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Rebuilding the Global Economy

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MEMORANDUM ON

INTERNATIONAL POLICY CHALLENGES FACING THE NEXT US TREASURY SECRETARY

To: The US Secretary of the Treasury
From: Lawrence H. Summers
November 2020

Congratulations on your nomination to be the 78th Treasury Secretary of the United States. Few of your predecessors took office at a moment of such risk or such opportunity. I suspect that, far more than is true for most Secretaries, your most significant acts will be in the international arena. This reflects in part the very limited scope the current political context provides for significant financial reform or tax legislation, and the fact that much of the financial response to COVID-19 has already been put in place by the Federal Reserve. Even more it reflects the profound deterioration in US international economic relations and international economic cooperation in recent years and the very substantial domestic and foreign risks on the horizon.

No Treasury Secretary since World War II has faced so diverse and consequential a set of international challenges ranging from maintaining financial stability to reconceptualizing macroeconomic policy and from meeting Chinese challenges to restoring the domestic underpinnings for global economic cooperation. As Tony Blair has said of progressives, "the problem is that the radical are not sensible and the sensible are not radical." Here are some thoughts on the tasks ahead.

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KEY PRIORITIES

I. Your first priority must be restoring the shared expectation among the major countries that international economic diplomacy will be consequential. A healthy global economy requires both the habit of international cooperation and the major mutual commitments at times of crisis.

There is a striking difference between the current COVID-19 crisis and the 2008 financial crisis. Even though the latter crisis was much more domestically rooted, the global component of the global response was as bold as national responses. A common commitment to major demand stimulus and reducing trade imbalances, huge new support for emerging markets from the international financial institutions, and universal commitments to avoid new protectionist measures and to scale back fossil fuel subsidies were all contained in the G20 communique issued less than 3 months into President Obama's Administration. None of this would have happened without Secretary Geithner's leadership from the US Treasury.

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In contrast to what has happened domestically in many countries, the global economic response to COVID-19 has been almost nonexistent. Yet today's challenges require coordinated international actions on multiple fronts: (i) Agreements on the funding of COVID-19 control measures and measures to protect against future pandemics are necessary to achieve a public health foundation for the return of prosperity. (ii) Without internationally agreed measures to support demand, global growth is likely to founder even with COVID-19 progress and the US trade deficit is likely to mushroom with serious domestic political consequences. (iii) Emerging markets have suffered less from COVID-19 so far than most would have expected, but this is likely to change without substantial infusion of new funds. It says something that no African country has been to the private markets since February 2020. Only with the enthusiastic support of the United States can lending from the international financial institutions be ramped up and can the private sector be induced to play its part in relieving unsustainable debts.

You should urge the President to invite the G20 leaders to Washington during the first quarter of 2021 to forge a Compact for Inclusive Global Growth and schedule a preparatory meeting of G20 Finance Ministers and Central Bank Governors to prepare the discussion. This will both signal the new administration's recommitment of the United States to economic cooperation and provide an action-forcing deadline for crucial actions to combat the COVID-19 crisis. If the United States can organize such a meeting, forge meaningful agreement on crucial issues, and then carry through quickly on its commitments (for example, to authorize a new allocation of special drawing rights), this first G20 on your watch will signal a return of US leadership in global economic cooperation.

II. You need to forge a global consensus on the nature of current macroeconomic policy challenges, which is very different from what it has been historically. The current period of slow growth, subtarget inflation, and extremely low interest rates has now lasted longer than the high inflation of the 1970s. Yet there has been no change in orthodox thinking comparable to what high inflation ushered in with independent central banking, inflation targeting, and an emphasis on debt stabilization as the proper objective of fiscal policy.

Neither excessive inflation nor the crowding out of private investment by budget deficits is a current problem in the industrialized world, and hyper low interest rates extending out 30 years in all major countries suggest that markets do not expect them to become serious problems. Instead as figures like Janet Yellen, Mark Carney, and Mario Draghi have recognized, interest rates at the lower bound despite very large budget deficits indicate that the world's macroeconomic challenge is the effective absorption and deployment of private saving in a world of depleted private investment opportunity.

Whether or not you accept the concept of secular stagnation, super low real interest rates indicate an incipient excess supply of saving. This is the ultimate cause of excess leverage, asset bubbles, sluggish growth, and insufficient inflation. In some countries where the phenomenon is particularly pronounced because policy is oriented to discourage consumption, it is the cause of weak currencies and large trade surpluses.

Monetary policy is much less important today than it has been in the past. It can crunch credit and growth and as we saw this spring can mitigate financial panic, but it cannot push on a string and create increased demand to any large degree. This means that maintaining demand, assuring a sustainable financial foundation for prosperity and avoiding excessive external imbalances will all depend on fiscal policy.

