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Dr. Lawrence Summers Keynote Presentation to the Drobny Global Conference Santa Monica, CA April 25, 2013

Thank you to all for your contributions to the conference last week. They were lively, stimulating sessions. Next on the agenda — the inaugural Drobny Macro Summer School July 18/19 in New York. — *David Berry*

Drobny hosted its 23rd semi-annual conference in Santa Monica, California April 25-26, 2013 for global portfolio managers from around the world. The event was exclusively sponsored by BNP Paribas.
Dr. Lawrence Summers delivered the keynote presentation Thursday evening April 25th.
Below is a summary of Dr. Summers' presentation.

I am delighted to be here with such a remarkable group of people. They used to joke in the White House, President Kennedy famously observed at a Nobel Prize winner's dinner that there had not been such a talented group of intellectuals in the same room in the White House since Thomas Jefferson dined alone.

I don't know whether I should say that there hasn't been a similar talented group in the same room since George Soros convened alone. Or just what name I should use. But this is indeed a remarkable group and I am glad to be here.

I am also glad to not have been introduced with an economist joke. It was not so long ago that I was introduced by the guy who said "Larry, do you know about Einstein's trip to heaven?" I said, "no, I don't know about Einstein's trip to heaven".

Well Einstein went to heaven and he wanted to relate well to the people there because he said he didn't feel that he had related so well to people on earth. So he said to the first guy that he met, "What's your IQ?" and the guy responded its "180". Einstein said "that is fantastic, I have a new interpretation of quantum field theory and I would like to discuss it with you". He met a second guy and said, "What's your IQ?" The second guy responded "140". Einstein said, "I have been rereading Shakespeare's sonnets and I have an interpretation of them that I would like to share with you and get your views." He met a third guy and asked again "What's your IQ?" The third guy responded "80". Einstein didn't know what to say and then it came to him "What's your GDP forecast for the second quarter?"

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I am going to kick off what I hope will be an interactive discussion with ten observations/views.

First observation, US growth risks are significantly to the upside. Housing is in the process of turning. Asset prices are higher. Fiscal contraction is largely in the rear view mirror. Confidence isn't bad and there is significant excess capacity. Lower energy prices relative to what had been expected is likely to give a kick to growth this summer. Surprises to the upside don't mean 4-5% growth but it does mean that surprises are more likely to be in that direction than surprises to the downside. And, as I will discuss in a few moments, I think the market is underestimating the pace at which the Fed will alter its current course and the consequences of that for interest rates.

Second observation, especially against this backdrop, the equity risk premium is conspicuously large right now. If you do a very simple calculation. Take the earnings/price ratio and subtract the 10yr TIPS rate. That number is at a near record maximum historical level. That logically could be because the equity risk premium is large or it logically could be because earnings are transitorily large. Of course, its possible that earnings are transitorily high but in an economy that is well short of its capacity and in a world where those earnings are increasingly tied to the global economy with 35-40% SPX profits from overseas and trends that are anti-labor and pro-capital, its hard to say that these earnings are transitory. I don't think that one would want to bet with confidence that earnings are way transitorily high. Absent that, a very high earnings/price ratio, a very low real interest rate, combined with volatility that is very low suggests that equities are likely to be very attractive in the United States right now and that probably carries over to significant parts of the world as well.

Third observation, the US fiscal picture for the medium and long term while hardly great or in order, is better than most people suppose. There are two underrated developments in the last period. First, for 3 years now healthcare costs have grown just in line with GDP. This is a surprise and not well known. Nobody quite knows why and the Administration would love to take credit but it's a little hard to find anything particular that they have done that would be the cause of that trend. It is tough to identify the cause of this change in trend and no one knows for sure whether this trend will continue. There has been a suspicion for some time that efforts at healthcare cost containment seem to have a balloon aspect. You squeeze in one place and costs rise elsewhere.

But eventually you start to squeeze the whole balloon and that may been happening with respect to healthcare costs right now. And, if you look at the dark news in the medium to longer term fiscal forecasts it is very heavily about healthcare. If healthcare is starting to turn or if we are in a position to do policies to influence health care reimbursements, which I think we are, there is the prospect that costs will come under better control than people imagine.

