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Program

GUEST OF HONOR

THE HONORABLE LAWRENCE H. SUMMERS

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Introductions

GLENN HUBBARD: Good afternoon. I'm Glenn Hubbard, the Chairman of the Economic Club of New York. I'd like to welcome you to the club's 405th meeting in its 102nd year. I'm pleased to say that the Economic Club of New York is the nations' leading non-partisan forum for economics in business. More than a thousand guest speakers have appeared before the club in the past century including our speaker today. Their names are listed in the program. I'd also like to recognize members of the club's Centennial Society. Several dedicated club members sparked the formation of the society in order to sustain the club's financial viability as a speaking platform for the second century of its life. Thus far, 126 club members, including 17 this year, have made personal contributions of $10,000 to the Centennial Fund and are members of the society.

This morning the advanced GDP number came out 3.5% for the third quarter. Our distinguished speaker today will have, I'm sure, some thoughts on that number and many others. We are obviously very honored today to welcome the Honorable Lawrence Summers, the Director of the National Economic Council. Until January, Larry was the Charles W. Eliot University Professor at Harvard. He was the 27th President of Harvard University from July, 2001 until June, 2006. From 1999 to 2001, he was the nation's 71st Secretary of the Treasury following his earlier service as Deputy and Under Secretary of the Treasury and Chief Economist of the World Bank. Larry's a legendary economist to all of us who have known him well for many years. His research contributions are too many to mention. He is a recipient of my profession's John Bates Clark Medal given every two years to the outstanding American economist under the age of 40, the first social scientist to receive the NSFs Alan Waterman Award for outstanding scientific

achievement and many other honors. Director Summers, Secretary Summers, Larry, welcome to New York. The floor is yours.

LAWRENCE SUMMERS: Glenn, thank you very much for that comprehensive introduction. I used to be asked when I first came to the Treasury what's different about working at the Treasury and being a Professor at Harvard? And I used to answer that the biggest difference was that, as a Professor at Harvard, the single worst thing you could do was to sign your name to something you had not written yourself. On the other hand, as a Treasury official, it was a mark of effectiveness to do so as frequently as possible. Then I had the opportunity to return to Harvard and serve as its President and people asked me in those first months, what was different about being the President of a University than serving as the Treasury Secretary? And I gave an answer in retrospect was breathtaking in its naïveté. I used to say, Washington is so political. Well, I'm glad to be back in Washington, glad to have an opportunity to advise President Obama and his economic team and honored by the invitation to return to the New York Economic Club.

When I last spoke here as Treasury Secretary in September of 1999, I remarked that history was important for the understanding that it affords as well as the humility that it imposes. I suggested that just as the world in 1999 looked very different from the world in 1989, that I had no doubt that the world in 2009 would look very different from how it did at that time. I went on to distinguish in discussing the appropriate way of thinking about the economy at that time between the Keynesian theory that was appropriate to situations of low private sector demand, substantial excess capacity and limits on the scope of monetary policy, and to distinguish that view of the world which I suggested was not the right one for that time from the alternative paradigm that

was relevant to a moment of surging, borrowing and investing and fully employed resources. That same distinction appears very relevant today after the reminders about humility that the last two years have provided us.

This morning we learned that GDP in the third quarter of this year was 3.5%, the highest level of GDP growth in two years, a stark contrast to the decline of 6.4% that the economy suffered just two quarters ago. After four quarters of negative growth, this is welcome news and a testament to the efficacy of policy efforts to promote recovery and stimulate demand. Today's news underscores the tremendous progress we have made this year. The acceleration in economic output over the past six months is the largest recorded in more than a quarter century and confirms that the American economy is turning a corner. Consider how far we've come.

Nine months ago the debate was about whether the recession would turn into a depression. Today the debate is about the timing of the end of recession and the shape of expansion going forward. Nine months ago financial markets priced in what might be called a substantial Armageddon tale. Today people worry about whether there are some bubble elements in credit spreads or in a stock market that has risen by more than 50%. Nine months ago the economy was in freefall. It had lost more jobs in a single month, quarter or year than at any point in American history. Today the question is at just what date job growth will resume?

