

The Future of Market Capitalism
Larry Summers
(Transcribed October 15, 2008)

It is my privilege to introduce our next speaker. He is an exceptionally brilliant economist. He served as Secretary of the Treasury and then as President of Harvard University where he became a great friend of the Harvard Business School. Now he is Charles W. Elliott University Professor. It is an honor to introduce Larry Summers.

Larry Summers:

Thank you very much. It is good to be here. When Warren McFarlan came to my office six months ago and asked me if I would be willing to speak at this important event, I said that, of course, I would be honored to have the opportunity to be a part of such a convocation. I suggested that we not discuss in detail what would be an important topic for my remarks at that point, because really a lot could change in six months.

There were a number of possibilities that I considered. I do not want to call into question Warren's gifts of prophecy, but I think I can safely say that neither of us expected that on the day that the Harvard Business School celebrated its 100th anniversary, the United States government would be investing \$150 billion in equity stakes in all of the country's major financial institutions. That is a reminder to all of us of the need for a certain humility and lack of confidence in trying to predict the future.

I have been privileged to watch closely ten US Presidential elections. It has been said in the course of each of those ten that this is a uniquely important presidential election because the choices that the new president makes will shape the country for generations to come. Sometimes clichés are correct, and I believe this is one of those time in the economic area because I believe that the choices that the United States, as a nation, makes going forward in cooperation with other nations will, in the broad economic area, have profound impact on the lives of literally hundreds of millions of people who will never know what a credit default swap is, who will never know who the financial minister of any country is, but whose lives will be affected in hugely consequential ways by the choices that our society makes.

Indeed, I would suggest that there are a number of issues on the plates of political leaders at the beginning of 2009 that are more important than any of the issues on the plates of political leaders at the beginning of most presidential terms. I want to focus today on three broad issues: the challenge of maintaining stable prosperity and economic growth; the challenge of making sure that that prosperity is widely and legitimately shared; and the challenge of building a global system that works for the citizens of all nations.

We all need to recognize – and I do not think I speak presumptuously when I say this – that Harvard Business School and its alumni are seen as part of a global elite. And that we are living in a period of abnormally high disillusionment with global elites. More Americans think the country is going in the wrong direction than any time since we began asking the poll question in 1963. More Americans think that their children are not as likely to be as economically successful as they were at any time in living memory. If one looks at Congress, if one looks at the President, if one looks at business leaders as a group, public faith in their leadership is at a low.

So, making the choices that lie ahead wisely and decisively and in the raw interest is of immense importance. Not just for people's economic well-being, but for a sense of a broader legitimacy of the society we are a part.

The challenge is in creating prosperity, maintaining prosperity, and increasing prosperity.

Today, we are being reminded of Keynes' famous insight that market system is not always self-stabilizing. The American economy and the global economy are caught in a vortex of five vicious cycles:

The first is what might be called a liquidation vicious cycle. As financial assets fall in value, their sale is forced by those on margin, which pushes the prices of those assets even lower.

Second, we have a deleveraging in capital vicious cycle in which assets lose value, causing institutions to have less capital, which leads to less lending and even more asset devaluation, continuing downward in a spiral.

The third vicious cycle is a credit accelerator cycle, in which a weakening economy leads to a weaker financial system, which leads to less lending, which leads to a weaker economy and the cycle continues.

Fourth, we can identify a Keynesian vicious cycle, in which lower spending leads to lower employment, which leads to lower incomes and then to lower spending, which in turn leads to lower employment, et cetera.

And finally, we see the panic vicious cycle, in which individuals see financial institutions in trouble, rush to withdraw their funds, putting those institutions in more trouble, and causing more of a rush to withdraw funds.

These five vicious cycles have created a situation unlike anything most of us have ever seen.

There was a brief period, ten days ago, when people paid the United States government to store their money. That is, the interest rate on treasury bills was negative, because putting your cash under your mattress didn't work very well and putting your money anyplace else made you nervous, and so people were actually prepared to accept for horizons as long as in six months negative yields on treasury bills.

In the face of such a crisis, there is no substitute for firm, decisive action. Perhaps with too much delay, perhaps with tactics that reasonable people will debate, at last, only in the last several days, are the essential elements of a response plan coming into place: guarantees and assurances to protect the basic flows of money between banks; infusion of substantial amounts of capital that prevent deleveraging; and direct provision of credit to areas where credit is starved. These are welcome and important steps that remind of us a crucial role of government as a guarantor of macroeconomic stability.

To be sure, and this is as yet less in place, the financial system will not ultimately be healthier than the broader economy on which it depends. The appropriate set of steps is debateable -- and there will be those who will think more tax cuts are the answer; there will be those who will think more infrastructure is the answer; there will be those who will think both are the answer -- but the appropriate set of steps must assure the strength of the economy through this period so that we can return to a more normal market condition. This is a crucial set of choices that will be made over the next year or two.

