Dean Brown: This is a terrific event for us, another in a series of great events sponsored by the Elliott School’s Institute for International Economic Policy. I am often asked “What makes the Elliott School a great place?” Of course, one of the things that make this a great place is our location here in the heart of Washington, D.C. And if you see a very large Marine Corp helicopter go by with the presidential seal on the side, please pay no attention. It is just another day at the Elliott School. Here in the neighborhood, in fact, if you draw a line from the White House to the State Department and another line from the IMF and the World Bank to the Fed, then you will find that those two lines literally intersect at the Elliott School. And if you draw those lines carefully then they will intersect right in this room. Not that I am trying to put any pressure on our speaker. So, our location is really quite extraordinary, and it allows us to do things like this, to bring leading experts to our campus to exchange thoughts with students, faculty, alumni, staff, and other friends of the university. We launched the Institute for International Economic Policy in 2007 to take advantage of our location and to shed light on important international issues. I wish I could say that we knew in 2007 what was going to happen on the economic front in 2008, but if we were that prescient, we would be wealthier than we in fact are. But, the Institute has taken full advantage of its great circumstances. It has held many terrific events over the past two years such as seminars, lectures, workshops, and conferences, and has launched some important research efforts as well. Today’s event will get the current academic year off to another terrific start. To say more about today’s event and to introduce our speaker today, it is my pleasure to introduce the director of the Institute for International Economic Policy, my colleague, Professor Stephen Smith. Stephen…

Professor Smith: Thank you Michael. It is my great privilege to welcome Steven Pearlstein, a 2008 recipient of the Pulitzer Prize, which was awarded for his insightful column that explored the nation’s complex economic ills with masterful clarity. Many of us follow your columns that have recently included “On Rethinking the View that Letting Lehman Fold was a Mistake,” “Whistle Blowing on Overlooked Wall Street Abuses,” and “Calling to Task Politicians Making Preposterous Claims About Proposed Health Care Reforms.” Mr. Pearlstein joined the Washington Post in 1988, and in 2003 became the Post’s Business Columnist. From which perch, as the Pulitzer bio put it, he has been offering edgy and unpredictable opinions on local, national, and international topics. Mr. Pearlstein, we are honored today to offer you our perch. Welcome to The George Washington University.

Steven Pearlstein: Thank you Stephen, and thank you all for coming. Since this is a rare opportunity for me to speak at an academic institution, I am going to start with a quiz. This quiz is only open to students and alumni, not to any professional economists. Political scientists can also participate. So, the question is: How is international economics implicated as a cause of the recent financial crisis and the global economic downturn? How is international economics implicated in the cause of the financial crisis? Anyone want to take a stab at that? Well, we have an alumnus here who wants to take a stab at it. I hope he is not an alumnus with a PhD though.
Steven Pearlstein: What is your name?

Audience Participant #1: My name is John Gardenier. I am a 1973 graduate of the School of Business. If I had been born at a later time, I would probably also have a Masters in International Affairs from the Elliott School because, in later years, that has sometimes been accompanying the graduates from the Naval Intelligence School. But, I attended that august institution well before it had a GW connection, and so I missed that. But in any case, I have been interested in the world ever since and I think there are many ways in which the global financial crisis is related. The whole issue of globalization means that there is greater connectivity and trade throughout the world, having some positive aspects, and some negative aspects of course. On the one hand, there are freer markets for under-developed and developing countries, but on the other hand, in some cases, it facilitates their exploitation. But, the more direct issue for your question is on the internationalization of global finance. We now have a global financial currency market that does over three billion dollars per day in transactions.

Steven Pearlstein: That would be trillion I think.

John Gardenier: What?

Steven Pearlstein: Billion or trillion?

John Gardenier: Trillion, three trillion dollars per day in currency transactions alone. Various countries, most notably Great Britain, have made financial trading, financial instrument manipulation if you will, a major part of their national economies.

Steven Pearlstein: I am going to stop you. So, your answer is globalization of finance helped to spread all these things around and all this money sloshing around was implicated in the cause.

John Gardenier: Right, it is because everybody is competing in some of the same financial markets, and therefore they try to keep up and occasionally get too greedy.

Steven Pearlstein: Ok, and who else? Yes sir, another alumnus.

Audience Participant #2: (inaudible)…Part and parcel of that, the risk was not sufficiently spread out.

Steven Pearlstein: How does international economics play into that? I mean, that is a true statement.

Alumnus: From an international finance prospective.

Steven Pearlstein: Ok, anyone else? Yes madam…

Audience Participant #3: Investor demand for yield.
Steven Pearlstein: Investor demand for yield. Ok, but why is international economics…that’s true…investors all around the world were looking for yield. But…

Audience Participant #3: (Inaudible clarification)

Steven Pearlstein: Ok. That was getting close. Is there anyone else?

Audience Participant #4: Well, I think part of the problem is that faith, and study, in international economics in the fiscal hand that, if we just allow capitalism to run free, will take care of itself in the end. And, it does not address the need for regulation.

Steven Pearlstein: Ok, anyone else?

Audience Participant #5: It has to do with the title of your talk, “Global Imbalances.”

Steven Pearlstein: And what does that mean?

Audience Participant #5: Well, China is running a large current account surplus (inaudible) oil exports (inaudible) the role of financial markets (inaudible).

