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Daily Observations

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(203) 226-3030

Ray Dalio
Larry Summers

Ray Dalio and Larry Summers Discuss the New Paradigm

Bridgewater founder and co-CIO Ray Dalio and former Treasury Secretary Larry Summers share their thoughts on the risk of inflation, what's next for the US dollar, and the Fed's difficult dilemma.

Last week, we shared the deck that co-CIO Ray Dalio has been using for recent client meetings to describe the new economic paradigm, with a particular focus on 1) high debt levels and debt monetizations, 2) internal conflicts over wealth and values, and 3) the rise of China as a great power and its challenge to the US as the existing great power.

In today's *Observations*, we are sharing a Bloomberg interview featuring Ray and former Treasury Secretary and Harvard economist Larry Summers at the Qatar Economic Forum where they expand upon all three of the above issues. Ray and Larry discuss the current environment of low interest rates and high deficit spending and what it means for inflation, the US dollar, and Fed policy. They also discuss how fiscal policy has shifted leftward to address wealth and income gaps, and how this policy shift may impact the economy and markets.

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A full transcript is included in today's *Observations*.

TRANSCRIPT
Ray Dalio and Larry Summers Discuss the New Paradigm

Note: This transcript has been edited for readability.

Chapter 1. Should We Be Concerned About Inflation?

Larry and Ray discuss the risk of inflation in the wake of a massive fiscal stimulus and zero interest rates.

STEPHANIE FLANDERS
Welcome to this session on restructuring the global economy. I'm Stephanie Flanders, Senior Executive Editor for Economics at Bloomberg, and I'm delighted to have two massive figures in the world of global finance for this session. First, the founder and co-Chief Investment Officer of Bridgewater Associates, Ray Dalio, and the Harvard economics professor and, of course, former US Treasury Secretary, Lawrence Summers. Gentlemen, thank you very much for joining us.

The title of this session talks about a new economic blueprint and that both of you, I know, have thought deeply about what a better version of the global economy might look like over the years. But I think those watching will not forgive me if we don't start by getting into something that could be changing the economic landscape before our eyes, whether or not we like it, and that's inflation.

Both of you have views on this. But maybe I'll start with you, Larry. I mean, we have a former Fed chair sitting as Treasury Secretary, Janet Yellen. But that doesn't seem to have made her more concerned about the inflation that we have coming down the track and indeed can already see in the US, and despite that massive fiscal stimulus that's also here and going to continue. Is there something that policy makers in Washington are missing that you're seeing when you say we should be worried more about inflation?

LARRY SUMMERS
Arithmetic. I don't think the arithmetic is terribly difficult. We are looking at an average GDP gap relative to potential GDP of 2% this year, and we're looking at a 14% of GDP fiscal stimulus, along with massive growth in the Fed's balance sheet and very low real interest rates.

Arithmetic. We're looking at labor shortages as measured by job openings or as measured by workers' comfort in quitting at record levels.

Arithmetic. We're looking at a current rate of inflation that, if you look at the last two or three months, is running close to 8%. Now, no one thinks that that's the new built-in rate of inflation. So, of course, there's transient inflation. The important question is whether that is six percentage points of transient inflation or four percentage points of transient inflation. And I don't see the basis for policy makers' serenity that it's a full 6% of transient inflation.

I welcomed the Fed's limited efforts to mark its views toward reality and a growing awareness that this overheating is likely to necessitate a monetary policy response. But I still think the reality of overheating, just if you look at the most basic numbers, is being overestimated. The prevailing forecast—at the Fed, in the White House, indeed, in much of the consensus of professional economic forecasters—in February was that we would have inflation just above 2% this year. We've already had more inflation than that in the first five months of the year. That would suggest to me that people should not just modify their forecasts but should think about what their errors of thinking were that led them to be so far off in their forecasts.

STEPHANIE FLANDERS
Ray, we heard there from Larry the economist's—and indeed the mathematician's—response to the situation. I mean, as an investor, we've seen that pivot of some kind by the Fed last week—quite a calm market reaction. But should markets, should investors generally be taking this threat a lot more seriously?