I would suggest to you that events did not have to work out this way. There was no assurance that the contraction that followed the Lehman collapse would be contained. What happened? How to think about the economic events of the previous year and the mechanisms of their

unwinding in recovery. One of the most important lessons you learn in any introductory economics course involves the self-stabilizing properties of markets. We teach our students about how when there is an excess supply of wheat, prices fall, people grow less; people consume more, and the market equilibrates. We tell similar stories about the supply of credit and investment. That's what Adam Smith had in mind when he talked about the invisible hand. We use as a metaphor the self-equilibrating character of a thermostat in which things return to their normal level.

The vast majority of the time that is the right way to think about how markets work. But it was Keynes' central insight that perhaps several times a century the self-equilibrating properties of markets break down and stabilizing mechanisms are overwhelmed by mutually reinforcing vicious cycles. The right metaphor ceases to be a thermostat and instead becomes an avalanche. When President Obama was preparing to take office last Winter, he faced an avalanche unlike any we have seen in our lifetimes, a combination of irresponsible borrowing and lending decisions on a massive scale, regulatory failures, unsustainable bubbles in key asset markets and a massive erosion of confidence created an extraordinarily dangerous economic and financial situation.

Vicious cycles associated with deleveraging took hold. A liquidation cycle where financial assets fell in value forcing their sale by those unmargined pushing their prices even lower. A capital losses cycle where lower prices on assets reduced institution's capital leading to less lending, lower asset values, continuing the downward spiral. A credit accelerator cycle where a weakening economy led to a weaker financial system, which led to less lending, which led to a

weaker economy. A Keynesian vicious cycle where lower spending led to lower incomes, led to lower employment, leading to lower spending, continuing the cycle. And at the worst of it, a panicked vicious cycle where individuals saw financial institutions in trouble rush to withdraw funds, creating self-fulfilling prophecies that institutions were, in fact, in trouble.

Starting in the Summer of 2007, but accelerating last Fall, these five mutually reinforcing vicious cycles created an extraordinarily dangerous situation. It created a situation in which one could not rely on the self-stabilizing properties of markets. Toward this end, the President moved vigorously to attack the vicious cycles I have just described at each of their key notes. The key steps are familiar. Substantial, direct, support for income spending and job creation through the fiscal policies embedded in the recovery act. Support for financial confidence through the activities of the central bank. Transparent stress tests and encouragement of capital raising by major financial institutions. A global effort to support, demand and divert financial panic, and in particular, to assure a continued strong flow of capital to emerging markets. Steps to support the flow of credit directly to homeowners and small businesses, and to contain the potential vicious cycle associated with foreclosures.

The result of these measures has been the partial reversal of the vicious cycles that were pulling the economy downwards. Panic selling has been replaced by anxiety about missed opportunities. Anxiety about capital levels has given way to eagerness to pay back government funds. A stronger economy has strengthened financial confidence which then has fed back to the economy. To borrow from Churchill, we are not at the end or even the beginning of the end to promote economic recovery, but we are perhaps at the end of the beginning as the economy turns

a corner. To be sure, crucial problems remain. Unemployment continues to increase. While given the seriousness of the recession, businesses are doing perhaps surprisingly well. Much progress comes to the bottom line from reduced costs rather than the top line of increased sales and flows of credit are certainly not yet fully normalized even as pricing has improved.

Today our economy face an economy facing an overhang of excess debt. We continue to confront the challenge of spurring demand in an environment in which borrowing and spending have been sharply reduced. At this point, a lack of demand is the major constraint on output and employment in the American economy. The pace of economic growth will depend importantly on the extent to which policy is able to support demand directly or indirectly. Measures that raise demand carry benefits in a number of forms. The direct impact of the spending and investment, the indirect effect as those who benefit in the first round from spending and investment increase their spending and investment and the increase in the economy's long run potential that prudent investment can bring about.

Through the Recovery Act, government has taken up slack in the economy and made important public investments. Yet even with the dramatic action of the Treasury and the Federal Reserve, the total level of borrowing in our economy is actually lower than in normal times, not higher. Accordingly, the volume of securities that have to be absorbed by market participants is lower, not greater, than normal. This is, however, a profoundly temporary state of affairs. As economic recovery takes hold, it will be essential to assure that expansionary policies appropriate to a downturn are withdrawn. That is why President Obama has consistently emphasized the

importance of fiscal discipline and why the process of reversing extraordinary interventions in the financial system has already begun.

