



## The Future of Market Capitalism Keynote

- Speaker: **Lawrence H. Summers**, Charles W. Eliot University Professor, Harvard University

### Overview

The United States stands at a time of unique challenge requiring decisive action. This includes both near-term action to deal with the current financial crisis, and decisions on three broad issues that hold enormous ramifications for American society and the world at large. These issues are: Maintaining stable prosperity and economic growth; making sure that prosperity is widely and legitimately shared; and building a new global system that works for the citizens of all nations.

Confronting these challenges represents a historic opportunity to save capitalism from itself, and in doing so, to create more prosperity and improve the lives of more people.

### Context

Professor Summers shared his view of the challenges facing America at a time of financial and economic turmoil, and the opportunities they present.

### Key Takeaways

- **America faces a host of major economic challenges.**

The current financial and economic crisis reminds us of Keynes's insight that the market system is not always self-stabilizing. Today's troubled American and global economy is caught in a vortex of five vicious cycles:

1. *A liquidation vicious cycle.* As financial assets fall in value, some asset owners (especially those who purchased assets using debt) are forced to sell, which pushes the prices of those assets even lower.
2. *A capital deleveraging vicious cycle.* As assets lose value, financial institutions have less capital, giving them less to lend, causing assets to lose more value.
3. *A credit accelerator vicious cycle.* A weakening economy leads to a weaker financial system, which leads to less lending, which leads to a weaker economy.
4. *A Keynesian vicious cycle.* Lower spending leads to lower employment, which leads to lower incomes, which leads to lower spending.
5. *A panic vicious cycle.* Individuals, seeing financial institutions in trouble, rush to withdraw funds—putting institutions in more trouble and causing more people to rush to withdraw their funds.

Beyond the current financial crisis, we are living in a period of abnormally high disillusionment with society's elite and abnormally low faith in our leaders in Washington and in corporate America. Most Americans don't believe the United States is progressing in the right direction or that their children have an opportunity for greater prosperity than they have.

- **The short-term response to the current crisis is taking shape, but critical decisions must still be made.**

In the face of such a crisis, there is no substitute for firm and decisive action. The essential elements of a near-term response plan are coming into place: guarantees to protect the basic flows of money between banks, substantial capital infusions to prevent deleveraging, and provision of credit to areas where it is starved—important steps reflecting the government's crucial role as a guarantor of macro-economic stability.

But other crucial decisions loom in the next year or two:

- *Economic stabilization.* The financial system can be no healthier than the economy as a whole. The appropriate set of steps to restore economic strength (be that more tax cuts, infrastructure, or both) will be necessary for a return to more normal market conditions.
- *Financial system stabilization.* At the same time that steps take place to stabilize the economy, changes must be made to the country's financial system. While the current financial system has been a source of flexibility and prosperity, over the past 20 years there have been seven major financial crises (the 1987 stock market crash; the S&L debacle and the commercial real estate crash of the late 1980s and early 1990s; the Mexican financial crisis; the Asian financial crisis; the LTCM liquidity crisis; the bursting of the NASDAQ bubble and the associated Enron threat to corporate governance; and now the current crisis, which is the most serious of them all). A system with seven major crises in 20 years is not working well enough.

The events of the past year make clear that the current system is not working and the system's architecture must change. Regulation will have to shift from its traditional focus on regulating individual institutions to focus on the stability of the entire system.

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*"There cannot be debate, after seven crises in 20 years, that we do not have a [financial] system that is functioning effectively."*

— Lawrence H. Summers

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While all presidential elections are said to be crucial, because of the critical decisions that must be made in the near future—decisions that will shape society for generations and have enormous effects on people around the world—the upcoming election is in fact crucial.

- **In the near term, the country must deal with the current crisis, but other broad issues must also be addressed.**

These key issues are:

1. *Maintaining stable prosperity and economic growth.* Without a sense of growth and without a sense of security in that growth, it is almost impossible in the United States or any other country to even think about



addressing the broader set of domestic or global challenges. The near-term response plan and the plans to stabilize the economy and the financial system are of enormous importance in restoring a sense of prosperity and economic growth.

2. *Making sure that prosperity is widely and legitimately shared.* Consider these facts that illustrate how the prosperity of recent years has not been shared widely:

— The rich have gotten richer and most of U.S. society has gotten poorer. Shifts in U.S. income distribution since 1979 reflect a wealthier top 1% (which has gained about \$600 billion per year in annual income, equal to about \$500,000 per person in the top 1%) and a less prosperous bottom 80% (which has lost about \$600 billion in income per year). The income of those in the 80th to 99th percentiles is unchanged. If incomes in the bottom 80% had kept pace, they would have been twice what they were over those years.

— The gap in health status between the fortunate and less fortunate has widened. Twenty-five years ago, the gap in life expectancy between the well-off and the less fortunate was close to two years. It has expanded to four years, which is hardly a mark of social and economic success. (While two years of life expectancy may not sound like a lot, it is equal to the gain in life expectancy that would be realized if cancer were completely eliminated.)

— Children of privilege and children of poverty are more likely to remain in those socioeconomic situations as adults. For most of American history, the tendency for prosperity to pass from father to son was diminishing. But for the last quarter-century, that trend has stopped and, some say, reversed. Prioritizing education must be part of the solution, along with creative approaches to assisting adults who are no longer in the educational system.

The failure to ensure that prosperity is broadly distributed represents a problem of legitimacy for society.

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*“Efforts [are needed] on the part of government . . . to assure that the distribution of opportunity becomes more equal, more legitimate.”*

— Lawrence H. Summers

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3. *Building a global system that works for the citizens of all nations.* This financial crisis, along with events of the past decade, has changed the world’s view of the United States. A decade ago America stood apart on several dimensions. The United States was widely

admired for its military strength; despite its faults, America was seen as a moral beacon for the world; and America’s economy was the envy of the world.

The situation is different now. Based on the country’s experiences in Iraq and Afghanistan, the country’s military strength has been diminished; after Guantanamo, Abu Ghraib, and Katrina, the United States is not the moral beacon it once was; and the financial crisis has altered the perception of the United States’s economic strength.

With this as the context, the United States must work with other nations in creating an integrated, collaborative world system that provides prosperity and peace for all people. (No single issue is more important for this world system to tackle than energy. There is not yet clarity on the specific solutions to the world’s energy-related problems, but what is clear is that the current path does not work economically, environmentally, or geopolitically.)

- **In these challenges lies the opportunity to make the world’s economic system work for the people of the world by saving capitalism from itself.**

These three issues reflect the need to forge systems that work for people—people who will never come to Harvard Business School; people who are living lives of great value but who no longer feel secure in their communities, their livelihoods, their nations, or the world; people who are uncertain that they will be a part of the world economy. Thus, the overarching challenge is to make the system work for all of those people.

This has happened before. A Republican Roosevelt (Theodore) and a Democratic Roosevelt (Franklin) both presided over periods when capitalism saved itself from itself. Enlightened public policy played a crucial role, and business leaders recognized that while there may be conflicts about their short-run interests, there is less conflict about their long-run interests, because of their enormous long-term interest in being part of successful societies.

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*“We have an enormous challenge of saving capitalism from itself.”*

— Lawrence H. Summers

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The challenge of saving capitalism from itself represents an immense opportunity to create more prosperity and better lives for more people than at any time in history.