Second fiscal issue, is that for reasons that are also not completely understood but probably have to do with the strong stock market, tax collections are running well ahead of forecasts. When the CBO makes a forecast, they divide their error for the next year into three sources — new policies with a fiscal impact, the economy, and the technicals. The technicals are now running in a favorable direction. The experience historically has been that the technicals are strongly serially correlated, the revisions of the technical were positive all 16 half years during

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Bill Clinton's term which is a lot of the reason why we got to a reduction of the deficit. So the fact that the technicals are in a favorable direction is a development that is of underestimated importance. That is the good news. And, it is good news that most of the fiscal contraction has already happened. The bad news is that there will be no major fiscal action/reform before 2014 midterms because the urgency has been dialed down, the divisions are very strong, and the political equation is not there. The fiscal problem is going to do more to solve itself than most people expect and politicians are going to do less to solve it than most people expect.

Fourth observation, QE in my view is less efficacious for the real economy than most people suppose. Remember that to be efficacious QE has to work through three channels. First, purchases of treasuries have to have a substantial impact on long term yields which after all also have to do something with expectations for future short term yields. Second, the impact of purchases on treasury yields has to be translated into the yields at which investors actually borrow. Unlike a change in the fed funds rate which would be expected to affect all interest rates, if you buy only treasuries you might well widen the spread between corporate rates and treasuries but not change the rate at which corporations are borrowing. Third, any reduction in borrowing costs that have been achieved have to flow through to real spending. And it is an open to question just how large the impact of reduction in interest rates from 2 point something to 2 point something less will be. More of what will determine things going forward will have to do with fiscal policy and that there is less efficacy from quantitative easing than is supposed. The corollary of that is that if QE won't have a large effect on demand, it will not have a large effect on inflation either. So this is not a compelling argument against QE.

I would offer the judgment that 18 months from now I would predict one of two things will have happened. Either, my instinct is, that growth will have accelerated more than is now supposed. Or, it will not have. In which case prevailing views about the potential for the economy will have been modified downwards. In other words, the likelihood is that prevailing views about the gap are likely to come down significantly. I think that most who forecast Fed behavior going forward underestimate what is a historical regularity across almost all countries and almost all eras which is a tendency for the so-called natural rates of unemployment as judged by observers to converge to actual rates of unemployment and for estimates of potential GDP to converge to actual GDP. To the extent that view is accepted, it should operate in the direction of leading one to expect the beginning of the tightening phase to happen sooner than is now supposed by many.

Fifth observation, the comparative experiences of Japan and the UK will soon offer a great empirical test of austerity doctrine when the results are in for the next few years. One of the things that economists do too little is to answer the question (I always try to answer this question when I formulate a view): "what could happen in the next several years that would lead you to think that you were wrong and would lead you to revise how you analyze the global economy?" Resounding economic success in Britain would be such a development. Resounding economic success in the face of an austerity to generate confidence policy would be contrary to my understanding of how economies operate. Similarly, a substantial failure of the economic policies in Japan to generate increased demand and an acceleration of nominal GDP growth would cause me to question my understanding of how economies operate. That is not to say that there will not be an adverse impact on JGBs resulting from these policies.

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Sixth observation, Europe. The odds that it will all stay together in my view are about 85%. Never before in the history of financial markets have so few words and so little action been so salutary in their impact as Mario Draghi's remarks last summer. It is a remarkable thing that he just kind of said those things, wrote them on the back of an envelope, and then he repeated it at a small conference no larger than this one, and the effect was miraculous. The clouds lifted and they lifted so decisively that he never had to spend any money. It is a miraculous thing. My best guess is that between his commitment to maintain the relevance of his institution (after all there is no ECB without the European Union) and a German judgment that Germany is part of Europe and a European Union is more powerful than a Teutonic monetary virtue. Those two things lead me to think that while I would not want to predict what will happen to Cyprus or Greece, the core of the European Union will stay together. It will stay together with substantial "ad hoc-erty" as far as policy goes, but a sufficient federal foundation will be laid in order to make the Union viable. Albeit quite likely with disappointing economic performance throughout.