Steven Pearlstein: Well that is getting to it. That is pretty much it. So, we can think about what went on last year in two ways: We can think of it as a story about bad guys or we can think of it as a story about regulators who did not do their jobs. We can think about it as a story of brokers who made loans, mortgage loans, to people they should not have made and were almost fraudulent. We can think about it as a story of rating agencies who were hopelessly compromised because their services were paid for by the issuers of the bonds that they were rating. We can think of it as a problem of investment bankers who were packaging all these loans and slicing and dicing them in ways that were even more complicated than they themselves knew. We can blame economists and risk economists for failing to understand the dynamics of markets and risk analysis for failing to understand that it was in fact possible for real estate across the United States to all go down at the same time, even though it had not happened at any time during the post-World War II period. We could blame all of these people and more. For those of you who remember the movie that is sort of like the movie about the Orient Express, “The Murder on the Orient Express,” who did it? Well, they all did it. But there is another way to think about this, and it is the way that a macroeconomist would think about it. That story goes something like this: The richest country in the world lived beyond its means, seriously beyond its means for ten, fifteen, twenty years, and if this country were any other country in the world, that would not have been allowed to persist because that country’s currency, to keep running these deficits, to keep consuming more than you produce, and investing more than you save, running current account and trade deficits, would cause something to happen to your currency. It would go down. And because the currency goes down, it is more expensive to import things and, actually, your goods that you export are cheaper, look cheaper to the rest of the world, and so the system equilibrates. And that is how free-floating currency is supposed to keep
everybody sort of in line. But our great advantage is that the world’s reserve currency, and the currency in which a lot of things are denominated, even if they are not made here, like oil and commodities, is our currency. Our currency did not go down because there were a lot of people who did not want it to, and those people were the people who sold us stuff. They sold us oil, as the gentleman mentioned. They sold us raw materials. And mostly they sold us sneakers, computers, clothing, and things like that from Asia. Those countries all wanted to sell us things so badly that it was important to them to keep selling and to keep growing their sales that they did not want that currency to equilibrate, they did not want that currency to adjust and to keep things in balance, so they pegged their currency to our currency. The way they did that was when we paid them in, lets say we paid them in dollars for all this stuff, they did not go to the currency market, which is a big market at three trillion dollars a day, and trade it in for their own currency. They said, “Nah, we do not want to do that because we want to keep this game going, so we are going to take that money and we are going to reinvest it back into the United States. We are not going to exchange the dollars, we are going to take those dollars and invest them in dollar-denominated financial assets.” So they bought stuff. They bought real estate, they bought some common stock, but mostly what they bought was United States treasury bonds, and particularly, Fannie Mae bonds, Freddie Mac bonds, and Federal Home Loan bank bonds, what is called Agency bonds, and they bought them in huge numbers. And that had the effect, as all of you who take economics know, when you buy a lot of bonds, of driving up the price of the thing you are buying a lot of, but when you drive up the price of bonds, you drive down the yields and interest rates. So, they drove down interest rates and created the largest credit bubble that the world has ever seen.

Essentially, this was a mechanism of seller finance. They wanted to sell us stuff, so they sold it to us and then basically lent us the money to buy it. That was our money that we had paid them and they lent it back for us to buy. They kept this going year after year after year, creating this great bubble because it was a mutually advantageous arrangement, or so it seemed at the time. Particularly, in the countries of Asia, but also in Middle Eastern countries, billions of people were lifted out of poverty. It is really a great success story because probably more people were lifted out of poverty in a shorter period of time than at any time in the history of the world. They put them to work, typically, think about it in terms of coming in from the countryside, where they were under-employed in China and Vietnam and places like that, and they worked in factories and they (we do not think they earned much but they thought they earned a lot relatively speaking) and their countries got a lot richer, and they sent money back into the countryside which created a lot of jobs. So, it was very mutually advantageous for them, and they wanted to keep it going and still do.

For us, it seemed great. People were throwing cheap goods at us because they are really cheaper then they ought to have been, and we had cheap money to buy them with. We thought it was great, and so we borrowed a lot. That is what that current account deficit is, an accounting mechanism, for how much we borrowed. We borrowed that much. We borrowed as much as $800 billion dollars a year, at the height, which was what, six, seven percent of GDP. Any other country in the world that ran a current account deficit like that would have had a terrible crisis, but we did not, in fact, we had great prosperity. And, on top of this financial bubble, first of all, it was not just a sub-prime bubble or a mortgage bubble; rather it was a bubble of great proportions, all sorts
of credits, auto loans, home equity loans, corporate take-over loans, and student college loans.

We had a bubble on all of those things, all of which were packaged, chopped up, and sold, so the financial bubble created, in effect, a bubble economy because people used this money to buy things that they otherwise could not afford, and this demand for all of the things that we were buying, some of which were foreign, but some of which were not, caused our economy to expand. We had really good growth rates and everyone thought this was great, or at least seemed great. However, it was a mirage because it was based on levels of debt, levels of household debt, and levels of government debt, because we continued to run, even during this good period, very large federal budget deficits that we could not sustain over time. It was really based on a false valuation of our currency. Since money is cheap, particularly because of financing being cheap, it causes the value of assets to go up. Since it costs less to borrow a financial asset, or a real estate asset, if interest rates go down, then the value of the asset almost always goes up, almost in direct proportion. Therefore, it also drove up the value of stocks, and real estate and such, and it caused a lot of extra demand. As Herb Stein famously said, “Those things that cannot go on forever do not, although they tend to go on for a lot longer than you think they can go on.” And this one did, but eventually it stopped. It stopped because investors overseas realized that there was a limit to it and they stopped buying it, and then the whole thing started to crumble.