RAY DALIO
There are different kinds of inflation. I'm not particularly worried about the classic supply—you know, demand pressing up against supply, although we'll find out soon, because there's something like 10% of GDP stored in financial assets that's going to be coming out. So it's likely that there's going to be a big pickup in demand and that will probably raise prices significantly. And it also depends how you account for inflation because, like, housing prices—housing prices themselves are going up a lot, but the rental prices are going down a lot. And if you went to a 3% inflation rate or some bounce, that's not one of those things that gets me very nervous or very excited.

The real issue is that we have a supply/demand issue of bonds, because we're going to have to sell a lot of bonds to those in the world who own bond inventories. And they have very low interest rates, negative real interest rates, and they're overweighted in US bonds and are going to have to buy a lot more. That is also coming at a time when Chinese capital markets are the capital markets that are becoming more attractive.

That creates a supply/demand issue that can create a monetary inflation because there will not be enough demand to buy those bonds. And that means that it's likely that the Federal Reserve will not be able to taper or cut back and might actually have to increase to prevent interest rates from going up. And that's a classic monetary inflation.

So, that's my bigger concern than just the spurt.

I think for most of the world, the real question is, what are interest rates relative to inflation, and also what is happening with all this liquidity? Because there's a huge amount of liquidity and negative real interest rates, and that means that it pays not to own any debt instruments, that it pays not to own cash—certainly not cash, where you get no interest rate in an environment, like Larry says, of some amount of significant inflation. I think it would be, let's say, in the vicinity of over 3%. So, you get taxed at that rate in terms of buying power.

And so, when I look at that, I think you're going to see the continued inflation in other assets, and it pays to borrow a lot. I know to borrow houses right now—I mean, to buy—I'm seeing interest-only loans being made when there's basically no interest rate. In other words, you don't have to pay back your principal any time soon, and the interest rates are so low. So, there's a lot of money being thrown around that way. Those are the things that concern me more because you build up a bubble.

You saw the reaction in the markets when the Fed just even hinted at tightening. I don't think they can tighten a lot without having a big negative effect. So, that's what it looks like to me: the whole picture of the low real interest rates, and then also the worries about the supply/demand, monetary inflation, and also the Fed tightening.

STEPHANIE FLANDERS
And you both focus not just on the short-term inflation, but on this long—because obviously, what really matters is whether we're moving to a long-term environment that is more inflationary and the implications of that. So, I guess, Larry, I would say to you, how much do you buy into the monetary side of what Ray was just saying? And also, how much would you say this is a global issue, not just something that's related to US fiscal policy, for example?

LARRY SUMMERS
Look, I would say, we're driving our car at 100 miles an hour on a road that is empty right now but won't always be empty. And I don't know what form the accident will come, but when you're driving 100 miles an hour, it's probably not actually the fastest way to get where you're going, because you're likely to have some kind of dislocation. Whether that comes in product and labor markets, whether that comes in spiking of interest rates, whether that comes first in a decline in the value of the dollar, I don't presume to be able to predict. But that we're on a problematic course—where anything can happen and none of us can predict markets precisely, but where the

balance of risks is very, very much on the too much liquidity, overheating side—seems to me to be relatively clear. I think these tendencies are present in many places, but I think they're by far more pronounced in the United States than they are in the rest of the world.

It's not that extraordinarily low interest rates are unique. It's not that extraordinarily big budget deficits are unique. It's that having them in tandem with an economy that's growing at what people think, I expect, will be a double-digit rate this quarter and along with an epic degree of labor shortage. That's what is, it seems to me, the extraordinary feature of this moment. It would be a very different thing if we were creating liquidity in an extraordinary way to respond to a major output gap. But to be doing this kind of thing in a labor shortage economy seems to me to be very intensely problematic.