Why do I say 85% and not 100% probability? Because World War I started. World War I didn't start because people decided that having a major war would be the best outcome. World War I started because people thought that they could have other things that they cared about, that they could maintain dignity and maintain peace in the Balkans . . . but that policy calculation turned out to be wrong. And, if the Euro collapses, it will be less because someone made a strategic decision in favor of the collapse and more about policy miscalculations — decisions to try to extract one more ounce of austerity out of a peripheral country or to further protect Northern Europeans taxpayers one little bit more. I think this is unlikely, but it is conceivable. And, the fact that such few words by Draghi had such a profound impact, and I don't understand why, does give me pause that all is well in Europe.

Seventh observation, emerging markets. The most important thing to keep in mind when thinking about emerging markets, in particular when thinking about China, that people tend not to keep in mind is the following very simple statistical fact. If you compute the correlation between growth rates in one decade and then the next. Take 150 countries. Look at their growth rates in the 70s and 80s. Look at their growth rates in the 80s and the 90s. That correlation is remarkably close to zero. Weight countries by their size. Do it within continent or across continent. It is a quite robust fact that that correlation is quite close to zero. That is contrary to most people's intuitions because almost everything we think of as determining growth is something that stays reasonably stable from decade to decade. And, it is fairly obvious that this is not the way that people forecast. People forecast much more by extrapolating. So in general if you are optimistic about a place because it has always done well you are probably wrong. And, if you are pessimistic about a place because it has had two decades of dismal performance you have a substantial chance of being wrong. The lesson for China should be obvious.

It is also important to recognize that the history of investment and export led, particularly investment led centrally-directed growth strategy is that it has ended badly, Russia in the early 1960s, Japan in the early 1990s, Korea and non-Japan Asia in the latter 1990s. Ponder that Brazil was the fastest growing country in the world for the century from 1880s to 1980s. So I don't pretend to be able to call the timing but in the next some

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number of years I would be surprised if there was not some important discontinuity in China and in general I would be careful about extrapolative forecasting with respect to emerging markets.

Eighth observation, it is a quite remarkable, yet relatively unremarked thing just how low real interest rates are across the industrialized world. 20 year TIPs are at or close to zero or negative rates. If you think about it you would think that the risk-adjusted productivity of capital in the industrialized world over the long term should be somewhere significantly above 0%. And yet markets looking forward are saying it isn't. In order to form a view about the future it is important to form a view about this phenomenon. One view is that real rates are actually higher, that productivity of capital is higher, that people are impatient, and that there is going to be a lot of money made shorting bonds over the next five years. I think there is something to that view.

A second view which also has some substantial truth is that there are fundamental forces that are operating to reduce equilibrium levels of real interest rates. One is that capital goods are cheap. Capital goods have gotten much cheaper relative to consumption goods than was ever the case historically. Think about what has happened to the relative price of any kind of computer and how much of capital is now information technology-related. Another aspect is the emergence of substantial levels of savings and capital export from the developing world and in particular the very large demand for safe assets and liquidity on the part of those who hold official reserves. In any event, a world where real interest rates are generally less than growth rates is a very different world and is likely to be a more debt-tolerant world than the world that we have been accustomed to. How much this will revert and how much we are living in a different world and what consequences of a world where normal interest rates are so low relative to growth rates is a profoundly important question for the future.

Ninth observation, do not forget as you ponder the low level of volatility that the world is a dangerous place. Just as financial crises emerge when people are feeling pretty good, conflicts also emerge when people are feeling content. All is not well on the Korean peninsula, all is not well in the broader Asian region especially the South China Sea, all is never well in the Middle East, and the fact that Iran is not in the headlines right now should not be confused with a durable solution.

As significant as US energy developments are for US economic growth (US shale/fracking advancements have been great), its delusional to think that world oil prices won't still be sensitive to the Middle East developments for the rest of our professional lives. There is a lot of political vulnerability out there.

Tenth observation, the most important long term issue is not getting out of this financial contraction. That will have happened 10 years from now. With reasonable luck, it is not the geopolitical problems that I spoke about a few moments ago. Very likely, it is not the maintenance of financial stability. We have not seen the last global financial crisis but they tend to come more like every several decades than like every seven years. The really large challenge is the combination of what technology is doing and what globalization is doing, but in particular what technology is doing to the relative productivity of different individuals in our society and what that means for the relative distribution of income and rewards and ultimately for social stability. Computers or information technology now drives 3D printing, they drive cars, they can grade school papers more accurately than teachers

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or professors. There are a lot of kinds of things that can be substituted. And for the people in this room who can master all of that stuff, who can direct all of that stuff you have more leverage than you have ever had before and the rewards are going to be greater. But for the people who mostly have to compete with these technologies, it is going to be harder. And, that is going to confront all of our societies with broad challenges. Not challenges that will affect asset prices over the next six months but challenges that are likely to affect how we live over the next generation.

