PRICEWATERHOUSECOOPERS
United States

Taking stock and looking ahead

Interview by Gene Zasadinski

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Concerning the state of the economy, the chatter of pundits is deafening and often confusing. Only a few voices have been able to pierce through the noise with meaningful analysis and forecasting. Chief among them is Kenneth S. Rogoff. Economist, professor, best-selling author, and media commentator, Dr. Rogoff delivers a point of view that is provocative, cogent, and thought provoking. In this interview, he brings his unique perspective to questions about our economy and our future.

GZ: In your new book, you suggest that well-informed people should have taken note of certain events that were predicting a coming recession. What were those events, and why do you think they were ignored?

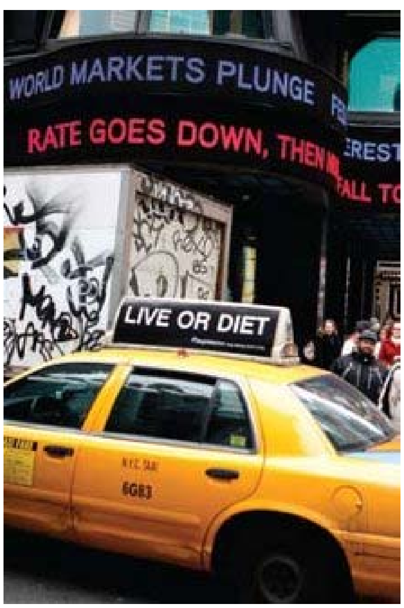
KR: The two big things that were blinking red lights were soaring housing prices and the huge amounts the US was borrowing from abroad. If one looks at historical benchmarks from other deep post-war financial crises, the parallels between the run-up to the US financial crisis and other catastrophes in Japan, Spain, the Nordic countries, and elsewhere, it was all too apparent that trouble was brewing. I and other economists who viewed this as highly worrisome and unusual were dismissed by many, and particularly by American policymakers, who attributed these developments to rapid growth in the US.

GZ: How could housing prices get so out of control?

KR: Prices were justified by complicated and erroneous explanations. People were told that thanks to deeper and more liquid financial markets, you can afford to pay more for your house, because you can always borrow on it later. Second mortgages were common. Most of all, everyone seemed to believe that no matter how much you paid for your house, someone would be willing to pay even more in a year or two. So there was nothing to worry about.

GZ: So, in a sense, the financial crisis is, in part, related to false optimism.

KR: In a way, yes. But this is nothing new. When you look back in history, it is clearly human nature to want to accentuate the positive. But that's not the only factor. It's also about how political systems work, about the fact that money is power. When a lot of money is rolling into the financial sector, it's very hard to put it in check.



We're going to come out of this with a greater sense of the limits on what we can have, which is probably a healthy realization.

GZ: You have used the terms *arrogance* and *ignorance* to describe a reaction common to financial crises down through the centuries. Can you explain what you mean by those terms in that context?

KR: Well, the ignorance is that in the run-up to a crisis, many people think that it can't happen to them. They believe financial crises happen to other people at other times in other places. The arrogance comes from the often mistaken belief that we're doing things better than in the past. That kind of arrogance permeates history.

GZ: But hasn't the world become more prone to financial crisis over the past three decades?

KR: No, I don't think so. Take banking crises, for example. They're pretty common throughout history, and I mean severe crises, not just little ones.

GZ: What about sovereign debt crises?

KR: Some people say they've become more common, and there's something to that. These things are happening more often, and they're getting resolved more quickly, but, you know, I actually think part of the reason we have more of these types of crises is because of the kinds of insurance we now have that creates moral hazard.

Former chief economist and director of research at the International Monetary Fund, Kenneth Rogoff is Thomas D. Cabot Professor of Public Policy at Harvard University. A prolific writer and sought-after media commentator, Dr. Rogoff is coauthor (with Carmen M. Reinhart) of the best-selling book *This Time Is Different: Eight Centuries of Financial Folly*, published by Princeton University Press.

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GZ: Can you elaborate?

KR: When a crisis occurs, the FDIC guarantees the banks, and the IMF (International Monetary Fund) guarantees the countries. Under such circumstances, people are less cautious, leading to more crises. I believe moral hazard is a very real problem.

GZ: When this recession arrived, the government responded with takeovers, bailouts, stimulus packages, and so on. Are those the right tools to deal with the crisis, or have they done more harm than good?

KR: By and large, these have been the right tools. There was a very real chance that we would have an epic recession, one people would write about for 200 years. We had a very bad recession, but there will be worse. So in that sense, government did a good job. There is one area, though, where we've fallen short.

GZ: What's that?

KR: Our strategy with regard to banks. The basic strategy was, let's be super-nice to the banks, and more to the point, let's be super-nice to the bank bondholders. It would have been so much better if we had a somewhat deeper recession but allowed bondholders to lose money. Then we wouldn't have to regulate the financial system in the way that we do now. We're going to be bearing that cost for a very long time.

GZ: Are you anticipating a wave of new regulation?

KR: If we don't have a huge amount of new regulation, we'll get another financial crisis as bad or worse in 10 or 15 years. With significant regulation, another financial crisis might be 50 or 75 years away. Right now, I am not sure where regulation is headed. But I do know this: Congress should be focusing on how to control short-term debt, how to drastically shrink the interbank lending markets and generally shrink the short-term borrowing of the banks, which is really, I think, the key to reducing our crisis risk.

GZ: What role should taxes play?

