

Peterson Institute for International Economics

The macroeconomic impact of new US international policies

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[00:01:23.23] - Adam S. Posen

Hello everyone and welcome back to the virtual Peterson Institute for International Economics for today's discussion of the macroeconomic implications of the Trump international economic policies, the new U.S. international policies. We're very fortunate to bring together again Olivier Blanchard and Lawrence Summers, who in addition to their many other qualifications are two of the great policy macroeconomists of the era. Uh, previously we had a discussion between them on issues like R^* and secular stagnation that was widely watched and cited. And for both good and bad reasons, I expect the same to be true today. Olivier Blanchard is a senior fellow at the Peterson Institute, previously having been the initial Siegfried Bergson Senior Fellow. He served previously as the chief economist of the International Monetary Fund and for a long time as a leading faculty member at the Department of Economics at MIT, where he was Robert Solow Institute Professor and now is still, of course, Solow Institute Professor Emeritus. Lawrence Summers is the Charles Eliot University Professor at Harvard. He has previously served as the US Secretary of the Treasury and the Director of the National Economic Council. He also has served in various other senior policy roles, including as Chief Economist of the World Bank and Undersecretary of the Treasury for International Affairs.

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I'm not going to go further into their intro. You know who they are. What is important is to take a stock of the broader systemic implications of what is going on in Washington. And for that, Larry, could we open with you?

[00:03:19.16] - Lawrence H. Summers

Thank you, Adam. It's good to be with the Peterson Institute, with you, and especially with my good friend, Olivier. I'm going to concentrate on the American perspective because that's probably my comparative advantage here. Step back from everything. I think the right broad frame for the moment is this. I've many times in my life given speeches about how Latin American democracies need to converge towards American-style democracies. Better

government for the people along with government by the people. Better democracy. We are seeing convergence, but we are not seeing convergence in a direction that I could have imagined. We are seeing convergence from North America, the United States, towards traditional Latin American patterns. The classic example in Latin America was Argentina's Juan Perón. What were hallmarks of his administration? Protectionism, hypernationalism, return to the soil in broad attitudes, crony capitalism, disregard for macroeconomic probity in terms of independence of the central bank. And in terms of budget deficits and the use of the tools of government to cow and punish his political adversaries. That approach to government turned Argentina from a country that was judged after the Second World War to have bright prospects paralleling those of Canada and Australia, to the record that we have seen over the last 70 years.

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Perhaps it will change in Argentina now. That is what we are seeing in the United States today, with the very important difference that Argentina was never central to the global political economy, never had aspirations to be a superpower, and was constrained by being embedded in a global environment in the way that the United States is not. This is by far the most dangerous moment since the end of the Cold War. And I believe we are looking at the possibility of epochal change where America will move away from a long tradition of democracy with profound consequences for the rest of the world. All that said, let me now plunge back into, uh, economics. The Trump tariff approach is premised on 5 fallacies and harms the economy in 4 major ways. Fallacy 1: bilateral deficits make sense. In thinking about exploitation. They don't. I run a big trade surplus with Harvard. I run a big trade deficit with my golf club. A golf club is not exploiting me. Harvard— I am not exploiting Harvard. There is no logic to thinking about bilateral deficits as a measure of exploitation. Policy 2, trade deficits are always bad. It is a matter of arithmetic that the only way you can attract capital is by importing more than you export.

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Arizona, where I live, has been a burgeoning part of the American economy since the Second World War and the invention of air conditioning. It has run a trade deficit every single year with the rest of America and the rest of the world. I would rather live in a country that capital is trying to get into than a country that capital is trying to get out of. And the arithmetic counterpart of that is a trade deficit. So framing the problem, even in terms of a global trade deficit, is a big confusion. Fallacy 3: tariffs are not a major determinant of the level of trade deficits. Look at non-protectionist, um, Switzerland and its vast surplus. Look at heavily protectionist Brazil and its substantial deficit. Look at the general correlation across countries, or look at the economist's logic that the trade deficit is ultimately about your total spending relative to your total income.