General Q&A:

Q – What are your thoughts on the Fed and the Fed Funds outlook?
A – First, how far are we away from 6.5% unemployment? And, with some probability we are closer to 6.5% unemployment than many people think. As you think about markets, remember that there is enormous uncertainty in any two-year ahead economic forecast. The 90% confidence interval is between 3-4% wide on the unemployment rate. If unemployment is more than expected, they can't bring the Fed Funds rate below zero. If unemployment is less than expected, they can start raising the Fed Funds rate. So as you forecast the Fed Funds rate, you have to keep that asymmetry centrally in mind. The second part of my view is that if we have slow growth, we are not going to keep thinking that 5.5% unemployment is normal. We are not going to keep thinking that 2.5% growth is potential when we have an actual to GDP potential gap. We are going to decide rightly or wrongly that the potential of the economy is less and therefore we are going to decide that we are closer to that potential and that is going to operate in favor of suggesting that we should normalize interest rates.

If you ask people what they thought potential GDP growth in Japan was in 1993, they thought that potential growth would be 3.5% for the next twenty years. So if you take those figures, Japan has a potential GDP gap of 50% but nobody thinks that Japan has a gap of 50%. Similarly, there is a very real possibility that there will be revisions in forecasts for potential GDP growth in the US. When these revisions occur they will operate in favor of tightening sooner than later as they will suggest that the economy is operating closer to potential than generally believed.

Q – What is the likelihood of the passage of corporate tax reform? Repatriation incentives?
A – I doubt it and I doubt it. I would be surprised to see corporate tax reform that was a net revenue loser in this environment. In this environment, unlikely to get these types of reforms passed especially when the biggest beneficiaries of these types of policies would be financial services firms. A windfall benefit to them wouldn't be politically feasible.

On the likelihood of repatriation program being instituted. Also not likely even though its enormously tempting. Call it 15% probability for a combination of reasons. First, it always scores as costing revenue. Second, it is a huge amount of money but really only about technology firms and pharmaceutical firms and there is a limit to their power. Third, we tried this in 2003-04 and repatriation "didn't work".

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Q – Can China transition to a consumption economy from investment without experiencing a lost decade?
A – It has been very expensive to bet against China over the last 30 years. Having said that, history suggests that it is very difficult to move those growth models. I don't think I would put it in terms of a lost decade. I think in terms of two cases. One is Japan which basically had an epochal event after 1989. If you talked about Korea in 1998, you would have said that would have been a history altering experience. Contrary to Japan, Korea didn't experience a lost decade after shifting their model. That is why I am forecasting discontinuity in China without predicting what the aftermath will look like.

Q – When you talked about lower real interest rates, you didn't mention the Gordon/Thiel argument about lower potential for growth in the economy resulting from less technological innovation in the future. What is your view of the Gordon/Thiel line of argument about lower long-term potential for economy?
A– On Gordon/Thiel, you can't have it both ways. It seems to me that there are two dystopian views out there. The first is that over a long period of history standards of living only rose 50%, therefore the norm for society is relative stagnation and that the last 200 years are an exception and that there is no particular reason to think that the next 200 years will be an exception and that is the sort of Gordon/Thiel view. You know we used to send men to the moon, now we have 140 character messages. That kind of thing. That is one dystopian vision. A different dystopian vision is that the vast majority of human toil can be done by machines. That is a rather different dystopian vision because that suggests an enormous abundance of goods and that much more can be done with much less.