I tell that story because, notice when I told that story, there were no bad guys there. There were no bad guys in that story. That happened irrespective of the fact that there were those ratings agencies and the regulators and all those bad guys. I did not mention that. That happened, and that would have happened even if there were not some of the bad guys. There would have been enough pressure building up behind the dam that somewhere there would have been a weak place, or two, or three, and stuff would have come out. It just so happened that it came out in the way that it did. But in a market economy you can pretty much be sure that it would have come out a lot of place. And in fact it did come out a lot of place. Remember, its not just about home mortgages. With take-over loans, there were no bad brokers, there were no bad regulators, there were none of those people involved in those take over loans, and yet, you had companies like Blackstone buying commercial real estate for ridiculous amounts of money in the end. Money and assets that today are worth half of or less, just a year and a half or two years later, than what they paid for them.

So, this is sort of a problem for those of you who are economics students. But, which is it? Is it the bad guys? Or is it these macro-imbalances that sound so theoretical. Okay, you can understand it, you can draw it on the board, you can take a quiz, and you can answer the questions, but which is it that really causes this thing? How do you explain it? What is the story that makes sense? I should tell you that I am not an economist and always have to tell that in the speech. I just play on television. In fact, I never have taken an economics course. When I was going to school, economics was considered not very cool, in fact, it was considered very un-cool, only the straight kids went to economics class. In fact, at the college where I went, it was the only department that continued to require, unlike the rest of the school, that you wear a tie and jacket. It was taught by very conservative people so I never took economics. But, I have had to learn a little bit about it.
One of the things that I find fascinating is that when you talk about all the bad guys, and all the little things that were done wrong, that is often referred to as microeconomics, and when I talk about big imbalances, current account imbalances, supply of money, and such like that, that is usually in the province of macroeconomics. One of the curious things about economics is that the macro guys do not talk to the micro guys and the micro guys do not talk to the macro guys, and so they never actually get together and tell a story that is really three dimensional and explains the way the world is. They tell either the macro story, and so that caused everything, and the other stuff was just a consequence, or they tell the micro story and they say the other stuff was just noise, or in the background. One of the problems of economics is that these things are still not well-integrated.

One of the things that I try to do is to tell stories, which is what a journalist does, and try to tell three-dimensional stories, which is not as easy as you might think because it is hard to reconcile these two things and figure out what caused it. Let us think about what happened. As a rough rule of thumb, we were living in this country at 6% beyond our means, and that is because we were consuming about 6% more than what we produced. There are economists here, I know you are going to start quibbling with me, who say, “You know there are also investment flows, “ but let us just think about consumption to simplify a little bit: we were living beyond our means by about 6%, and in terms of households, we were not saving at all, which is a bad thing. We thought we were saving because people thought the value of their house was going up and that their stocks were gaining value. Their stock portfolios were going up so fast that they thought, “Well why do we need to save?” That was a form of saving and they thought that they were saving, but what was being accepted was a mirage.

We were consuming about 106% of what we produced. Now, when you think about it, what would be healthy? I mean, you have to save, and in an aging society, you had better start saving for retirement now that your portfolio is a third or two-thirds of what it was. So what is it, we need to get down to about 96% of what we produce in terms of what we consume? Think about that because is a pretty big swing. 106%, 96%, I am just using a rough magnitude of stuff, but that is a very large adjustment to make, and what it also means is that in terms of our own productive capacity, and those from other countries from which we bought stuff, means that they had too much capacity. To go to a long-term sustainable arrangement, we are going to have to cut out ten percent of capacity, and that is hard to do. If we were a closed economy, which we are not, think of it as a simple model: we would have to add ten percentage points to unemployment. So, if you started out as four, you would have to go to fourteen.

We do not buy everything from within, we buy a lot from the outside, so our unemployment rate is not going to go from 4% to 14%, but it is going to go from 4% to 10%. That is a big adjustment, and that means that not only do a lot of people lose their jobs, but that we also have too much stuff like airplanes and hotels and too much commercial office space. I do not know about GW’s finances, but I have been reading about other universities’ finances, and some rich universities have imposed a ten percent budget reduction. I just keep hearing that number. That means we have too much capacity in our universities. All these places where we had bubbles, we had too much capacity. And that is a difficult adjustment process and it does not all happen at once. The more
you think about it, it is just not reasonable to expect that we are going to make that kind of adjustment in only two quarters.

Officially, the recession began at the end of 2007, but unemployment really did not start rising until the end of 2008, and it is probably going to keep rising through 2009 and much of 2010. It takes a long time to adjust. And, I was speaking the other day to a group of general counsels, and I said, “Well, how is the general counsel business? How many legal services are you buying?” And they said, “We are buying about ten percent less.” So they are buying about ten percent less, so it is a good thing none of you are going to the GW law school because if you were graduating this year, you would find that there were not many recruiters, and if you had a summer internship, you might not be getting that job you expected to get starting in next September after you passed the bar next year. Law firms are also cutting back. Law firms start slowly, and reluctantly, cutting back, and then they start needing less office space, and so there are too many of those buildings over there that were being rented out at sixty or seventy dollars a square foot. People are starting to sublet space. Law firms that had started to cut down office staff have gone to developers and said, “Well, we do not really need all of that space,” and some law firms have just disappeared. All of that just takes time, so when I hear from those macroeconomists that do not really understand micro say, “Well, I am looking at this overall graph and it looks like this recession is over,” and you think about how the world really works and how industries are related to other industries like dominos, and it takes time to work out because there is a lot of momentum in the economy, there is a lot of reluctance because it takes time. People constitutionally are very reluctant to take losses, so they sort of deny that things are going on, and they say, “Well things are going to come back so I will just hang on,” which just delays this sort of adjustment process. If you look at the micro, you can see that it is still going on very much, and it will still be going on for awhile. So that is why when I hear things about it being over and that we are on an upswing, I tend to be a little suspicious and tend to think that maybe what is going on is that we have succeeded in using public policy, monetary and fiscal policy, to prevent this from spiraling out of control on its way down. I think we have accomplished that, but in the process, we have done something that we probably needed to be careful about, which is, if you flood the markets with enough newly-printed dollars, which is what we are doing, trillion/trillion and a half dollars, which is a lot, it creates a lot of liquidity. A lot of that liquidity is sitting around and not doing very much just sitting in bank reserves, but some of it is doing something. For certain borrowers, money is still available and cheap so it is beginning to work its way back into the financial system. Even though in the past few days the market has not been doing great, Dow Jones has gone up to 9,500 from 6,500 last March, so in a space of about six months, it went up about fifty percent. That would be considered a very good run-up, even if over a three-year period. We have interest rates for the government of the United States at about 3.25 percent for the next ten years borrowing, which is close to a historic low. Short-term interest rates are close to zero, so there still is a lot of liquidity around. Where we keep things from spiraling out of control is by keeping the air back in those old bubbles, and if you start at the premise we started at in this talk, that premise is not a sustainable model, you have to be a little bit worried.