KR: In the short term, I favor providing help to state and local governments to extend unemployment benefits. In the long term, we need to increase tax revenues without unduly raising the marginal rate. In order to do that, we're going to have to devise a vastly simpler tax system, based, perhaps, on a two- or three-tier consumption tax or some other fair approach.

GZ: You mentioned unemployment, and we hear the term *jobless recovery*. What's your outlook with regard to a turnaround in employment, and can a real recovery happen without an increase in jobs?

KR: As long as we have double-digit unemployment, we can hardly talk about a recovery. Unfortunately, we may have difficulty producing the kinds of jobs we need. The credit markets are still very weak. Small and medium-size businesses especially, which provide a lot of job growth, are having difficulty getting access to credit. In addition, the bubble fueled an artificially low unemployment rate. We should have realized that normal unemployment is closer to 6 percent, not 4.5 percent. I don’t see the unemployment rate dipping below 5 percent unless we have another bubble.

GZ: Unemployment is one problem. The deficit is another. With regard to the deficit, are we on an unsustainable course?

KR: Clearly, yes. The question is, What are we going to do to fix it? The United States is in more danger than most Americans realize, not so much because of our economic situation—we’re rich; we ought to be able to manage it—but because of our psychological situation, our sense of entitlement, our sense of invulnerability.

GZ: What do you mean?

KR: Well, take Europe, for example. Europe is in a very similar situation made even worse by their aging problem. But they accept it. The major European countries understand that growth is going to be less and are prepared to do what is necessary— tax hikes, and so on—to keep their budgets stable. In the US, we want more government services than we’re prepared to pay for through higher taxes. So, it’s about making choices. We’re on an unsustainable trajectory because we haven’t even acknowledged that we have a problem.

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GZ: Is it conceivable that at some point our creditors will decide that we can't pay them back?

KR: Not exactly, but we may experience the typical dynamic of an emerging market, where the world challenges you, basically by demanding higher interest rates because they don't trust you. If you respond aggressively and tighten your belt and show that you're willing to respond as necessary, they'll cut you a lot of slack, and interest rates will come down and you can go on for a lot longer. But if you don't respond well because you're politically paralyzed, things can close in on you very fast. So I don't think default is likely, but significant inflation certainly is.

GZ: Some say that a weak dollar is good for the American economy. What's your take on that?

KR: In the short term, a moderately weak dollar is good for the US. It boosts the competitiveness of our exports, and it also makes imports more expensive, which helps stabilize our trade balance. However, we don't want the dollar to fall too far too fast. We're by far the world's biggest debtor. We depend on getting a lot of money at low interest rates, and if the rest of the world begins to see the dollar as rudderless, that would be a disaster.

GZ: Given its vulnerability, how long will the dollar remain the world's reserve currency, and when it no longer is, what will replace it?

KR: I'd say another 50 years. Eventually, the yuan will replace it. In 20 years, China's economy will be bigger than ours, and maybe it will take another 20 or 30 years before its financial markets reach maturity and it's really ready to assume the mantle. The US had long surpassed England as a global economic power before the dollar replaced the pound, and a long period will go by before China's currency replaces ours.

GZ: In the US, what's in store for equities and the housing market?

KR: Historically, in almost all cases— Japan being a notable exception—after deep financial crises, the equity market regains its precrisis high within a few years. Housing, however, never comes back. The only reason the housing market seems to be recovering is that the US is subsidizing it like crazy. Ironically, the policy for getting out of the housing crisis is the same as the one that got us into it.

GZ: What should businesses be doing in this economy? Should they be retrenching, waiting this recession out, or should they be looking for opportunities and taking prudent risks?

KR: Despite the fact that the overall economy is in recession, there are pockets that are doing great—for example, export-oriented businesses, health and technology sector companies. As the dollar depreciates, even manufacturing is doing better. Many businesses have been holding back, but many good investments are emerging as the economy recovers. So businesses need to look out over the landscape and think about how to move forward.

GZ: Will America come out of this a stronger or a weaker country?

KR: We're going to come out of it a more European country. By that I mean a country with more lethargic growth, more redistribution of income, and a larger role for the state. We're going to come out of this with a greater sense of the limits on what we can have, which is probably a healthy realization.

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Chess

I think part of my brain is hardwired for chess; I still think about it to relax.* I follow the top championship games and occasionally correspond with active top players. Deciding on economics over chess as a career was a very tough choice. While I have no regrets about having chosen economics, I think I could have been a professional chess player and probably been very happy.

Influences

My thesis adviser, the late Rudi Dornbusch, was a huge influence. He had this incredible enthusiasm about the interplay of policy and research in economics. He was just a very exciting, dynamic man, one who inspired a whole generation of economists, including Paul Krugman, Jeffrey Sachs, and Lawrence Summers, among others. Another was my undergraduate teacher the late James Tobin. He really conveyed the fact that economics matters, that these things, which seem so theoretical, actually affect people. The late Paul Samuelson, one of the other great economists of the 20th century and one of my professors at MIT, was also a huge influence. Despite his great gifts, he was a humble man. He set a great example from which I'm still learning.

The future

By and large, the emerging markets can look forward to a very good decade starting next year. The United States will not grow at the rate it had been growing prior to the financial crisis because of increased regulation, higher taxes, and the aging of our population. We could be saved by technology, but the best bet is that we are entering a period of slower growth. As a result, we will need to make decisions about Social Security and Medicare debt that we've been postponing. But these are things we should be able to cope with as we mature into a new phase. We're a rich country. We are still the greatest country in the world.

* Dr. Rogoff is an International Grandmaster of chess.

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