I guess I was very influenced by, I can't remember where I saw it, people were asked in the third world which they would rather have flush toilets or their mobile phone? The answer by an overwhelming margin was their mobile phone. That says something about the technological progress of our age relative to the technological progress of earlier ages. The I-phone that I have in my pocket has more computing program in it than the Apollo did. As someone who is concerned about getting and processing information, if I had to choose between full access to the Harvard University library, I teach there and live three blocks away, and no access to my I-phone and vice versa. That would be a really easy choice. And, if you ask in terms of the ability to connect with people all over the world which I would rather have – my I-phone, Facebook and Linked-In or the White House communications system as it stood when John Kennedy was President? I think if you thought about it you would rather go with my I-phone. So I think that one underestimates the significance of the innovations that we currently have underway.

I don't think that you can rationally worry about both dystopian visions. I find the vision of all of this technology creating all of this abundance without quite needing people and what is going to happen to the people to be the more compelling of the two visions. Now the fact that debating the long run potential involves choosing between the two dystopian visions is itself not a happy thing. But, I bet against the Gordon/Thiel line of argument.

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Q – What is your view of inflation?
A – With respect to inflation, the evidence is pretty compelling that industrialized countries do not get to significant accelerations of inflation without significant accelerations of wage inflation and that they do not get to significant accelerations in wage inflation without significant levels of tautness in labor markets. And, if that view is close to right we are in the industrial world at substantial remove from serious inflation threats. If you go back and study the 60s and the 70s, it really took a long time to generate that inflation and it involved a lot of tightness in labor markets. I think we are a long way from tight labor markets and therefore that the risks of acceleration in inflation are substantially less than many people suppose. It is a fallacy to think that liquidity, somehow defined, translates into product price inflation without operating through pressure in labor and product markets. Since our problem right now is that there isn't enough pressure in labor and product markets, I don't see the risk that we are headed for significant levels of inflation. I would include a list of propositions that if it turned out that somehow wage and CPI inflation drifted up to 4.5% in the United States in the next two and a half to three years with unemployment remaining in the 6s, I would say that my reading of how the world worked and my reading of the empirical evidence had basically been wrong. So I have a theory and the implication of the way I think about the world is that at least for some time product price inflation is not a substantial risk. In how many countries in emerging markets will the central bank lose control and the government lose control and resort to the printing press to generate hyperinflation? That will happen somewhere. But in general it is remarkable how little inflation there is in the world today relative to twenty years ago.

Q – What is your view of European austerity measures and the implications?
A – The absence of austerity is a much greater problem when you have a credit-worthiness problem than when you don't. I don't think the United States has a creditworthiness problem. I don't think Britain has a creditworthiness problem. I don't think that Japan, right now, has a creditworthiness problem but I think they are much closer to an edge than the United States or Britain is. In Southern Europe there are real creditworthiness problems. So the idea that they should just borrow and spend more is a problematic idea given the rates at which they can borrow and given the supply curve for funds that they face is not perfectly elastic and the more that they borrow the higher that interest rate is going to be. In Europe the need is to use the parts of Europe that can borrow strongly to help the parts of Europe that cannot avoid austerity so that you get a reasonable level of demand.

Of all the things that people say in these macroeconomic debates, the one that strikes me as the least well-grounded is the German idea that we did it and so can you. The German view that the German model is somehow to be emulated throughout Europe to success overlooks the fact that the German model turned centrally on exporting to the rest of Europe by becoming more competitive to the rest of Europe. Suggesting somehow that if Europe does that as well, they will be able to gain is ludicrous. The one proposition that economists don't debate is the identities and the identities hold that you can't have an increase in exports without having an increase in imports. What is the theory of where the improvement in Southern Europe's

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trade position and ability to repay debt is going to come from if it is not through someone's trade balance deteriorating? When you have a neighbor with a 9% of GDP trade surplus, they are a natural candidate. So I think that the reversal of austerity in Europe is more a matter of continent-wide policy than it is a matter of policy on a country by country basis in the European periphery.

Q – What is the next bubble? And, you cannot say bonds.
A – Well you made it very hard by saying I cannot say bonds. Can I say credit? Can I say very compressed credit spreads? I don't think I would be very likely to lend Rwanda money for seven years for under 7%. Rwanda has a massively oversubscribed bond issue. Credit and emerging market credit is starting to look a little frothy again. There is a lot of yield chasing going on. That is when spreads compress in ways that they probably should not. This is being driven more by the signaling by the Fed of rates staying low for longer than it is by quantitative easing.