Some of the macro data is still running large current account deficits, even in the middle of a pretty bad recession. I checked with one of your professors before I came in
today and it is running about four-hundred billion dollars a year. This is not as bad as eight-hundred billion a year, but that is in the middle of a recession with not a lot of people buying stuff and with a lot of people being unemployed. That is not a good equilibrium, and if you sort of imagine unemployment coming down and things going back to normal, that is going to go back up to five or six-hundred billion. That is in that danger zone again that means that we are going back to those old ways where we are living beyond our means and others are financing that, and if you start at where we started this, we do not want to go back there. That is not a sustainable long-term growth model.

So we have not really worked this thing out yet or really gone a long way toward figuring out a new place that we can go to where producing what we consume plus maybe a little more so we can do a little saving so we can pay back some of these bills we have built up all these years, which are considerable. The recent meeting that was held in Pittsburgh, the G-20 meeting, which if you ever mention G-20, it is surely enough to make a person’s eyes glaze over. Maybe you are here now studying economics, or international economics, and it does not make your eyes glaze over, but there was an interesting thing that happened there at that meeting, which was that the United States convinced the other major countries of the world that we needed to do something about this new place that we want to get to so that the engine of global economic growth is not the United States living beyond its means, so everyone was assigned a task. The United States was assigned to live within its means by saving more and spending less. Asia was assigned to basically spend more and save less by relying more on domestic demand than foreign demand, rely less on exporting stuff to us, and rely more on their resources for their own uses, consumption, and investment. Europe was assigned the task of attracting more investment. Now why would that be a problem for Europe? Well, the problem is that even Europe’s own companies do not want to invest there, especially in Western Europe. They like Eastern Europe but not Western Europe because they do not get a very good return, comparatively anyway. They do not get a good return because of taxes or on labor-laws because they are restrictive, and their workforce is not as innovative. They do not have an entrepreneurial class or at least as entrepreneurial class as we do, or a lot of small companies and business creating jobs. That is their task, and if you look at all of those things, they really have not changed that much.

There has been a little increase in demand in China, but only because the Chinese government spent a ton of money as part of their stimulus program. That was a good thing to do, but not unless they are planning on doing that year, after year, after year. Savings rates have not come that much down in China either. We now have household savings rates of about five percent, which is a lot better than zero. They have household savings rates of 40%, which is reflection partly of culture, and also they do not have things like social security and Medicare that they can rely on in their old age so they quite rationally save for their old age. Europe, as far as I can tell, is nowhere in terms of making itself a more attractive place for investment. There have been no significant changes there, so we have a long way to go, even in terms of getting macro balances in order. Again, we have stopped because governments were quite clever and aggressive in stopping the downward spiral that could have happened otherwise. We have contained that, but we really have not solved the underlying structural problem, so that is what causes me to be a little bit, or a lot bit, skeptical both about the recession being over and
that when it is over, we are going to be getting very robust growth, because getting all of those things back in balance is going to be quite hard, painful, and it takes time. It does not lend itself to a lot of growth, but rather to a lot of painful restructuring. People do not talk much about this because it is sort of hard to talk about. It is a lot easier to talk about good guys and bad guys and say that we should pass some regulation to prevent them from doing those bad securitizations, reform the rating agencies, and make sure the banks keep more capital. But, if you do not think those actually caused the problem and that they were simply the manifestation of the problem, the vehicle by which the problem from which the water leaked out of the dam, or the water was building up behind the dam, then we have not gone really far yet in addressing those problems.

So, what would be the right policy for us to have since I have been asked here by an institution interested in international economic policy? What would be the right policy for the United States? Well, the wrong policy is to keep interest rates so low and keep credit so loose and cheap that we go back to living beyond our means and back to blowing up the asset bubbles, stock market, and real estate market. That is the wrong approach because a lot of that is mostly consumption-based. That would not be a terrible idea if rather than consuming more than we produced, we productively invested more than we saved by continuing to attract the savings of the world, but instead of using it to buy sneakers, use it to invest productively in things that have good long-term pay-offs. Now, when I say “we,” we could do that individually, and we should, but there is not a very good mechanism where we can all sit around and decide we should do that, but there is a way in which we do it collectively, and that is through government.

