A Pat on the Back at Pittsburgh?

Michael Mussa, noting that the global economy is heading out of its slump, says that the G-20 summit in Pittsburgh should also deal with an "exit strategy" from stimulus programs and the future of global financial regulation.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Michael Mussa, senior fellow at the Institute, is here today to talk about the prognosis for the G-20 Summit meeting in Pittsburgh later in September. Thanks for joining us, Mike.

Michael Mussa: My pleasure.

Steve Weisman: The first thing that the G-20 will take note of is the state of the recovery, to the extent that it is already underway. Bring us up to date on your assessment of the growth prospects in the United States and the globe.

Michael Mussa: Clearly the news is much better now than it was when they met in London. The global economy has pretty clearly bottomed out in terms of the real output. A number of countries have turned upward, some quite sharply, especially in Asia. Others seem more to have been flattening out in the second quarter, but there's some evidence that there's a general pickup now in the summer quarter in the United States, United Kingdom, and a number of the industrial countries, which are lagging a little behind the Asian emerging markets.

Steve Weisman: Mike, what is your figure for what the growth will look like in the United States?

Michael Mussa: Well, I think we're going to have between 3- and 4-percent annualized growth in the second half of this year accelerating to about 5 percent during 2010. Now, that's above the sort of average consensus forecast a fair bit, but I think history indicates once you start a recovery from a deep recession, it tends to surprise virtually everyone on the upside.

Steve Weisman: Mike, is there a cause for these leaders from the G-20 to pat themselves on the back over these projections?

Michael Mussa: I think there certainly will be considerable self-congratulation and it is even to some extent merited. Though the main accomplishment so far I think has been that we avoided, really, a prolonged catastrophic downturn, and that goes back more to what was done last fall. I think that we will be seeing the benefits now of the policies that were adopted earlier this year in the remainder of 2009 and 2010.

Steve Weisman: The issue of stimulus spending has been a contentious one over the last year and even at some of the G-20's summits going back last year under the Bush administration. Is that a live issue still or is anyone going to be pushing for more stimulus do you think at Pittsburgh?

Michael Mussa: I doubt that there will be any sort of official push for more stimulus at this stage. I think more they're likely to say that the recovery is not yet securely underway, and so this is not yet the time to begin to withdraw stimulus, but the so-called issue of the exit strategy—that is a gradual withdrawal of monetary stimulus and the fiscal stimulus—will become relevant as the economies gather strength.

Steve Weisman: Let's talk about the exit strategy. What do you think they should say and what do you think they will say in Pittsburgh about that?

Michael Mussa: I think first they're going to say that it's necessary for certain in the medium and longer term, that it's not yet quite time to begin it now, but they need to be thinking about how to implement it perhaps beginning as early as next year. But taking account of how well the economy is progressing before actually moving to reduce the amount of stimulus.

Steve Weisman: The reduction in stimulus would take the form of what on the fiscal side and what on the monetary side?

Michael Mussa: Well, on the fiscal side, you're talking about reducing government deficits somewhat more than will occur as a natural consequence of economic recovery. At least in countries like the United States where you've added discretionary fiscal stimulus, you'll need to wind that back. Now, of course, the US fiscal stimulus is going to peak anyway sometime late this year or early year and then gradually wind down, so that is not going to take any explicit additional action. It's sort of already built in to the stimulus program, and the same is true in most countries. But even with that winding down, the United States and some other countries are still looking at very large deficits, looking ahead four or five, ten years and they're going to need to address those problems progressively over time as we move forward if our fiscal policies are going to be put back on a sustainable basis.

Steve Weisman: How quickly should the United States start to address those actions even just in terms of committing themselves to future actions?

Michael Mussa: Next year, the Congress will consider the budget for fiscal 2011 and in that context they will need to begin to consider these questions. Among other issues, the Bush tax cuts enacted in 1981 and in 1983 are scheduled to expire at the end of next year and they're going to need to decide—they're not going to let them all expire, I think that's fairly clear, but they are going to need to decide how much and with what timing they're going to pull back on at least some of the Bush tax cuts. Then the issue of the expenditure side of the budget will need to be addressed as well and in that context, some of the money that was put in the stimulus bill is due to be spent in 2012 and 2013. Well, maybe that deserves to be on the table for reconsideration along with other components of the budget.