Q – What about TIPs being a bubble? You have given an argument that negative real yields make no sense, that the economy is accelerating, and that the return on capital is above the future implied growth rate.
A – First, TIPs are bonds. Second, capital goods have gotten cheap and demand for safe assets globally is very strong. Those considerations operate in the other direction to suggest that over the long term you might have steady low real rates. But if you asked me a Yes or No question about whether TIP yields will rise or fall, I would say that TIP yields will rise.

Q – What are the prospects of Kuroda's policies working? What additional policies would you recommend in Japan?
A – Just so we are clear. I was intending to speak with considerable confidence that what Japan is doing is going to have the effect of raising aggregate demand and raising nominal GDP growth in the short term and I was intending to project a fair amount of agnosticism about what the medium term path of medium term rates will be and what the financial consequences of that will be for financial intermediaries and what the consequences will be for sovereign credit. I wasn't intending to express confident buoyant optimism on that latter set of issues.

Having said that, the first thing to say is that by arithmetic the higher your debt to GDP ratio is now, the more effective increasing nominal GDP is in terms of reducing the nominal debt to GDP ratio. That is when you have a very high stock of debt you get more traction out of growing nominal GDP faster. The most important determinant of Japan's creditworthiness isn't the fiscal decisions that they make. The most important determinant is its success in growing nominal GDP. That is why Kuroda's policies are oriented in that direction. Kuroda's statement of objective seem to me to be relatively well calibrated.

The dimension on which it is unclear – what Japan will do and how much will happen – is the dimension of structural policy, reduction in regulation, openness to foreign investment. I think there is a risk that they are

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in something of a cul de sac. Their two best things in many ways were automobiles and consumer electronics. Automobiles have moved out and they have lost their position of leadership in consumer electronics. It seems to me that when people think about what the equilibrium level of the yen is and perform a purchasing power parity analysis on the yen relative to the past that the relative value of the yen is weaker than those calculations suggest because there has been a structural loss of competitiveness in what were crucial export sectors for Japan. It seems to me that the important policy measures go to structural issues that will increase confidence and encourage spending and may also go to longer term budget policies.

One of the things that has always surprised me is that in the United States the CBO prepares budget forecasts for 10 year periods and longer term forecasts as well. The CBO publishes them every six months and we all obsess about them. By and large in most other countries they don't have those kinds of long term forecasts. So they don't think in terms of pre-committing policy five and ten years out. It seems to me that more imagination about pre-committing fiscal reform further into the future would be constructive and increase confidence in Japan. But that type of discussion, at least in the types of discussions that I have been part of, has been less of a part of the dialogue.

Q – What are the derivative impacts of change in Japanese policy on the rest of the world?
A – Expansionary fiscal policy is unambiguously good for the countries neighbors because it expands the economy and reduces the competitiveness. Expansionary monetary policy is good for the neighbor because it expands the economy so the neighbor can sell you more. But it is bad for the neighbor because the weaker currency affects competitiveness. The usual calculations are that those two things roughly balance each other out. So from U.S. point of view, Japan expanding is all to the good. The more it happens through greater consumption, greater housing construction the better it is. The more it happens through increased exports, less good. The tool that they have expansionary monetary policy operates on both margins. But I don't think that a sensible person upon hearing that Kuroda was abandoning his current agenda would revise U.S. GDP forecasts. They might predict that the Nikkei would fall 25% and the yen would retrace some of its losses. My instinct is that Japan's expansion is good for us.

Q – Why are you dismissive of QE efficacy in the US but embracing of its potential efficacy in Japan?
A – That is a good question. You have much more of an exchange rate channel in Japan than you have in the United States because the US dollar is a reserve currency. That is one part of the answer. The impact in Japan is psychological as a signal of future monetary policy intentions around generating reflation over a long time period. Whereas in the U.S. you have a set of forward guidance policies and you don't have an expectation of the central bank being stuck in the mud. In Japan you had more profoundly distressed asset prices so the reflation of asset price channel has more potential impact. The Japanese policies need to also be considered from a quantitative standpoint. Japan is undergoing somewhere between 2-3 times as much QE relative to GDP than the United States depending on how you think about duration. But in any sensible calculation, they are doing at least twice as much as the United States.

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