We have come off of a period of about twenty-five years of radical and dramatic disinvestment of public goods. Ever since Ronald Reagan, we sort of gave up the idea that government was a smart investor in public goods and that would be better to privatize more public goods than have the government continue to invest in them. That is not just roads and bridges, public transportation systems, or sewer and water, but other things that have much higher pay-offs like smart-grids so that we can run a more efficient energy system, research and development (particularly basic research and development) which in the last century has been the source of our economic strength and lately have been under-investing in, and public education, specifically preschool, early-childhood education for at-risk kids who we know that if you spend a little money early will not do as badly at school or wind up in jail, and elementary, or secondary, education. We all know about that problem. It is not solely a money problem, but when looking around, schools need more money and teachers need to be paid more in the short-run, but also need to perform more, and finally universities.

I am standing here at a distinguished private university which is distinguished by many things, one of which it is that it is one of the most expensive universities in the world. That is one way to educate people, but another way to educate people, and frankly, more efficient way, is through great public university systems, which we are allowing to atrophy. Just across the river in Virginia, at the great University of Virginia, started by Thomas Jefferson, so has been around for a long time, the Commonwealth of Virginia provides all of thirty percent of the operating budget of the University of Virginia. In fact, the university’s president and trustees want to privatize the university because they receive so little money from the state and so much public interference that they would rather just be private. University of Maryland had a deal with the legislature and thought
they would reduce the costs per student if they would maintain the same level of support per student at where it was a few years ago. That deal worked for a few years, but now the state has broken it. The state of California’s university system was the model, or pride, of the state, and model for every other state. This is a state that was obviously added a little later into the country than those on the East coast and so there were not as many private universities, and so they set up an elaborate system of universities, colleges, and teacher colleges, though now called something different. Again, this is another system that has been allowed to atrophy, and, as a result of this budget crisis, there is another one of those ten percent budget cuts, again that ten percent. That is just really stupid, and is about the stupidest thing we could do by not investing in those things at this moment. The only way we can get to a new level of sustainable growth is to invest now in things that will generate real good long term productivity-enhancing growth. We cannot consume our way out of this, we cannot borrow our way out of this, and we cannot even cut our way out of this, even though there is some cutting that is necessary. We need to invest our way out of this.

There has not been a lack of private, or corporate, investment over these past years, and, in fact, it has been pretty good. Now it is down for obvious recession-related issues, but that has not been the problem. This problem is that we have misdirected too much household investment to bidding up assets like stocks and house prices. It is very unproductive to be in an arms race bidding up this or that or a house in the Hamptons or Cleveland Park or a share of Google stock. That is really not creating any wealth, but rather just getting into a bidding war. That is how we have used our savings in a very unproductive way. We need to start using it in a more productive way, and here, by the way, Wall Street has failed us in its primary task of allocating capital to the highest and best use because it has not done so, instead is has given it to this bidding war and along the way took in big fees, so they have not served us well. They are not serving the function for which God made Wall Street. So, I think the best way we can do this collectively is through government, smart government, not dumb government like building bridges to nowhere, but making good investments in research, energy infrastructure, transportation infrastructure, and in human capital which is the educational stuff and training. If you do that then there are the pay-offs, which economists argue exist, and have great long term returns, especially when the government can borrow money at two or three and a quarter percent, then that is something worth doing now. It is something we have to do, and if we do not since our government does not have any money now, then it is something we should borrow for. As long as the world is still throwing its money at us, which is what three and a quarter interest rates mean, and we now ourselves are afraid of investing in the stock market or whatever and are buying treasury bills, the government should borrow even more, believe it or not, to run up the deficit because you get those good returns and only that will get us to a more sustainable model for growth. So, the next time you hear a politician say it is terrible that we are running these huge deficits, think about it. It may be terrible, but it matters what you are using the money for. But if you are using the money to invest in a new growth model for the United States then that would be a good use, so it depends on what it is being used for. So, that is what I have to say, and you might have some questions and other things to say.
Audience Question #1: Thank you for that very succinct presentation. I am in the business school but have never really studied economics. Assume for a moment that these cultures of the United States, Europe, and Asia do not change. Is there an institutional economic approach to somehow level out those differences?

Pearlstein: Well, I think that as a matter of observation we can say that cultures take a long time to change, but remember that they only have to change a little at the margin. So, the Europeans have to get a little more efficient and not take hour and a half lunches, just take a half-hour lunch. The Chinese can still save a lot, but just go from forty to thirty percent savings rate, which is still a lot. We may have to get used to the fact that if we want all of the government services that we seem to want, we may have to raise taxes from 19% to 24% and just bite the bullet. As long as you protect poor people, most of us who are above that can handle it. We just take one fewer vacation a year. We might not like that, but it is not the end of civilization as we know it. This is why I think it is hard because it will involve cultural, economic, and political change. I think it can be done but you are right that it is largely institutional and cultural, which macroeconomists do not have a clue about. It is doable, but just not in two quarters, so that is the thing to remember.

Audience Question #2: Hi, I am in the international development program here, and I was just wondering about how people have been discussing the end of neo-liberalism and the end of increasing privatization following the financial crisis, and I was wondering to what extent you thought Obama would be able to accomplish that? I know that was a big part of his campaign.