At the same time, and it must be at the same time if there is to be the credibility necessary for the extraordinary efforts that will be required, we will need a fundamental set of reflections on a financial system. This incredible economy is one that has on the one hand been a tremendous source of flexibility and prosperity. It has, in the United States, created the only place that there has ever been in the world where if you are sufficiently able and sufficiently creative, you can raise your first \$100 million before you buy your first suit, and that has spawned a tremendous spirit of entrepreneurship.

But we must also recognize at the same time that in the last 20-year period, we have seen the 1987 stock market crash. We have seen the S&L debacle and the commercial real estate collapse of the late 80's and early 90's. We have seen the Mexican financial crisis, the Asian financial crisis, and the LTCM liquidity crisis. We have seen the bursting of the NASDAQ bubble and the associated ENRON threat to corporate governance. And now we have seen this, which is more serious than any of that. Twenty years, seven major crises. That is one major crisis every three years. I would suggest to you that that is not good enough.

How will the financial regulatory architecture need to change? This is not the place for detailed prescriptions. Certainly, rather more skepticism about self-regulation, and more skepticism about elaborate,

self-generated computerized models has to be in order after the events of the last year. My own view is that the focus of financial regulation will need to shift from the traditional focus of a narrow regulation of individual institutions to a broader concern regarding the stability of the financial system.

That will mean focusing on developing a system which we now know we do not have. A system that is safe for the failure of any one institution without endangering the remainder. After what happened at Lehman Brothers, we know that we do not now have such a financial system in the United States or globally.

It also means establishing a set of arrangements that prevent the kinds of perverse incentives that have driven what has happened in recent years, and in recent months, as institutions lose value and then delever, causing other institutions to lose value and actually exacerbating rather than mitigating the cycle. There is much else that can be done, and there is ample room for debate about what changes are necessary. Where there cannot be debate, after seven crises in twenty years, is with the fact that we do not have a system that is functioning effectively to achieve these objectives.

I begin with this question of economic stability and maintaining prosperity because without a sense of growth and without a sense of security in that growth, it is almost impossible for us in the United States or for any other country to even think about addressing the broader set of domestic or global challenges.

The second broad challenge where we will have to make fundamental choices in the months and years ahead goes to the fairness and legitimacy of the distribution of the rewards of prosperity. Consider if you will, hopefully you will forgive me for focusing on the United States, but much of what I say with small changes apply to large parts of the world.

Consider three facts: first, compare the income distribution of the United States today with the income distribution in the United States in 1979. If you do that, you will find that the share of income going to those in the 80th-99th percentiles has stayed about the same. Those in the top 1% of the income distribution have gained about \$600 billion dollars. Those in the bottom 80% have lost about \$600 billion dollars. That translates into \$500,000 for every person in the top 1% of the income distribution and translates into \$8,000 lost for every person in the bottom 80%.

If the bottom 80% had kept pace and had earned that \$8,000, their incomes would have doubled. Their income growth would have been twice as high over the last generation as what we in fact observed. Think about this, \$600 billion dollars a year. It is immense compared to any discussion of changing the tax system here or there, any assistance adjustments program thought to accompany trade agreements.

Second, the Congressional Budget Office, as it has a number of times in the past, released a recent study looking at the health status of those who are more fortunate and those who are less fortunate. Twenty-five years ago the gap in life expectancy between well-off Americans and less well-off Americans was close to two years. Today, the gap in life expectancy between well-off Americans and less fortunate Americans is close to four years. Two years of life expectancy may not seem like a lot, but if we eliminated all cancer and the possibility of all cancer for everybody in this room, it would raise life expectancies by only about two years.

So, the gap in life expectancy between those who are fortunate and those who are less fortunate has widened by an amount that's comparable to the total burden of cancer. That's not all about availability of healthcare, that's about pursuing healthy habits. That's about many different things, but it is hardly a mark of our social and economic success.

Third, as the best economists and those who study these things can measure, for most of American history, from the Revolutionary War until a quarter century ago, the correlation between the economic success of fathers and their sons was diminishing. The tendency for prosperity to be passed on was diminishing as opportunity was becoming more and more equal. For the last quarter century that trend has stopped and according to some may even have reversed. For the first time in history today because of a constant

correlation and widening in equality, the gap and the life prospects of the children of rich and children of poor has declined.

Whether you are or are not a believer in redistribution, whatever your broad approach to public policy, I would suggest to you that this represents a critical problem of legitimacy. For almost all of us, I think, there is an essential role for improvements in education both setting higher standards, insisting that they be met in our educational system and showing that we mean what we say when we tell our children that education is the most important thing by creating a country where no child has to go to school in a classroom where the paint is falling off the walls. Where no child studies chemistry in a laboratory that you can only spend 20 minutes because the ventilation system doesn't work because there's no budget to fix it and so forth.

Education is a crucial part of it. But education is not going to solve the problem for those who are in the 30's or 40's or 50's or 60's.

As we address this question of the global economy as we build the new institutions that Jay spoke about, we are going to have to find ways of addressing what is a devastating syllogism which too many of our citizens are confronted with today goes something like this: step 1, you are facing much more severe competition from workers all over the world. There is no alternative; your workplace becomes more flexible and so you become more vulnerable. There is no alternative that your incomes don't rise in a way that they once did it is necessary and is an inherent part of a global economy.

