Comments at "Restoring Robust Economic Growth in America" Conference
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It's a pleasure and honor to be here, especially next to such distinguished panelists.

John suggested I do something simple and easy for the panel, like cover all the troubles in Europe and the US and how to fix them. In 10 minutes. So let's go on a quick tour of Europe first.

In case you're not reading the papers, we're in financial crisis 3.0, a run on European banks stemming from their sovereign debt losses.

This is not high finance. European banks have been failing on sovereign debt since Edward III stiffed the Perruzzi in 1353. This is not a "multiple equilibrium," a run of self-confirming expectations. People are simply getting out of the way of sovereign default, since it's pretty clear that governments are at the end of the bailout rope.

By dutiful application of bad ideas and wishful thinking, the Europeans have turned a simple sovereign restructuring into a currency crisis, a fiscal crisis, a banking crisis, and now a political crisis. They could have had a lovely currency union without fiscal union. The meter in Paris measures length. The Euro in Frankfurt measures value. And sovereigns default, just like companies. They could do what George Schulz beautifully called the "simple obvious" things, and return to the kind of strong growth that would let them pay off large debts. Alas, the ECB is full in, both buying debt and lending to banks who buy debt, so now a sharp euro inflation – which is just a more damaging and wider sovereign default -- seems like the most likely outcome.

How did we get here? Financial crises *are* runs. No run, no "crisis." People just lose money as in the tech bust. (Let me quickly plug here Darrell Duffie's "Failure Mechanics of Dealer Banks." This wonderful article explains exactly how our financial crisis was a run in dealer banks.)

For nearly 100 years we have tried to stop runs with government guarantees -- deposit insurance, generous lender of last resort, and bailouts. That stops runs, but leads to huge moral hazard. Giving a banker a bailout guarantee is like giving a teenager keys to the car and a case of whisky. So, we appoint regulators who are supposed to stop the banks from taking risks, in a hopeless arms race against smart MBAs, lawyers and lobbyists who try to get around the regulation, and though we allow – nay, we encourage and subsidize –expansion of run-prone assets.

In Dodd-Frank, the US simply doubled down our bets on this regime. The colossal failure of Europe's regulators to deal with something so simple and transparent as looming sovereign risk hints how well it will work. (European banks have all along been allowed to hold sovereign debt at face value, with zero capital requirement. It's perfectly safe, right?)

The guarantee – regulate - bailout regime ends eventually, when the needed bailouts exceed governments' fiscal resources. That's where Europe is now.

And the US is not immune. Sooner or later markets will question the tens of trillions of our government's guarantees, on top of already unsustainable deficits.

What financial system will we reconstruct from the ashes? The only possible answer seems to me, to go back to the beginning. We'll have to reconstruct a financial system purged of run-prone assets , and the pretense that nobody holds risk. Don't subsidize short-term debt with a tax shield and regulatory preference; tax it; or ban it for anything close to "too big to fail." Fix the contractual flaws that make shadow-bank liabilities prone to runs.

Here we are in a golden moment, because technology can circumvent the standard objections. It is said that people need liquid assets, and banks must borrow short and lend long to provide such assets. But now, you could pay for coffee with an electronic transfer of mutual fund shares. The fund could hold stocks, or mortgage backed securities. Nobody ever ran on a (floating-NAV) mutual fund. With instant communication, *liquidity* need no longer coincide with *fixed value* and first-come first-serve guarantees.

We also now have interest-paying reserves. The government can supply as many liquid assets as anyone wants with no inflation. We can live the Friedman rule.

Short-term debt is the key to government crises as well. Greece is not in trouble because it can't borrow one year's deficits. It's in trouble because it can't roll over existing debt. Governments can be financed by coupon-only bonds with no principal repayment, thereby eliminating rollover risk and crises. The new European treaty, along with wishing governments would mend their spending ways, should at least insist on long-maturity debt.

You may say this is radical. But the guarantee – regulate – bailout regime will soon be gone. There really is no choice. The only reason to keep the old regime is to keep the subsidies and bailouts coming. Which of course is what the banks want.

On to the US:

Why are we stagnating? I don't know. I don't think anyone knows, really. That's why we're here at this fascinating conference.