Pearlstein: We have not officially privatized that much in this country. You can point to toll roads that have been privatized, but the bigger privatization has not come directly through government but rather people now spend a lot of money on private because cities and towns do not build recreation centers and playgrounds, instead everyone has a private health club. Since public schools are not good in a lot of areas more people send their kids to private schools. We tend to privatize things privately. The impetus has not been to privatize them from the government, but if you look in DC you see a lot of private firms doing the work of government employees, which is a form of privatization, but I do not think we have gotten into that form of privatization that you probably had in your mind in a big way. Obama has said he wants to stop the growth of outsourcing to private contractors and do more work in-house. I think that is probably not a bad thing, but, coming back to my point, if you do that, it will probably cost a little more, even though government employees look like they earn less than private employees, but actually do when you add in all of their benefits. For example, if we want to reverse that trend, one of the things that public employee unions have been fighting is outsourcing of government work to private contractors, but they need to get used to the fact that maybe they cannot retire after thirty years with full pension, and between the age of 55 and 65 get the same health benefits that they had when they were employed. That gets very expensive. These things involve sacrifice on everyone’s part but is it the end of liberalism? You mean liberalism in the European sense or market liberalism? (Inaudible response and rephrasing of question). Well, the best thing in healthcare is not to spend more money,
but to get more for what we are already spending, but that would fall in a different area. He is trying to move in that direction, but you can see how hard it is.

Audience Question #3: I am with the US National Trade Commission. (The rest is somewhat unclear but this is the general statement). The value of US-manufactured shipments have increased by 32%, but at the same time the number of manufacturing employees decreased 17%. Productivity going up is good for manufacturing, but the decrease in jobs is bad for society.

Pearlstein: I just do not share the idea that manufacturing jobs are the only good jobs in the world. I think these are artificial distinctions that do not really matter anymore. I work for the Washington Post, so I am technically a manufacturing employee because the Washington Post produces a newspaper, and that was considered manufacturing by the government. I think we have about a hundred guys left who actually work on the physical production of the newspaper. The rest of us sell ads, or write and edit things. I do not think that these are useful characteristics, or categories, in which to think of the world. There are a lot of service components that go into a manufactured product and vice-versa. Those of us who think we do a service typing words, well what are we typing on? We are typing on something that is a manufactured output. I am not sure this matters. There are a lot of good non-manufacturing jobs in the world, and some of which are in government or in universities, and I do not think those are bad jobs. If by that you mean to say, “Why are there not middle-class jobs for people today that just graduated from high school and do not go beyond that?” then that is the problem. The trick is not to create new jobs for people who do not go beyond high school, but to make people go beyond high school, because the first way is a not a way to get rich, it is a way to give people employment. Employment was not a problem in this country though until about a year and a half ago. We had about 4% unemployment, but there was a problem in that it was based off of a bubble economy. However, our economy is pretty good at putting people to work. In fact, we are not only so good at putting our own people to work, but we are also good at putting half of Latin America to work too. Our problem is not in our labor markets, but rather our supply side. If we had more skilled workers, the supply would increase the demand. I know that is not considered good economics, but sometimes supplies do create their own demand.

Audience Question #4: You were talking about Europe and how to make it more market-friendly and more appealing to companies. Do you think that the victory of Angela Merkel and her Center-Right Coalition and the pretty likely event that the Tories will win in the UK next year is helping Europe move in that direction?

Pearlstein: Yes and no. Yes in case of Germany, no in a case of Britain. I think, actually the Labor government is the one that really understands it both: economic growth, and investment, and public investment, and by the way also supports European unity, economic unity, the other party does not. In England, it’s not as clear cut a case. England had essentially reformed its economy under Ms. Thatcher. And that debate has been won. That’s there. In Germany, in France, in Western Europe they still have a long way to go in terms of making themselves investment friendly. Britain has been investment friendly
for a long time. Unfortunately, too much investment has gone into the financial services sector where they have been much more heavily dependent on financial services than even we are. Their sector is almost as big as ours, and their country is not as big as ours. They, and I will include Ireland with them, they have a problem there now, because they now have all this capacity in a wrong area. And England has lost a lot of its industrial capacity, and it’s got to figure out something else to do rather than shuffle paper around for purposes of financial speculations.

Audience Question #5: So much has been said about not pursuing protectionist policies. And a lot of people who have talked about that that was allowing the source for the big downwards spiral on a Great Depression. And President Obama at the beginning of the year really warned European leaders against protectionism and he peppers his speeches a lot with that. And yet I think last week and a week before that we saw a lot of ink on the Washington Post, and the other paper from New York talking about tire tariffs and tariffs that China’s looking into for some way of retaliating that. Trade wars are basically going down the route of protectionist policies, but still talking about how we will not go down protectionist policy routes? Do you think that there is actually a move towards that and that people are not really talking about it? Or, do you actually think this one little blip of protection of manufacturing jobs and picking on the “winners and losers” of trade. I wonder what you can say to that.

Pearlstein: The world has behaved really very well to this period in terms of trade protectionism. Nothing is perfect in the world, but really the steps that had been taken have been really mild and relatively temporary, the rhetoric has been pretty well restrained. There is the whole community in Washington that anytime anyone does anything that is the slightest bit of protectionism there are like Chicken Littles. They say, “Oh God, the sky is falling.” This sky is really not falling.

People have behaved themselves well because they learned the lessons of the Great Depression. Everyone has to operate in a real world of politics and I do not see any sign that either we or the Chinese… The Chinese, you know, that is a Kabuki dance. I am mixing my cultures here, but that is Kabuki dance. That whole thing that we did and what they said, and then what we said in response to what they said, you will have to take my word for it that that had all been worked out. I will do this and you say that it is ok. The bigger problem is what are the Chinese going to do about their currency? Remember, I started this with how they kept their currency peg. Okay? They have to let their currency appreciate, and they were quietly letting it appreciate for several years before the bust. And it was at a good pace because it was fast, it was not so fast that it was disruptive, but it was not too slow. People did not tend to notice, but it was going up 5%, 6%, 7% a year. That is fine, but then they stopped doing this.