This is not only a matter affecting the economy over time. Even in the near term, expectations of future policies have a direct impact on both capital costs and confidence. So policy signals will be very important. I should say in this regard that while legislative discussions continue, we are confident that health care reform will have an important positive impact on the long run health of the federal budget. To encourage businesses, consumers and investors to spend and invest, we must foster an atmosphere in which they feel both that recovery can be sustained and that the economy is returning to a long run sustainable path. No actions to combat short run output gaps must ever be allowed to call into question our fundamental national commitments to sound money, non-inflationary growth and sustainable evolution of government debt. An atmosphere of confidence is central to our efforts to raise demand and in turn to enhance economic growth. This will depend on appropriate fiscal discipline.

How then to think about economic recovery that is not driven by unsustainable consumer borrowing and spending or by the public sector? By the way logic of national economic, national income accounting, it depends on three things. It depends on private sector investment, it depends on exports and it depends on income growth that can support consumer spending increases. And let me say a little bit about each of those three things.

Given the capacity utilization is at very low levels, it is inevitable that private investment will lag for some time to come in some parts of the economy. But in a variety of other spheres, private investment will be profoundly important for the next economic expansion. That is why the president has emphasized measures to support the availability of credit for small business. That is why the public sector is taking a crucial role during this period in the financing of new houses. But experience with U.S. economic growth, think of the information technology boom of the 1990s or the successful and rapid growth of the ’50 and ‘60s or even the 1920s, suggests the importance of strong actions in key sectors. Two cutting edge sectors for the American economy at this juncture are energy and environment and information technology. We are currently working with Congress on major cap and trade and energy legislation to build on the substantial steps contained in the Economic Recovery Act to support both energy efficiency and renewable energy and in the legislation more efficient and effective exploitation of our traditional energy resources.

Turning over the capital stock more rapidly to meet environmental and energy independence objectives can be a significant contributor to aggregate demand in the short and medium term even in the presence of significant unused capacity. Certainty, if provided, as to the likely price path for energy can also be a spur to investment. It has been demonstrated again and again that the greatest barrier to long term investment decisions is residual uncertainty. If we are able to resolve uncertainties in the investment area, there is substantial scope for increased investment and demand in this key sector. We are also working to support what is dominantly a private sector undertaking the improvement of our information technology, infrastructure investment in this country. Our broadband program is a complement to continuing efforts to knit the country

together in very important ways. With respect to the health care system, these issues are important as well. It cannot be right that an average 7-Eleven uses more information technology than the average doctor's office at a time when lack of record keeping is thought to be associated with tens of thousands of unnecessary deaths each year in the United States. Investments in the Recovery Act directed at stimulating private investment in this sphere can both contribute to our economy's long run potential and to increasing demand in creating jobs in this short run. Promotion of investment is one key component of an economic strategy.

A second key component is support for increased exports. During my time in government in the 1990s, I was fond of warning that the world economy could not fly indefinitely on a single American engine and expressing concern about the then magnitude of our current account deficit. In fact, it flew rather longer and rather stronger than I would have imagined at the time, but even stopped clocks or right twice a day and ultimately after 2007, we saw the undoing of the world's unbalanced growth strategy. If our economy is to enjoy the growth it needs and if the world economy is to be stable, a reorientation towards a more balanced global growth strategy will be essential. That is why I believe the decisions taken this year to establish the G20 as a central global economic forum including all of the major emerging market countries will prove to be of historic importance. That is why the framework agreed in Pittsburgh for rebalancing global growth has great potential. You know, rebalancing has to be reality rather than rhetoric. At a time when we cannot afford to have consumption share of GDP rising from starting levels above 70%, the world economy will under perform. If China continues to have a consumption share of GDP that declines from initial levels below 40%, rebalancing is an additional component of a sound long run private sector led growth strategy. We're also working to

support U.S. exports by again putting the weight of the U.S. government behind U.S. producers in international competition, working to relax export controls that no longer serve valid national security purposes and to make sure that our trade laws are fully enforced for the benefit of U.S. producers. Stronger exports, stronger private investment