Steve Weisman: The central bank chiefs won't be in Pittsburgh, but what should the leaders in Pittsburgh say about interest rates, monetary policy and the exit strategy from the very stimulative monetary policies of the last year?

Michael Mussa: Since the central bankers will not be there—and it really is the job of the independent central bankers to manage this—they probably shouldn't say very much in detail other than that they expect monetary policy will continue to deliver reasonable price stability while supporting expansion recovery in the near term. That they look to their central banks to exercise their independence in that way.

Steve Weisman: Speaking of the central banks, let me ask you about the future of financial regulation, which is a big concern to everyone who feels a regulatory breakdown led to this current crisis. What do you understand the leaders' plans are for addressing concerns about future financial regulation?

Michael Mussa: There was an announcement really out of Basel—where the central bankers meet—rather than out of London where the finance ministers were meeting last weekend, that indicated general agreement on the notion that banks, particularly the larger more systemically important banks, need to hold higher levels of capital and higher quality of capital. I think that really is a key reform. It means that the cushion they will have to absorb losses if they take on excessive risk is larger, and hence the need to call upon the government and the taxpayer in the event of future difficulties is smaller and the incentive to take excessive risk because somebody else is carrying the load is reduced.

In my view, this is the single most important reform in the financial area. These institutions should be holding more capital to protect themselves and the rest of us. If they're doing so, then one is relying much less on the detailed judgment of either bank managers or bank supervisors. As I like to explain it, I don't care how good the captain and the crew are or how well regulated they are. The Staten Island Ferry is not fit for transatlantic service. I mean, you need to build the boat that's capable of absorbing the shocks. That's the idea of a higher capital standard—build a better boat.

Steve Weisman: But how many boats are going to be overseen by this new set of rules? Isn't there a concern that they're going to leave out a lot of the non-banks and investment banks and hedge funds that also need to be governed by some of these formulas?

Michael Mussa: I think the concern may be more on the other direction that there are too few institutions and as a consequence, those few institutions are too big to fail, which makes it much more difficult to regulate them effectively. We've had a number of small banks fail in the United States, which is a problem for their owners and so forth, for some of their business customers, but it's not a systemic problem. The crisis arose because the largest, most important, most interconnected financial institutions were either in trouble themselves or were feared they would go into trouble because their colleagues were in trouble. That's really what most needs to be addressed in order to reduce the risk of future financial crises and getting these institutions in particular to hold larger amounts of capital to guard against risks is a key part of the reform, but there are a number of other things that are going to also be important going forward.

Steve Weisman: Are the G-20 ahead or behind the curve of what's going on in Congress in this area?

Michael Mussa: I think they're modestly ahead of the curve in terms of Congress. Congress seems likely now to move on consumer protection, which is not particularly an international issue that would attract the attention of the G-20. It's sort of a national issue in each country. Then Congress has also focused a lot of attention on salaries and bonuses, which are a relevant issue but not the centrally most important issue. Congress has not considered the question of capital requirements and so forth and I think that the G-20 and the central banks are ahead of them on the single most important issue, but there are a number of other issues where progress has not yet been very great. I tend to think that having been burned so badly in the recent crisis that the key financial institutions are going to be careful about taking on excessive risk over the next year or two. When you begin to look further down the road, then you begin to worry more that we might recreate the same problems that led to the current difficulties.

Steve Weisman: I suppose it's instructive for them to meet in Pittsburgh, which once upon a time was the city where the most American millionaires lived and it's not that anymore.

Michael Mussa: No, that was in the day of Henry Clay Frick and Andrew Carnegie and the height of the US steel industry, but I mean Pittsburgh is an outstanding example of economic adjustment. The economic activity that goes on in Pittsburgh now, which is quite a vibrant city, is very different from what brought it to wealth and prominence a century ago.

Steve Weisman: On that typically interesting point from you, thanks very much, Mike, and let's talk again as we head toward Pittsburgh.

Michael Mussa: Very good.