Trade deficits are not determined by tariff policies. So even if they mattered, tariff policies are not the way to go after them. Policy, uh, 4: the, uh, manufacturing is not going to be a major source of opportunity for Americans going forward. Robert Lawrence has written a wonderful and remarkably clear book for, uh, the Peterson Institute, in which he shows that trade surplus countries, trade deficit countries, everything, everybody has a declining trend in manufacturing share of employment, even China during the 21st century, because it's all being driven by technology, not by patterns of trade.

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Germany, with a massive trade surplus, has a very sharp downwards trend in manufacturing employment. My only criticism of Lawrence's book is that he doesn't make what I think is a central point, which is that of the 8% of US employment that is in manufacturing, only half and that's a declining fraction, is in production work. The rest is jobs that aren't at all specific to manufacturing, doing accounting, doing advertising, doing sales, being an assistant, uh, to an executive. So it's a number that is 4% and sharply declining. The idea that this is somehow going to be transformational for the American economy because of a change in relative position is, to be direct, completely delusional. Fallacy 5: Indiscriminate tariffs are a form of manufacturing subsidy that is on net effective. Very often wrong because very often the main input to exports is imports. Classic example, there are 60 times as many people working in the steel industry, in the steel-using industries as there are in the steel industry. So when we raise the price of steel, we raise the price of, uh, a key input for every industry from automobile production to home, uh, construction. And we are on net hurting competitiveness rather than increasing.

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Competitiveness. So this program and this broad approach is founded on a fallacy and grounded on economic mistruths. Not the kind of economic mistruths that are debated between people like me and Chicago School economists like John Cochrane. Or are debated between me and Olivier and economists associated, uh, significantly, uh, to the left, like those in the Roosevelt, uh, Institute. Across almost everyone who has studied these things, there would be agreement on my 5 fallacies. What about the costs of these policies? They fall in 4 areas. Cyclical dynamics. This is a first cyclical dynamics. This is a major stagflationary, uh, shock. It increases prices. And because those increased prices reduce income and therefore reduce spending, which reduces employment. How big is the stagflationary, uh, shock? The Yale Budget Lab estimates an impact effect from the regime as currently defined of \$4,800 per, uh, household and a long-run impact that's about half that size. Here's the comparison that some of your colleagues at the Peterson Institute, uh, helped me do. In terms of its impact on prices

approximately and on reducing the income of households, this in its current multiply amended form is the equivalent as a supply shock of a doubling in the price of oil.

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That's a lot. And it's not something that anyone would— something that every government of the United States has tried enormously hard to resist. And it's hard to imagine being something that anyone would willingly embrace. So cyclical macroeconomics greatly complicates the Fed's task, is the biggest invitation we've had to stagflation since, uh, the 1970s. Second, it courts financial crisis. Nobody knows for sure what is going to happen in, uh, financial markets. But these policies, coupled with the general change in the atmosphere that I described at the beginning of my remarks, causes the— has caused, has caused, not— this is not a prediction— has caused the pattern in U.S. financial markets to move from the traditional bastion of the economy, global economy, where stock markets fall and bond markets rise as people seek insurance, to the traditional submerging market paradigm where increases in— decreases in stock markets are associated with rising bond yields rising, uh, revulsion to the local currency, which falls. And this is a classic pattern. Every emerging market financial crisis sees a country fall into that pattern. And that is even before you get to the issue, which certainly has to be recognized as a possibility, of large-scale selling of U.S. financial instruments by foreign reserve holders or those influenced by, uh, foreign governments.