They have to continue to let their currency to appreciate as does Japan. By the way, China is not just China. China is that whole nexus of countries that supply things to China. It actually imports a lot of stuff from cheaper places like Vietnam, and, to a certain extent, Taiwan and other places in Asia. So there is a whole network in Asia that often ends in China and comes here. They all have pegged their currency, but they need to let it go. If you think our bubble was bad, then go to Dubai. They have a real bubble because they started to peg. They had all this run-up in the oil prices and then run-down.
They pegged their currency, and I do not want to go into detail of that, but that is a mess. If you worry about these international issues, currency is a better place to worry about right now because it has more trade implications than trade laws. By the way, at the G-20 and subsequently in those papers people are reading that you mentioned, there has also been some progress toward reviving this new round of trade talks they keep saying every six month that they are going to do it. I take it with a grain of salt, but they are still working on it, and that could be a great breakthrough. But, that breakthrough would be the result of there being a recession, and some of the developing countries of the world who have been resistant to opening their markets are now a little more open to thinking about the ways in which they can sell more stuff to us, and one way to do that is if they open their markets a little more.

**Audience Question #5:** Good afternoon. My name is Joshua L. with the U.S. Global Leadership Coalition. The international affairs budget, although a small percentage of the GDP, represents several billions of dollars of what the government spends each year and it intends to increase in the next few years. Now, with all this talk of investment within the United States, the government is still investing worldwide in various projects. Do you think that this money should go towards more investment in the U.S.? Or, do you think that the government should continue as it has previously done?

**Pearlstein:** You know, it is really not a lot of money and it is good to do this for international relations reasons, national security reasons, and moral reasons. It is not big money. So yes, you keep doing it.

**Audience Question #6:** I know that at GW our graduate school applications this year as well as our law school applications were up pretty significantly.

**Pearlstein:** Right, these people who cannot get jobs figured out they should all go to school.

**Student:** Yes. Do you think that is a good idea? I know so many GW graduates last year that were struggling to find jobs and that sort of thing. Do you think it is a better idea to take a year off or something to go back and get a higher education? What do you think it will mean for us in three more years from now with this significant increase in people with law degrees and graduate degrees?

**Pearlstein:** In theory it is good thing to invest when the cost of investment is low and returns are high. So, you could think of financial cost and you can also think of opportunity cost. What else are you going to do? It is one thing if you would be making 65,000 dollars a year, but if you would otherwise be living in your parents’ house and not doing anything, then it means there is no opportunity cost. In theory, it is a good thing to do. It is the way the markets actually sort of equilibrate and correct for themselves, so it will be a good thing. It depends on how much you are paying and what you are studying. If you are studying journalism, then you might want to invest somewhere else. I am old enough so I do not care about the competition.
Audience Question #7: When you mentioned the adjustments that are needed are structural and the way to address them is investment in things such as education, alternative energy sources…

Pearlstein: By the way, I did not say so much alternative energy sources, but rather I said a smart grid. But anyway go ahead. The distinction is that a smart grid makes energy use more efficient for everybody. Subsidizing things that we like, such as solar energy, which might never be cost competitive, is not actually a good investment. Investment in R&D that leads to solar energy that is cost effective will be good. I know there are small distinctions, but sometimes particularly young audiences think that any investment that sounds like it is green is good. And the question is: What is the payoff for the investment? If it is not good, then it is not good regardless of how green it is. Sorry.

Student: While those adjustments create more sustainable growth in the long-term and yield in the long-term, how can you address, and balance, the differences between adjustments that yield in the long-term and current short-term needs of fiscal imbalances of growing those dynamics? What sort of investments do you suggest? Is that monetary-fiscal policy mix enough to address those short-term needs?

Pearlstein: Well, I am a sort of market guy. So, if people are still shoving money to the United States government at three and a quarter percent, I do not really worry about the deficit if you are spending it well. But, if they change their minds and they say that it is now going to be 6%, then that is a bit of a problem. When that happens, the currency will go down. When the currency goes down, then the system will start to equilibrate in a way we would have wanted it to happen a long time ago. Just so you understand, this is a complicated machine where all sorts of things are connected to everything else. Right now the dollar is strong because people want to throw money at us, so it is fine to take it, but only as long as we either spend it or invest it, rather then spend it or consume it. When they change their minds, then we have to change our minds. However, when they change their minds, the system will adjust in another positive way, but, at the moment, as long as our major export is treasury bills, it is alright if they want to buy them because we will sell them. They are not buying anything else we are making.

Audience Question #8: If we travel back in time to twenty-two years ago, you could have given practically the same talk about Japan instead of China and the imbalance that emerged from the Reagan deficit and the macroeconomic policy coordination process that emerged as an attempt to solve that imbalance at that time. So, I am wondering, what do you think is the current problem? Is it a continuation, or extenuation, of that process? Is it a new imbalance that is different from that?

Pearlstein: It is the same story, but continued and enlarged.

Student: So, why do you think we will be more successful? Or do you think we will be more successful in addressing this imbalance this time than we were twenty-two years ago?
Pearlstein: Because the Chinese are smarter than the Japanese. Seriously, we have said it to them, but they do not need it because they are pretty smart. They lost a decade. This imbalance makes it look like we did not do so well, you know, because lots of our industry got hollowed out and those sorts of things, but they had a lost a whole decade. So it has not turned out so well for them. And the Chinese think: “Well, maybe we have got a chance, because we can see what happens over time with the exporter, the export side of the imbalance, and the person who is doing the exporting.” Now we sort of have a lost decade too. If you think about where stocks are and where medium household income is, it is at about the same level as a decade ago. We have our own lost decade. This arrangement looked like it was beneficial, but in macro-sense it has not really been beneficial. Internally, in terms of China, for example, a lot of people got employed, got out of poverty, and are still out of poverty so it has been better for them, and it has been for us as it was in Japan for many years, but then it stopped getting better. This is what China is facing. The prospects are okay in that it will not get any worse, but it is going to stop getting better unless they go to a new place. And they do know that, they really do. I think the Japanese were really stubborn about this. They thought that they could just keep doing that. They believed their own propaganda which was that it all had to do with how much better they were than we were.