Ultimately, of course, what happens to the economy will depend crucially on what the consumer does. Consumption is by far the largest component of our GDP. Here it is important to recognize in thinking about the medium term just how depressed certain consumer related expenditures are relative to long run norms. Allowance for normal scrapage plus a rising population requires the sale of some 15 million automobiles each year. Automobile sales are currently running between 10 and 11 million. New family formation results in a demand for somewhere between 1-1/2 and 2 million new housing units each year. Housing starts are currently running closer to half a million. At just what point these figures will normalize is difficult to judge, but that moment will come and will come with significant impetus to the economy. So also we can promote growth in consumption while not encouraging unsustainable borrowing if we are able to raise levels of consumer income. Health care reform has an important role here. If it is successful in containing the growth rate of costs, it will accomplish some combination of reducing businesses' hiring costs and increasing households take home income. So also over the longer term, the ultimate determinant of what workers earn is their productivity which depends crucially on the education that they have received. By supporting investment, by supporting exports we lay the foundation for private sector led growth.

Keynes, in talking about Britain's economic problems in the 1930s, referred to them as a magneto problem. I have since learned that magneto was a British term of that part of history for the alternator of a car, and what he meant was that a cyclical downturn like the one that Britain was suffering at that time did not reflect a profound inability of the economy to produce, but instead reflected a breakdown of the economic mechanisms that manifested itself in a lack of demand. And that is importantly true in our country today, and that is why so much of the focus of our policy for the very short run has been on encouraging demand, on expanding the flow of credit. Ultimately though, if we do this in the right way, we will also succeed in increasing our economy's productive potential and increasing the character of our economy's ability to include everyone in its prosperity. That is why, and I would be remiss of my concluded without remarking on this subject in New York, that is why financial reform is such an important part of the president's economic strategy.

Over the last generation, all of us in this room have seen the Latin American debt crisis, the 1987 stock market crash, the S&L debacle, the Mexican financial crisis, the Asian financial crisis, LTCM, Enron and the NASDAQ bubble and now the events of the last two years. It works out to almost every three years for a generation there has been a substantial crisis in which a financial system that has as its fundamental purpose the dissemination and diversification of risk has misfired and has proved to be a source of risk leading to the loss of jobs for hundreds of thousands, if not millions, of people. Establishing a sound foundation for recovery, in addition to spurring demand and in addition to raising the economy's productive potential requires a serious and collective effort by all of those involved with the financial system in the private and

the public sectors to strengthen its stability, to increase regulation and to make the kind of risks that we have seen in the past less likely.

So I conclude where I begun. We have come a long way over the last year. We are in many ways in a better and stronger position than appeared likely at that time, but we still have a long way to go in moving the economy forward, in increasing its ultimate potential and in assuring its more stable and steady growth in the future. Thank you very much.

GLENN HUBBARD: Thank you very, very much, Larry, for those excellent remarks. As is the club's tradition, we will have two member questioners, David Malpass, who is the President of Encima Global and a trustee of the club and Rodge Cohen, the Chairman of Sullivan & Cromwell and a past trustee. David, first question is yours.

DAVID MALPASS: Thank you, Glenn. Dr. Summers, thank you very much for speaking to us. It was very interesting. I think I understood most of it, but don't test me. I want to ask you about the top marginal tax rate both on the individual side and on the corporate side. After tax returns are critical to job creation, the U.S. has one of the highest corporate tax rates and we're going to be raising the individual – the top marginal tax rate substantially on individuals and small businesses. So I want to ask you how will that affect the incentives to work particularly for small businesses? Thanks.

LAWRENCE SUMMERS: I think that in the short run, our constraints are more on the demand side than they are on the supply – are more on the demand side than they are on the

supply side. You know, David, this is a question where you and I are probably going to not agree completely. As I look at the evidence on the 90% tax rates at the top end that we had in the 1950s until 1964, the 70% tax rates we had at the top end from 1964 to 1980, the 50% top tax rates that we had in place for the vast majority of Ronald Reagan's presidency, the 39% tax rates that we had in place during the 1990s when the economy created 23 million jobs, I don't find there to be much evidence that would suggest that raising top marginal tax rates from 35 to 39%, as would be implicit in the repeal of the Bush tax rates, would do substantial damage to incentives in the economy, and I'm much more struck that lack of spending power on the part of middle class families is likely to be a constraint on economic growth and that excessive government borrowing, which is not an alternative to spending cuts or to tax increases, but only a way of postponing them with interest is likely to be a problematic – is likely to be much more problematic.