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So the second risk is that this quartz, um, financial crisis The mechanisms and details are all different, but we are running a risk, um, that is probably below 50%, but certainly greater than 10%, that in the next several months, the United States will have a Liz Truss, uh, moment. It's not caused by the fates. It's caused entirely by ourselves. Third, lost competitiveness. This is— what I've talked about so far is the domain of macroeconomists. It's not the domain of trade economists. What two centuries of research in trade economics has taught is that there are gains from the international division of labor that translates into higher standards of living, uh, for, uh, people, translates into higher levels of real wages. I already suggested the magnitude when I referred to thousands of dollars per family. And notice Notice, and people haven't said this enough, that the thousands of dollars per family estimate is an estimate of the pure boomerang effect of our policies before you get to any retaliation by other countries with adverse effect or any weakening of the global economy. Which reduces the market for U.S. goods. So it is a very conservative effect. Notice also that this is an effect that, insofar as it affects inputs and affects our capacity to develop, uh, exports, is an effect that may have lasting and cumulative effects on the rate of growth.

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Research I did a generation ago with Brad DeLong suggests that low-priced equipment, something we're very much compromising with these policies, is a significant predictor of economic growth. Fourth, we have taken uncertainty to epic levels. I would not have imagined that we would all be breathing a great sigh of relief because the VIX, the measure of implied volatility on Wall Street, was only in the low 30s. That's about 70% higher than its normal level and is regarded as substantially elevated. And is favorable only, only by the standards of where it was a week or 10 days ago. Policies had taken it to levels that had only previously been seen during the pandemic and during the height of the 2008 financial crisis. There should be no confusion, and I'll conclude on this point, that a study of the daily or even the hourly movements in markets suggests that all of any calming we have seen is a consequence of a growing perception that these policies will be reversed. None is a consequence of people adjusting to these policies or a judgment that these policies will be successful. So what we are seeing is an unprecedented and massive self-inflicted economic wound.

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And judging the prospect going forward, is less about analyzing the wound where the causal mechanisms are very clear than trying to judge the extent to which there will be a course correction, a course correction that has never been more necessary in the last half century than in the United States today.

[00:22:12.24] - Adam S. Posen

Thank you, Larry. I also want to note, thank you for your service as Vice Chair of the Board of the Peterson Institute. You've been standing up for independent institutions and civil society's ability to speak frankly about these issues, and we're grateful to have you with us endorsing our ability to do that. In that spirit, let me turn to my colleague Olivier Blanchard for a European perspective on both how Europe sees this, but how Europe responds.

[00:22:43.03] - Olivier Blanchard

I'm delighted to be with you. Happy to see Larry. It's always fun to talk to each other. He has given really a masterclass in thinking about what is being done. And I agree with him 100% on everything, including the meta aspect, the non-economic aspect, the much larger effect that he started with. Turning, turning to Europe, my message is going to be a bit more optimistic in the sense that because of Putin first and because of Trump and because of the interaction between the two as well, I think that Europe has what is now known as an Overton window, a window of opportunity which it didn't think it had before and may not again have in the future. And if it acts

on it, I think Europe will come out stronger. And the probability that this happens, I would say, is, you know, it's a bit like Larry's ranges, between 20% and 60% or something like this. But there is something to be done. So what I want to do in the intro remarks is make 4 points. The first one is where Europe was pre-Trump and maybe pre-Putin. It was going through an existential crisis, psychological more than economic, but psychological.

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There was a sense that it was being left behind, that productivity growth had been weaker than in the US, had been much weaker in the last 5 years, actually negative in many countries. And that was a big issue. There was the Draghi report indicating that we were losing our position in a number of high-tech industries. There was the notion that the German model, which was based on, you know, cheap energy from Russia and a large market in China, could not continue. So there was a sense that everything was really going down the drain. Consumers were pessimistic, firms were pessimistic, and the best projection was very low growth. And very low inflation and very low rates as well. So that's the first point. That's where we start from. The second point is what has happened as a result of what is happening in the US and what's happening on the Ukraine border. A number of things which go in different directions. So this is going to be more strictly macro and then I get to larger issues later. The first one is, as you well know, It has led Germany to do a 180 degrees on fiscal policy and basically be willing to finance investment in defense and maybe even more through debt, which is an incredible change provoked by the need to do it.