Audience Question #9: Hi, my name is Rameeth Hundle, and I am a student here in the International Trade and Investment Policy program. My question pertains to China. Recognizing that the country needs to reduce private savings and increase consumption, what policy measures or structural reforms would you suggest that the country embrace in order to rebalance its growth?

Pearlstein: I do not know enough about it, but you know every system has its advantages and disadvantages. If they want to do that, they just do it. If their government wants to just do that, then they can just do it. One way to reduce savings and increase consumption is for the government to tax someone and take away what they might have saved and then go and spend it. There is really not a huge amount of difference between public consumption and private consumption and public savings and private savings. It is all savings and consumption and, particularly in a country like theirs, they can make it very similar. That is one thing they can do, but we have told them that the best thing that they can do is to provide those social safety nets so the people do not feel the need to save. We say that because our policies are driven by macroeconomists who do not understand culture. They think that if you give everybody the right financial and economic incentives, then they will be rational actors and will therefore save less. However, if savings are hard-wired into the culture, then they might not respond that way, which is another way to say I do not know the answer to your question. But, it sounds like what we propose is a good idea: give yourself some social safety net. I think that they are working on that actually. But, a lot of that is cultural, which I do not understand. It may be that the best and fastest way is for the government to do the consuming for people. When the government says: “I am going to give you a voucher for health care,” then that is a form of consumption. Or, “I am going to give you this health care,” or “I am going to give you public housing,” or “I am going to give you something.” That is probably a
better way for their government to do it than sort of wait for individuals to change the way they behave.

**Audience Question #10**: What do U.S. firms that love to push cheap goods for the means of U.S. consumption, Wal-Mart for example, do if you are able to change the U.S. culture to decrease consumption and how do they change their business model? How do firms like that operate if they do not have the U.S.’s reliance as much in the future?

**Pearlstein**: Well, you just answered your own question, didn’t you? Well, almost. Open a branch in China.

**Student**: They have been doing that.

**Pearlstein**: Wal-Mart realized a long time ago, probably eight or nine years ago, that their goals were going to slow radically in the United States and that they would have to go somewhere else. However, it turns out that it is not so easy to go somewhere else. They went to Germany, and I think they have left. They tried to go into Canada and I think they have left. That is because they have a certain way of doing business which is not always consistent with the so-called “economic culture of other places”. But, places like Wal-Mart will just have to grow less. There are lots of ways they grow though. One of the ways they grow is when the pie is growing because we are all consuming more. That is one way to grow. Another way is if we take business away from other people. They are pretty good in that too, even within the United States. But, they are bumping against their limits. And that is why they suddenly got into food as a whole new category, which is not an imported category. Then they got into medicine and pills, and now they are opening up, as a matter of fact, not only their own pharmacies, but they are also opening up their own day-clinics. So, they are getting into things that are not imported for the first time.

**Audience Question #11**: I think everyone pretty much acknowledges that global warming is going on.

**Pearlstein**: Yes, except the U.S. Chamber.

**Student**: And something has to be done about it. Well, we are in the midst of this global recession trying to get China and Asia to do anything about it. Hilary Clinton recently went over there and tried to build support for that and she is basically told: “Thanks, but no thanks.”

**Pearlstein**: I am sorry, for what?

**Student**: To tackle global warming and climate change. I am curious as to how you see all this playing out.

**Pearlstein**: I do not know. There is a lot of the world trying to do something about it. Perhaps, they are doing it less productively than they Europe and Japan, but they are trying to do something. We tend to demonize the Chinese, but I think the Chinese are
probably moving faster than we are. It is easier over there; they do not have to worry about elections and things like that. We will get there. I do not know exactly what it is that you are driving at.

Student: Specifically, building support for this because…

Pearlstein: Building support where?

Student: Globally. If there is legislation regarding climate change in the US, for example, Ford just moves its plants to China, so specifically to carbon emissions.

Pearlstein: It is not what it appears to be. Ford moves its plants to China because Ford wants to do business in China. Ford is not going to…

Student: I do not necessarily mean Ford specifically, but that businesses in general start to move to the countries that do not have these policies. So, it seems that the whole world would need to agree on this.

Pearlstein: Yes, it is a common problem. You cannot do it country-by-country.

Student: Right, and Asia so far has not.

Pearlstein: Yes, that is what I would say. China says one thing and does another. Sometimes they actually behave better than they say they are. They do not like people interfering or being told what to do. We do not either, but they really do not like being told what to do. They have recently changed some of their industrial policies in a good way. The Chinese are good people to deal with. They are smart, they get it, and they do what they said they are going to do when they say that they are really going to do it. But, I do not know. The Indians are the bigger problem. They never do what they say they are going to do. They talk a good game and then do not do it. One of the reasons is because they are a democracy, and things are hard to do. Not to downplay democracy, but it can be pain in the butt sometimes. I do not know. I have not given you a satisfactory answer. The best thing we can do is pass a global warming bill and set the right model for the rest of the world. Or, pass a gas tax or carbon tax, which can be better because it would be simpler.