and we probably should be looking for opportunities to reduce the deficit more than to increase the deficit, which is kind of the opposite.

In 2017, I would have said all things considered, if fiscal policy ends up being more expansionary, that will be good because we're in secular stagnation. If I think about the next five years, I would say, all things considered, if fiscal policy ends up being more less expansionary. That would be good. And I'd be a bit more agnostic about how to think about the time beyond that, but tending in the same direction.

Olivier Blanchard: Two remarks, I like the Larry Jason proposal. When you lay down the dynamic equations, you realize what matters is that [inaudible 0:59:52] is defined as r Minus g times the debt to GDP ratio. And that basically, if you can finance that, if your primary balance, then you're fine. The problem with this is that r can move a whole lot from year to year and therefore this is a variable which can look very good one year and not as good one year down the line. And so I suspect that's the direction in which to look for something to look at rather than the level of debt. But it comes with a large amount of variation, which makes it difficult to use.

Adam Posen: Let me stop you there. Olivier, I'm afraid we're out of time.

Larry Summers: Wait, can I say one thing? That I really want to say.

Adam Posen: Because if you don't yell at me for not ending on time like you usually do. Larry.

Larry Summers: I will now. I will praise you for recognizing that when you have a participant of Olivier's quality, allowing the program to run long is doing the audience a great service.

Olivier Blanchard: We just lost a minute here.

Larry Summers: There's an aspect to Olivier's comment about interest rate variability, which is the longer term you're borrowing, the less you have the problem of interest rate variability because you can lock-in what you're borrowing cost is going to be. And from my perspective, QE past the first three months of COVID was a grave error.

At a moment when every smart corporate treasurer in the world was locking in low long term rates by terming out its debt, the government of the United States and a number of other governments were firming in their debt by issuing what was, in effect, short term debt in order to buy back long term debt. I think the mark to market cost of that is probably approaching $1 trillion. And it was, I think, an unfortunate step that should not be repeated.

Adam Posen: Okay.

Olivier Blanchard: You realize that the target inflation of 1% higher would have avoided that major issue.

Adam Posen: I'm glad that we finally got this agreement in the -30 seconds we have remaining. So with that flexibility on our rule used, I think we are in intellectual surplus thanks to the high returns on time with Olivier Blanchard and Lawrence Summers.

They have defined the key macroeconomic debates for the last several years, and we're grateful that the Peterson Institute was able to host them for this discussion today. Thanks to everyone who joined us. Of course, this is on the record. The transcript will be available, as will the recording of this video online forever and a day, no matter what happens to R-star. Thank you both very much.

Larry Summers: Thank you.