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But anyway, it is, it is happening. The other, the other shocks go in the opposite directions. And clearly the tariffs are going to have some effect. On exports from the EU to, to, to the US. We were hoping, because it went in the textbook that way, that there would be a depreciation of the euro. It turns out, for reasons that Larry has explained, that the uncertainty effect implies an appreciation of the euro, which is good for the euro but not so good for the European economy. So you have these forces, the fiscal being pushing demand and the decreased exports and the stronger euro going the other way. How is it going to work out? Hard to tell. My sense is fiscal is going to take a while to actually come in play. So we're going to see negative effects, so lower growth, but not by a very large amount. And on inflation, you have these different forces at work. The appreciation of the euro tends to be disinflationary. Recession or a slowdown also. So my sense is that there's not going to be a whole lot of inflation. The second point is, you know, thinking about what happens in the next 6 months.

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But it's, it's very narrow. As you know, the underlying theme of our discussion is that much bigger issues are coming. And we can discuss inflation. We can discuss whether growth will be 0.5%. Above or below our previous estimates. But it's clear that there is more. So that's the last two points. The third one is how Europe should react to US tariffs. It has the tools. It actually has put in place a tool called the anti-coercion instrument, which allows to basically take measures against a country which misbehaves with a lot of flexibility. What should it do? I think it depends very much on what we are not sure of, which is whether we can make Trump retreat. If we thought that there was no hope that he would retreat, that he's going to put the 25%— the 20% tariff plus the 25% on automobiles, aluminum, steel— then the economic answer is don't do anything. It's not because this guy is shooting himself in the foot that you should do the same. So the pure economic answer is do nothing, maybe do a few symbolic things to show that, you know, you're not weak, but in effect do nothing.

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So the issue is, if we think that we can get Trump to retreat, and Europe is a big player if it stays together, then what is it that we should do? And there I think the answer is the same for every country in the world, is look at what hurts the US the most. And the EU the least, and make a list and basically start from the top and threaten to do that. Parenthesis: in the case of China, rare earths is kind of the ultimate item at the top of the list. Very costly for the US, totally costless for China. We don't have rare earths, but we have a big input of the GAFA. And we can be nasty to them. We can put a tax, which they wouldn't like. We can reduce what they can do. We can limit what they can do. Again, we have the instruments to do it. And I think we should threaten to do it, not do it, but threaten to do it and be willing to actually do it if there is no retreat. But that's how I see what Europe should do. And then the The last point, maybe the most important one, which is that, again, on the Overton window, it seems to me that there are things that Europe can do, which it was not willing to do before and now may have the strength to do it.

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The first one is Europe is much more popular with the Europeans because of Trump. So there's much more support for doing things at the European level, or at least working together. The first issue is maintain unity in the face of tariffs. Now, the tariffs have been put on Europe, not individual countries, which was kind of a gift. It would have complicated things if they had gone country by country. I think that Europe will succeed in having— in keeping unity. There'll be tensions, as we know. The automobile industry has very different positions around the world. If you're looking at the German industry or the French industry, but I think we'll succeed. So we'll present a big front, which is essential. I mean, given that we have moved from a world with rules, good or bad, but rules, to a world of the law of the jungle, then you have to be big. And

Europe is big. And if it remains big as a whole, then it will make a difference. Other things—defense. And that's more Putin, but that's Putin with Trump indicating that the US is not eager to help. And there I think again that the need is perceived and the will is there.

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And we're going to increase defense. There is no question. There are a lot of issues. The usual ones, which is that each country has its own tanks, its own planes, so that we have to do a lot in terms of diminishing these doublons. But I think that's coming. That's going to be big. We're going to support Ukraine. We've continued to support Ukraine as the US was stopping to do so. That costs about \$30 to \$40 billion a year. So far, I think that we're perfectly able to continue and do more if needed. I'm just going to take examples. So something that has been talked about a lot, especially during the euro crisis, is euro bonds. Now, investors, as Larry described, it could be that investors are going to look for other places, other safe assets. Now, the natural place is euro bonds, but the euro bond market is very small. So what happened in the euro crisis was that a number of people said, well, maybe we can turn some of the national bonds into true euro bonds, and this would extend the size of the market. It didn't in the end work out because there are issues of risk sharing which come into play and technical issues.