So I don't think any of us should be under an illusion that somehow the whole fiscal problem can be solved by addressing any single segment of the population. But it does not seem to me that prudent changes in taxes of the kind, for example, that were contained in the president's budget would seriously threaten incentives in any important way. Though none of us would want to go back even to the kind of regime that was in place through most of Ronald Reagan's presidency. On the corporate tax, the issues are a little different. The statutory rate is, as you note, quite high by international standards, but if you use what, in some ways, is the more relevant number, which is how much taxes are actually paid as a share of profit, there the American figures are actually quite low by historical standards. So I think there are important issues – there are issues around the height, the level of the rate. There are also issues around the fraction of profits that

are actually paid in taxes, and so I think those are the issues you have to look at in thinking about corporate taxes.

RODGE COHEN: Let me begin by thanking you for a message which was positive in not only its current assessment, but really even more so for its comprehensive approach for proceeding into the future. First question is based on the fact that over 100 small and medium size banks have failed this year including seven just last Friday. Many observers have suggested that the number could reach 500 to 1000, which is consistent with the very sharp increase in the FDIC's troubled bank list. Some have suggested that this failure rate is not worrisome, but others believe that such a failure rate will be very damaging to local communities and will reduce small business lending. Do you share any of the concerns, and if so, what remedial or preventive actions do you think might be effective?

LAWRENCE SUMMERS: Something interesting, when somebody is the leading observer of the banking system and then they say many observers believe of the banking system. They believe that mostly because you told them, Rodge. I don't think anybody can look at what is out there in banking system with any sense of complacency or serenity. And I think it is almost certainly the case that once one moves behind – beyond the largest institutions, there is, as you suggest, a fair amount of pent up difficulty. As you know much better than I, much, but not all of it, is associated with commercial real estate. And so on your first question, is it a matter of concern? Absolutely.

If you then ask well, given that it's a matter of concern, what is the right approach? There is always a temptation at moments of this kind to deny and to try to keep everything going regardless of economic reality. We do not think that that is the prudent approach while the decisions are made by the appropriate regulatory authorities of whom I'm not one. The administration has I think been very clear on wanting to have a philosophy of addressing problems and putting problems behind us. The administration has, and the president recently announced, a commitment to be prepared to make additional capital available to small banks on very favorable terms in order to support increased lending to small business. Clearly, this is the sector where the greatest concerns about credit flows exist.

If one looks, for example, at the housing sector, a very large share of the lending is in one way or another supported by the Federal Government. We don't have mechanisms that are of comparable scale relative to the lending flow for small business. So increased efforts by the Small Business Administration, increased efforts to provide capital to financial institutions that are most likely to lend additionally to small business are very important, and as you know better than I, successful resolution and prompt resolution of banks that have to fail ultimately serves the objective of adjusting loans and restarting credit flow and we would be very reluctant to do anything to interfere with that process.

We are on the lookout for measures that can help these adjustments go through more effectively such as the REMIC changes that were announced recently to promote the flow of credit in the commercial real estate sector. I do think this is a time when as we think about cooperation between the public and the private sector, it is important for financial institutions to remember

the stake that we all have in adequate credit flow and the desirability of engaging the virtuous circle of increased lending supports asset values, which supports collateral values, which supports increased lending, and that is something we certainly want to encourage and try to bring about.

GLENN HUBBARD: David?

DAVID MALPASS: I'd like to ask you about the residential mortgage market and I'll mention two problems and wonder your response. One is the Fed is buying a big percentage of the conventional mortgages, so the trading volume in that market has gone way down and it would be hard to restart that market once the Fed's not an active participant. The second problem is the one of non-conventional mortgages where there's been a blurring of the first lien and the second lien. So it's going to be very hard to restart that mortgage market, non-conventional mortgages, because there will be the risk that the second lien trumps the first lien as is being done with mortgage modifications. So my question on that second one is do you think of it as a one time problem or deviation from contract law or what's the plan to restore first and second liens?