Nothing on the conventional macro policy agenda reflects a clue why we're stagnating. Score policy by whether its implicit diagnosis of the problem makes any sense:

The "jobs" bill. Even if there were a ghost of a chance of building new roads and schools in less than two years, do we have 9% unemployment because we stopped spending on roads & schools? No. Do we have 9% unemployment because we fired lots of state workers? No

Taxing the rich is the new hot idea. But do we have 9% unemployment – of anything but tax lawyers and lobbyists -- because the capital gains rate is too low? Besides, in this room we know that total marginal rates matter, not just average Federal income taxes of Warren Buffet. Greg Mankiw figured his marginal tax rate at 93% including Federal, state, local, and estate taxes. And even he forgot about sales, excise, and corporate taxes. Is 93% too *low*, and the cause of unemployment?

The Fed is debating QE3. Or is it 5? And promising zero interest rates all the way to the third year of the Malia Obama administration. All to lower long rates 10 basis points through some segmented-market magic. But do we really have 9% unemployment because 3% mortgages with 3% inflation are strangling the economy from lack of credit? Or because the market is screaming for 3 year bonds, but Treasury issued at 10 years instead? Or because 1.5 trillion of excess reserves aren't enough to mediate transactions?

I posed this question to a somewhat dovish Federal Reserve Bank president recently. He answered succinctly, "Aggregate demand is inadequate. We fill it. " Really? That's at least coherent. I read the same model as an undergraduate. But as a diagnosis, it seems an awfully simplistic uni-causal, uni-dimensional view of prosperity. Medieval doctors had four humors, not just one.

Of course in some sense we are still suffering the impact of the 2008 financial crisis. Reinhart and Rogoff are endlessly quoted that recessions following financial crises are longer. But why? That observation could just mean that policy responses to financial crises are particularly wrongheaded.

In sum, the patient is having a heart attack. The doctors are debating whether to give him a double espresso or a nip of brandy. And most likely, the espresso is decaf and the brandy watered.

So what if this really is not a "macro" problem? What if this is Lee Ohanian's 1937 – not about money, short term interest rates, tax*es*, inadequately stimulating (!) deficits, but a disease of tax *rates*, social programs that pay people not to work, and a "war on business." Perhaps this is the beginning of eurosclerosis. (See Bob Lucas's brilliant Millman lecture for a chilling exposition of this view).

If so, the problem is heart disease. If so, macro tools cannot help. If so, the answer is "Get out of the way."

People hate this answer. They want to know "what would you do?" What's the bold new plan? What's the big new idea? Where is the new Keynes? They want FDR, jutting his chin out, leading us from the fear of fear itself.

Alas, the microeconomy is a garden, not an army. It grows with property rights, rule of law, simple and non-distorting taxes, transparent rules-based regulations, a functional education system; all of George's "simple obvious steps," not the Big Plan for the political campaign of a Great Leader. You need to weed a garden, not just pour on the latest fertilizer. Our garden is full of weeds. Yes, it was full of weeds before, but at least we know that pulling the weeds helps.

Or maybe not. This conference, and our fellow economists, are chock full of brilliant new ideas both macro and micro. But how do we apply new ideas? Here I think we economists are often a bit arrogant. The step from "wow my last paper is cool" to "the government should spend a trillion dollars on my idea" seems to take about 15 minutes. 10 in Cambridge.

Compare the scientific evidence on fiscal stimulus to that on global warming . Even if you're a skeptic, compared to global warming, our evidence for stimulus -- including coherent theory and decisive empirical work -- is on the level of "hey, it's pretty hot outside." And compared to mortgage modification plans, strange "unconventional" monetary policy, the latest creative fix-the-banks plan, and huge labor market interventions, even stimulus is well-documented.

There are new ideas and great new ideas. But there are also bad new ideas, lots of warmed over bad old ideas, and good ideas that happen to be wrong. We don't know which is which. If we apply anything like the standards we would demand of anyone else's trillion-dollar government policy to our new ideas, the result for policy, now, must again be, stick with what works and the stuff we know is broken and get out of the way.

But keep working on those new ideas!