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But my sense is that that's something which could happen. I think it's not going to happen overnight, but I can see the development of a euro bond market, maybe not quite of the same size as the US Treasury market, but big enough and good enough and deep enough and liquid enough that investors will be able to get out of the dollar and at least partly out of the dollar and go into the euro, euro bonds. So the the extraordinary privilege that the US has, that Iran wants to get rid of, would actually partly go away. But that would be a good thing for Europe. The other thing is that, as I said, before Trump and Putin, there were a lot of things that Europe needed to do, and now I think has a stronger incentive to do. So these are constructive things to do rather than just defensive things vis-à-vis tariffs. So the Draghi report is actually very useful. I think it has been overplayed, but it has indicated that indeed there is a number of high-tech sectors where we are not there and we could be there. It costs money. That's my sense. And we cannot do everything that Draghi would, would like us to do, but we can do quite a bit.

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And I think there'll be more of that. The next point is even more general. It's that, again, the crazy country is the US. The rest of the world is quite willing to play by the old rules, not necessarily exactly. They want changes, but in general, they are willing to behave. And my

sense is that Europe is in a good position to sell the idea of coalitions of the willing on various issues, which is the countries which continue to be willing to play by the WTO rules, revised or not, should get together and continue to basically act within the coalition so as to respect these rules. And I have a sense that Europe can do something here. I have a sense that there's a lot of openness to the idea, surely in Canada, for example, but also in Latin America and maybe in China. And that's something I think that Europe can play an important role in. Then the last thing on this is China. And I think one of the big issues in thinking about how all this evolves is, to caricature, what side of the US-China Europe is in. Now, the US would like very much Europe to be with them, put tariffs on China and work together.

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That's almost surely not going to happen because the way— I think Europe was never eager to do it. And the way Europe and others have been treated implies that this will not happen. So I think that Europe should be more on the side of China, but not an ally of China, because we have a number of tensions and problems to solve. There has been a number of attempts over time to actually create EU-China agreements or relations between the EU and the TPP. I think these are things that we should explore and basically create again, if you want to call it, safe spaces or coalitions of the willing. I think that good things could happen there. So, you know, listening to Larry, it's clear that there is a big tension between what's happening in the US and the way the rest of the world is reacting. Whether the rest of the world will be able to avoid some of the worst outcomes which happened in the US is to be seen. But again, I see possibilities for Europe to actually do good things.

[00:36:43.07] - Lawrence H. Summers

Adam, if you'll permit me, an observation, a small disagreement with Olivier, and a question for Olivier. The observation is for so divisive a figure, Donald Trump is a remarkable unifier. The Harvard faculty is now more unified over every political question than it has been any time in the last 30 years. As people who like affirmative action, people who don't like affirmative action, like DEI, don't like DEI, differ on all sorts of things, everybody agrees on resistance to the oppressiveness that we've seen. Democratic Party far more unified than ever before. And Olivier tells us the different nations of Europe far more unified. It shows the capacity of unreasonable opposition to unify opponents. And we're seeing that. And I think it's potentially quite dangerous for the United States. In a world where alliances are important. Mild disagreement with Olivier. I think bullies should be resisted, and I think it's important to resist bullying, and I think serious countries don't bluff. So I think there should be strong response and commitment to strong conditional response to what's happening in the United States. And the point Olivier alluded that I think is quite important is that even the United States at this moment

is not a monolith, and that the response isn't about what will hurt America most, but will hurt those constituencies that are closest to the president.

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I never thought I would say this about the United States, but in consideration of the response to Russia, authorities in every major G7 country were very much aware of which oligarchs were closest to Putin. And most enablers of Putin, and which were not. And I think that kind of sensibility should inform responses that bully. The way in which the president appears to be going back at the law firms that bended the knee just a few weeks ago, asking for more should be a highly cautionary tale for any institution or nation that thinks that they can get advantage by being one of the first to the table in supplicating, uh, this kind of authoritarianism. My question for you, Olivier, is what is your view about the use of financial leverage as a retaliatory tool. One could imagine selling off U.S. large quantities of U.S. financial instruments to substantial retaliatory effect. One could imagine selling one category of U.S. securities versus another and creating substantial instability in markets. One could imagine doing those things in ways that were highly visible. One could also imagine finding ways to do those things where one's tracks were very difficult to, uh, track.