You will need to lead the world towards a new view of economic stabilization that emphasizes the risks of sustained underemployment, the importance of fiscal policy, the room for greater deficits in a low interest rate environment and the idea that fiscal policies can be reformed to increase demand without increasing government debt burdens. Fiscal policy is expansionary without increased deficits when (i) public investment is tax financed, (ii) income is successfully redistributed towards entities like middle-income households with higher propensities to consume, and (iii) contributory social insurance is enhanced in ways that reduce households' precautionary saving with respect to retirement, catastrophe, or children's educational needs.

It may or may not have ever been true that ultimately prosperity depends only on structural policies and not on policies to promote demand, but it surely is not true today or for the foreseeable future. If only the United States promotes demand, much of the benefit will flow to other countries' exporters as our trade deficit increases. That is why it is crucial to influence global thought on the dangers of austerity.

III. As the leader of the President's economic team, you need to establish in the public mind that your Administration's international economic policies are not acts of charity to other countries or service to American elites but are direct contributors to raising the incomes of middle-income families.

It always needs to be clear that prosperity for Americans is your first priority. The Bretton Woods Institutions and the Marshall Plan would not have been possible without the GI Bill and the Treaty of Detroit. Your credibility abroad will ultimately depend on the success of the American economy.

You should be clear at the outset that you will not spend your scarce personal capital or US political capital on the commercial agenda of US financial firms operating abroad where their success has almost no nexus with US job creation. The focus of all your international efforts on financial sector issues should be on cracking down on regulatory arbitrage and preventing regulatory competition. The competitiveness of the US financial sector is way subsidiary to the prevention of financial crisis.

You should from the first join with the French and others who insist that no highly profitable company should be able to use tax technicalities, transfer pricing, tax havens, or location in cyberspace to avoid paying a reasonable share of its reported profits in corporate taxes. It has become the goal of the United States to win a race to the bottom in corporate taxation. Your goal should be cooperative leveling up of corporate tax burdens. The Base Erosion and Profit Shifting (BEPS) framework is fine as far as it goes but this issue is as or more important than further trade liberalization and should be lifted to the highest political level.

Given the divisions in the country, the scarcity of a new Administration's political capital, and the absence of a compelling economic agenda, this is the right time to resist protectionism, to enforce existing trade agreements, and to pursue sectoral regulatory agendas in areas like finance and technology. It is not the right moment to make commitments to new trade agreements. You will likely at some point need to use the credibility of your office to resist the coalition of US businesses looking for commercial benefit in other countries, USTR looking for projects, and the State Department, which is always eager for international agreements, always pushing for new trade agreements. Divert the energy towards regulatory and tax collaboration.

You should speak of US participation with international organizations as "cost effective forward defense of US security and economic interests." It is cost effective because each dollar we contribute typically levers five or six foreign dollars. It is forward defense because we will be neither prosperous nor secure if the world economy is stagnating and other nations are not addressing issues like global disease and climate change. If you are successful in establishing yourself as on the side of the American middle class, you have a chance to put the US role in international institutions on a stronger footing than it has been on in a generation.

CONCLUDING THOUGHTS

Much in all of this will depend on how the US-China relationship evolves, which is beyond the scope of this memo. Broadly, your challenge will be to take the temperature down at a time when there is a bipartisan tendency to suppose that a wish list constitutes a strategy. You should seek to ensure that your Administration considers what leverage it does and does not have and what accommodations it is prepared to make as it makes demands. At the same time you should be prepared to use the need to "maintain the power of the US example" as a spur to necessary policy steps.

The reality is that in multitrillion dollar daily foreign exchange markets, you have limited capacity to influence the foreign exchange value of the US dollar. You will almost certainly find with respect to dollar talk that less is more. An oft repeated phrase will promote more financial stability than any amount of thoughtful theorizing. While I do not believe the dollar has serious peer competitors, at this point given your commitment to expansionary policy it would be unwise to appear actively devaluationist or indifferent to the dollar. Favoring a strong dollar based on a strong economy or some such seems prudent. Within the councils of the Administration it is your vital role to emphasize that if the United States overexploits the central role of the dollar in the international financial system to pursue parochial objectives it puts that central role at risk.

Finally, never forget that your credibility is a crucial national and global asset. There likely will come a time when you will need to make a reassuring statement of some sort and be believed or else there will be grave and expensive consequences. Your response to some crisis may well define your time as Secretary. Do not dissipate your credibility to pursue dubious, transient, or political agendas no matter how great the pressure.