LAWRENCE SUMMERS: So let's see. Your first question is have you stopped beating your grandmother and your second problem is – your second question is are you going to always abrogate contracts or are you just going to abrogate contracts willy-nilly just once? Is that sort of the question you're asking? Gosh, I'm really glad to be here, Glenn. It's really terrific. If I do a good job, can I come back and just have a one on one discussion with Mr. Malpass.

Look, on your first question, we are – we didn't know it, but for a long time, we had an unsustainable and untenable housing finance system in the United States. It was a classic example of the no problem as you pass the 30th story on the way down, but you're getting closer. And how that's all going to be rearranged, I think is too early – it's too early to make a judgment on, but clearly, we're going to need to – clearly a great deal of thought is going to have to go into what that system looks like when conditions normalize.

I'm not into the details closely enough to want to speak in front of a thousand people about second liens versus first liens. I would just say that we have a very strong commitment to the rule of law that the approach does not have as its direction the inappropriate abrogation of contracts, and I think that there is some confusion in a range of financial spheres about the role of government with respect to contracts. I know that issues not totally dissimilar to the ones you raised have come up with respect to our transactions with the automobile companies where I am familiar with the details.

The government functioned as a dip lender. Dip lenders make judgments about how different classes of creditors are going to be compensated. They are constrained to make those judgments so as to assure that each class gets more than they would in a liquidation. Beyond that, they are not constrained from pursuing proper – pursuing what they see as their appropriate business objectives. And if you compare, for example, the automobile deals that were done with the fully private sector, steel arrangements that were negotiated with VEBAs, in fact, in many of the steel arrangements, the VEBAs did better relative to other private creditors than they did at Chrysler or at General Motors. Nonetheless, there's all this talk about abrogation of contracts for the

benefit of unions when, in fact, what was being pursued was a quite natural and quite normal dip lending strategy. That's a different context, but I only say it to illustrate that the publications that you read are not always entirely authoritative in their judgments on questions of this kind.

GLENN HUBBARD: Rodge, last question.

RODGE COHEN: Most of the focus on government deficits has been at the Federal level, but the deficits at the state level, which are currently being masked by the stimulus funding, are arguably even more alarming particularly because the states lack the power and seemingly the will of the Federal Government to deal with their deficits. My question is do you see a role for the administration in dealing with this issue?

LAWRENCE SUMMERS: It's important to recognize the administration has taken really important steps in the stimulus bill in the Recovery Act. You know, on one estimate, an additional 14,000 teachers would have been laid off in New York City alone without the Recovery Act and there are estimates suggesting that figure could be as much as 250,000 nationwide. Very substantial support to state and local governments has been provided to meet Medicaid obligations that otherwise probably wouldn't have been possible to meet. I'm not going to get ahead of the president's 2011 budget, which will be released, of course, in late January or early February, but I would note that the Recovery Act does contain substantial and continuing funds for state and local governments not just last year, but through 2010 and it is a situation we are watching very carefully.

We have taken a number of measures such as the Build America bonds that provide a tax credit rather than the traditional municipal bond tax exemption that are directed at expanding the availability of credit to state and local governments. So I'm not in a position to forecast future Federal financial actions, but I would agree with you that the situation in state and local governments is a matter of significant concern and it's a matter of significant concern either way in a sense. It's a matter of significant concern if debt is accumulated in an unsustainable way. In many cases, that's not possible because of state constitutions, and so it is a matter of concern in a different way if there are unsustainable spending cuts or distressingly procyclical tax increases at the state level. So these are situations that we are watching with very great concern.

I would say – I would come back to something I said at the beginning of my remarks when I talked about vicious cycles and virtuous circles. To some extent, actually probably to a fairly significant extent, as the recovery proceeds, there's the prospect that increased economic growth will translate into increased revenues and for a variety of reasons, those affects are particularly pronounced at the state level. And so, I think the states are not likely to be an independent source of major problems because if the problems are otherwise on a trajectory to being solved, more rapid economic growth will operate to improve state and local fiscal situations.

GLENN HUBBARD: Thank you very much. Thank you again very much, Larry, for taking the time to be with us today, and, of course, to David and Rodge. Enjoy the rest of your lunch. The club's next meeting will be on November 16th with Fed Chairman Bernanke. Thank you.

(END)