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What would your advice be to other countries about how to think about their financial holdings in the context of a desire to retaliate against what's happening? I ask you the question because I'm very uncertain in my own mind as to how to think about this.

[00:41:11.08] - Olivier Blanchard

I will take a minute to try to On the unifier, you're completely right. I mean, it has changed the dynamics of Europe in very dramatic ways. There is still the issue of weak countries which have leverage, of institutions which have leverage in bargaining, and those which do not. And I worry a bit about his ability to actually bully some small countries. And that's, that's an issue. On the bullies should be resisted. Again, I think it completely depends on whether you think they'll, they'll retreat. If for some reason, which I think is unlikely, he decided not to retreat and just put the 25— the 20% across the board tariff on Europe and stayed with it, then I think it would still be the right thing to do not to react, except again, in symbolic ways. What you say is basically that you can probably find ways for him to retreat. Now, the GAFA, I think, is in that spirit, which we think that they have his phone number. And so when they become unhappy, then they call him and he retreats. This is what we saw this weekend with respect to chips and laptops. Somebody made a phone call.

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So I think if you think that you can get somebody very unhappy, but quite powerful on the other side, then you do it. But if you don't, then again, the general principle that these tariff wars are basically losers implies that you don't do anything. You only do something if you can actually use it in—

[00:42:56.25] - Lawrence H. Summers

So I get, believe me, I get completely your logic. It was kind of the essence of Winston Churchill that he ignored all that logic, that there were a lot of people in Britain who wanted to do a careful calculation about the probability that you could win the war. And maybe if you couldn't win the war, it was better to appease and all that. But sometimes there was a view that the right thing to do was you just had to stand up to bullying. And so the sense of how— of, um, amoral calculation about prudence. While I completely understand the economic logic, seems to me in a multi-period activity, establishing the principle and the precedent that that's the way in which you will think and you will react is, uh, quite problematic. So as an observer of this, I would just be tentative about that and would want to see more resolution. And I think that exactly the calculation that you're describing is the calculation that Columbia University went into. It is the calculation that the law firms that capitulated went into. And I don't think history will remember those institutions well and for the way they have responded, uh, to this, uh, crisis.

[00:44:37.21]

And so that's why I just want to register concern about the approach, even though I completely recognize that there's a kind of internal complete economic logic to it.

[00:44:54.20] - Olivier Blanchard

Again, I think you stand up to the bully if there is a chance that you make him stop what he was doing. And to do this, you have to have something. So Harvard has \$50 billion, right? And he can afford to lose \$2, maybe more. Other universities don't. Paul Weiss probably decided that the law firm would just disappear. So I understand your point. But again, I think standing up to the bully makes you feel good, but may destroy what you cherish. And therefore, you have to be very careful. On the last one, the fact that you're uncertain is highly correlated with the fact that I'm also uncertain about it. Because I have a sense that when you start playing with these financial measures, some of them can be nuclear. I mean, for example, SWIFT, we would love to have something else than SWIFT, possibly. How can we go from SWIFT to something else is not very helpful. Shifting, I think, funds away from the US is something that can be done. There

was this old argument that China would never sell its treasuries, because by doing so, it would basically incur a capital loss.

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And therefore, it was not going to do it. My impression is China is a bit like Harvard in the sense that it can actually afford to sell 10, 20 billion of treasuries. And yes, I'm sure that the price will fall, the yield will increase, there'll be a capital loss, but China can take it. I think There are things to do at those margins, selling US assets. But exactly how it should be done, I know my reluctance to say anything precise comes from two things. 2008, in which, you know, what were kind of small changes led to a financial implosion. And we didn't quite understand in real time exactly what was doing what. And you know very much about that. And the other thing is, this is finance, granular finance is not what I know well, and therefore, I approach this with great care. We've been discussing financial leverage, but I don't have strong views either.