Step 2, your government, your nation can do less to help you cope than it used to be able to do, because if it tries, if it enables you to organize, if it seeks to tax those who are wealthy so as to help you in this new era of globalization, they are much more likely to move overseas than every before, and so we actually have to tax you more and those who are more fortunate less because of the realities of global competition.

That two-part syllogism is understandably unacceptable to large numbers of our fellow citizens. If we are to succeed in doing what is terribly important to do, which is to support and build and enhance and develop and increase this process of global integration, we are going to need new and more creative approaches to make sure that it works for everybody.

Global cooperation is crucial not just to support more opportunities for businesses, but also to make sure that the system works for workers. Efforts on the part of government to not insure that not everybody is equal, that is a shimmer that will never be achieved, but to assure that the distribution opportunity appears more equal and more legitimate than it does today.

Creating prosperity and making sure that the benefits of that prosperity are more equally shared are two of our critical challenges. There is a third challenge and it relates to the process that I just touched on of spreading global integration and it is certainly more important than the others. It is a challenge where the right perspective will depend on where you live. I think of it in terms of finding America's role in a new world.

It is only a small exaggeration to say that a decade ago, America stood apart on a number of dimensions. It stood apart for its hard power, for its military strength. It had resisted tyranny and slaughter with great effectiveness at almost no cost in American lives in Bosnia and in Kosovo.

Today we worry about the future in Iraq and acknowledge that we are not able to provide the security that we'd like to in Afghanistan because our force is not adequate. So that military pillar is not what it once was.

A decade ago, for all our faults, we were in many respects a moral beacon, a country to which people from all over the world wished to come. And as the students I meet each year, at the business school, they make me recognize we still remain an enormous magnet for people from every part of the world, but after Guantanamo, after Abu Ghraib, after Katrina, it is not what it once was. So, that sense of being a moral beacon is not what it once was.

The third place we were a decade ago is our economy was in so many ways the envy of the world. We were bringing you the Internet, we were bringing you cutting edge biotech, and our firms were templates for so many others. That, too, was an enormous source of strength.

There is different now that we are in the midst of this financial crisis. There was a moment, albeit the briefest of moments, when the General Electric Corporation had to pay 10 percentage points above the rate at which the US Treasury borrowed money in order to borrow money for one month. This financial crisis, too, changes the view of the United States and our sense of economic strength.

So, the third great challenge for us is going to be to work with others to create a world system, not for the sake of others admiring us but for the sake of prosperity and peace for all world people.

Probably no single issue is more important in that than the broad set of questions that Joe touched on surrounding energy. The largest flows of financial capital in history are now taking place between the world's democracies and the world's more totalitarian, less democratic, oil states. How is that all going to play out? In whose interest is it going to be?

Make no mistake, there are many aspects of all of this that one can argue with, but to suggest that the current growth trajectory for energy is consistent with a healthy planet for our great-grandchildren is epistemologically tantamount to suggesting that cigarettes are not harmful to human health.

For all that has happened, and there has been enormous amounts of positive innovation. As one looks at the figures, and one looks at the trajectory that people who were predicting before the 1997 Kyoto agreement, and looks at where we are now, we have only made the barest beginning of a conversion. We have not fully decided in our political debate, and I don't know that this has been fully decided in political debates in other countries, whether our objective is higher energy prices to spur efficiency, to spur innovation of renewables and so forth, or lower energy prices to protect consumers and to help squeezed families.

What's the right way forward? What's the right role for incentives? What's the right role for prices and regulation? What could be accomplished by calling on the better angels of people's nature? These are hugely important questions. What should not be in doubt is that the current path, if sustained, does not work geopolitically, does not work environmentally.

You know, these three issues have something in common. They all create a sense of insecurity for people. People who will never come to the Harvard Business School, or people who are living lives of great value and great contribution in their own way, who once felt secure. Secure in their communities, secure in their livelihoods, secure in their nations, and secure in the world. Who now do not feel secure. Who now feel that their prosperity is hanging on a thread connecting buildings in Manhattan or buildings in Manhattan and buildings in London. Who are not sure that even if the global economy keeps going that they are going to be part of it, and who are not sure what the future of a global system is going to be.

So the really important challenge for all of us is to make that system work for all of those people. It has happened before. A republican Roosevelt, Theodore; and a democratic Roosevelt, Franklin, both presided over periods when capitalism saved itself from itself. Enlightened public policy had a crucial role. Business leaders who recognized that while there may be conflicts about what is in their short-run interest, there is much less room for conflict about what is in their long-run interest because of their enormous long-run interest in being part of successful societies.

I would suggest to you going forward that we have an enormous challenge of saving capitalism from itself and that that very challenge represents an immense opportunity because as the enormous array of people in this room from so many different places attest to a much smaller world than we have ever had before. There is also, if we can meet these challenges, more opportunities to create more prosperity and better lives for more people than in any other time in history.

Thank you very much.