[00:47:36.06] - Adam S. Posen

OK, let me push this a little bit, prompted by a question from Mexican former Ambassador Luis Bernal. Larry, if we assume Olivier is right that there's not going to be rapid uniform collaboration between Europe and the US in terms of export controls or standing up to China, But we also assume that the US Congress in both parties is very anti-China. How does this play out? And how does— how do you think— I mean, obviously we've discussed in the past how the Trump administration is not necessarily handling the China relationship well. But given the changes in our economic regime, how does that play out?

[00:48:30.00] - Lawrence H. Summers

Um, at one level, I don't know enough to say anything, and at another level, answering the question thoughtfully requires much more time, uh, than, uh, we have. So I'll just say these things, uh, the most sobering hour and a half that I've spent in the last 6 months was visiting the World War II Museum in Tokyo that presents a rather different perspective on the events that preceded December 7th, 1941 than the one that I learned in my U.S. high school history, uh, course. And so I think we need to be very much aware of the possible consequences of economic aggressiveness on our part, even economic aggressiveness that is reasonably well justified. We need to be prepared to think consequentially about that vis-à-vis China. Second thing I would say is I think we need to be pretty cautious about the view that decoupling is increasing of our leverage. You could only decouple once. You could only take advantage of dependence once. And if we do it now, all the leverage that we would have had 5 years from now or 8 years from now, from undercutting interdependence will be lost. I think it's probably

reasonable to say that our truculence over the last 7 years has contributed to a whole set of Chinese actions that have very substantially reduced our leverage relative to what we might have hoped.

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So I think it is very important that the United States work harder than it has to date to, while being firm, also engage in strategic reassurance that it is our desire to protect a rule-based global economy, but it is not our desire to suppress the prospect of Chinese economic success. I have used many times the metaphor for thinking about the United States and China of two men in a two-oared lifeboat who don't know each other that well, are not comfortable with each other, come from entirely different backgrounds, but the boat only moves if both oars are pulled. The sea is turbulent and the shore is a long way away. And so there really isn't an alternative to finding a modus vivendi. And I think a greater signal of U.S. commitment to find a modus vivendi and a bit less of a sense that this is an opponent that can be seen off would, I think, be constructive in the current moment.

[00:52:19.28] - Adam S. Posen

Thank you very much. And obviously your fellow PIIE board member and colleague Robert Zellick has made similar noise about that kind of probity. Not yet, Olivier. I'd like to ask you both, we're getting near closing time, to circle back to—

[00:52:37.07] - Olivier Blanchard

Two-handed, I insist.

[00:52:38.14] - Adam S. Posen

No, there is no such thing as a two-handed, Olivier.

[00:52:41.16] - Olivier Blanchard

Basically what Larry is describing is something that a Trump administration has destroyed. There is absolutely no trust, no confidence that anything like this would actually be respected by the administration. So the next administration may be able to do it. But let's go on.

[00:52:59.06] - Adam S. Posen

Okay. Let me try to get the two of you back to macroeconomics for a closing bit. You're both world-leading experts on the theory and practice of fiscal policy. We had a discussion, not really a debate between the two of you about the rise in R^* , the equilibrium exchange rate. And you both have said, and Larry initially when talking about secular stagnation said large-scale fiscal expansion was the way up for R^* , which might be beneficial under certain circumstances. How do you see the current configuration of both U.S. and Europe expanding their fiscal approach? Many people see the European expansion as positive. Uh, many people see the U.S. expansion as taking us towards crisis territory. What does this mean for r -star? What does this mean for potential divergence between the effective r -star in Europe and the US? Let me start with you, Olivier.

[00:54:01.10] - Olivier Blanchard

So indeed, this was a topic of our previous discussion, and I thought that r -star would be less than g , and Larry was more skeptical, had become more skeptical that this was going to be the case. And so the question is whether I concede or not, I'm of two minds. I'm not sure. And I think there's a difference between the US and Europe in that respect. It seems to me in the— again, in general, I don't see what factors which explain the long decline pre-2019 should be gone. But clearly there has been a change in fiscal policy. So it's clear that in the US, it's not so much the level of debt. Which I think is a big issue. It's the deficit which is the big issue. And I think this is leading to an R -star which is higher than it would have been otherwise. I still think R -star and G are probably over 10 years, probably fairly similar. But you don't get the kind of advantage you get when R is much less than G , which we had at some time in the past. In Europe, it seems to me that despite the fact that there is going to be a bit of a fiscal expansion.

[00:55:12.03]

It is much more reasonable. I think there are a few countries like mine which will have to do something more drastic. But in general, the deficits are not extremely large. And my impression is that we're returning to an R minus G or an R -star less than G of the order of 1 or 1.5%. I think what's interesting is We tend to think that there should be one R -star in the world, given arbitrage, given that people move funds. But if I had to guess, I think we're going to be in a state of higher R -star in the US for a while and lower R -star in Europe. So this is where I am. Again, I don't think we were totally sure of what was underlying the decrease, the steady decrease in our R -star before 2019. So we can't be sure exactly as to what will happen. But that's my best guess at this point.

[00:56:08.17] - Adam S. Posen

Thank you, Larry. You get the last word.

[00:56:14.04] - Lawrence H. Summers

I think Olivier and I appear to disagree about r^* a bit more than we do because we gravitate to different questions. I gravitate to the question of whether r^* has increased substantially from where it was 5 years ago when the Fed put the— put our star at 2.5%. And I think the answer is overwhelmingly yes, because there are higher inflation expectations than there were when we were struggling to reach 2% because of major budget deficits and because of huge, previously unforeseen investment demands around the construction of data centers, larger houses for people post-COVID and all of that, and around large wealth effects reducing flow savings rates. So my view is that our star is probably somewhere in the 4.5 range, representing a 2.5, 2 to 2.5 inflation expectation. A 2% to 2.5% real neutral rate. And a corollary of that view is that with normal term premia, that puts 4.5% plus 100 to 150 for the term premia, puts the 10-year comfortably into the 5s and perhaps approaching 6%. as the place to which the world is headed. Notice when I go through all that syllogism, I'm having a real neutral rate between 2% and 2.5%, which isn't very different.

[00:58:09.17]

It's perhaps slightly above, but not hugely above estimates of US potential. So Olivier and I are not really that far apart from the point of view of the R versus G on which, uh, he focuses. I don't think, whatever you think exactly about R versus G , that anybody's best guess could be that the current U.S. policy path is fiscally sustainable. There's sufficient uncertainty that nobody can rule out the possibility that it will turn out to be fiscally sustainable. But I think a— I think the range of reasonable best guesses as to how much adjustment is necessary probably has 2 as a lower bound and probably has 5 as an upper bound. And it's sobering to remember that that is significantly greater than Bill Clinton's 1993 deficit reduction program or the kinds of numbers that were discussed at the time of the Simpson-Bowles program. So I think that Olivier and I are in agreement. I suspect that the neutral rate has increased significantly in the last 5 years. Are in agreement that the fiscal situation in the United States is very serious and are probably somewhat in mild disagreement about which side of R versus G is, uh, more likely in the United States.

[01:00:02.19]

And we're also in agreement that R is greater than— R is neutral rates are higher in the United States than they are in Europe. And I think we would probably also be in agreement that in a world where total levels of current trade surplus or trade deficit are constrained politically, that

there's no reason to have deep conviction that our star should be neutral and should be the same everywhere because the arbitrage flow is inherently limited.

[01:00:41.12] - Adam S. Posen

Thank you, Larry, and thank you, Olivier. We've come to the end of our time. We're grateful to Lawrence Summers, the Vice Chair of the Board of the Peterson Institute, and Olivier Blanchard, Senior Fellow at the Peterson Institute, for sharing their time and their views. Thank all of you for joining us.