Chapter 2. The Risk to the US Dollar

Ray and Larry discuss whether the current environment of low rates and high deficits is a risk to the dollar—and why the Fed may soon face a more difficult dilemma than they have faced in recent history.

STEPHANIE FLANDERS
You mentioned the dollar. I mean, I guess one could see there are different scenarios that come out of this. I mean, the classic scenario for the US growing faster than everybody else, sucking in a lot of imports, would be that actually the dollar could rise and export problems to the rest of the world that way. But Ray, you just mentioned that you potentially see the dollar heading down. So, is there a fundamental threat to the dollar that comes out of this?

RAY DALIO
Yes. I mean, I'm just dealing with the mechanics. The way it works is you sell a lot of bonds. So, now, who do you sell the bonds to? And then when I look around and calculate who owns the bonds and what they have to buy and what the incentives of buying, they're bad. In fact, you could see the dollar selling of bonds. What that means is then the Federal Reserve is in the position of either seeing rates rise, because there's not enough demand to meet that, in fact, that they start selling. It would be a very bad situation. And they can't let that happen because that would be very bad for the economy and markets and all sorts of things.

So, we have to keep in mind where we are. We're at the end of a long-term debt cycle, and that means that the Federal Reserve will have to do what they did last time, which is to buy a lot more to prevent the interest rates from going up. That's very noncyclical. It's one of those cases where, in reserve currencies, it's a very dangerous thing. Now, you compare that with alternatives. First, the best alternatives are other asset classes, but also, let's say China, for example. I think the situation that we're in is quite similar to going from the late '60s into the early '70s, when there was a different core inflation rate in the United States versus Germany and Japan. It's a different balance of payments situation. We're in basically a balance of payments deficit; they're in a balance of payments surplus position. That means that they chronologically are worried about imported inflation, and there's favorable capital flows. So, I think that that's negative for the dollar, particularly against Asian currencies.

STEPHANIE FLANDERS
Larry, do you agree with that?

LARRY SUMMERS
I have Ray's instincts but considerable agnosticism on timing. There are classic periods—the early 1980s is the one that comes to mind where large budget deficits spurred growth, sucked in capital, and were associated with an appreciation of the dollar. So, I'm not sure of the timing here, and I'm not as confident as Ray is in the long-term attractiveness of Chinese capital markets and indeed of foreign capital markets to the dollar.

But I think the risks are substantial. And one of the things that I hear people say that seems most bizarre to me is they say, "No, you don't understand. Now we're in an era of globalization. And so the inflation process is much stickier," or, "We can't get rapid inflation because of globalization." I think the opposite. Because of globalization, we are much more like a small country than we used to be. And that means if the dollar gets into trouble, which it easily could, that the pass-through to inflation is going to be more rapid than it would have been decades ago. So, I basically share the kind of concern that Ray is expressing, just with a bit more uncertainty about timing.

And I guess I'd add one more thing, Stephanie, and I think it's kind of an important point, and it's implicit in something that Ray said. The really hard monetary policy challenges are not actually moments like the period after Lehman or the period a year ago this spring, when there's massive illiquidity and markets are breaking down, and it's entirely obvious the direction that policy should move—you need to provide liquidity, and the questions have to do with how.

The really hard monetary policy dilemmas are when it's not clear which way to go—when on the one hand, you have a falling currency and an excess supply of bonds, and on the other hand, you have a weakening economy and rising inequality and a fear of recession. And you don't know whether you're cutting rates to respond to the latter problem or doing tightening things to respond to the former problem. Those are the really difficult moments in monetary policy—where even the direction is not entirely clear. And my fear is that we're setting ourselves up for such a moment.

Chapter 3. Closing Wealth and Income Gaps

Ray and Larry discuss what various efforts to reduce wealth and income gaps—including the Fed's new average inflation targeting mandate and a higher tolerance for big deficits—might mean for the economy and markets.

STEPHANIE FLANDERS
I think that the Fed, though, will argue that they are actively looking to have that overshoot in inflation, the change of approach in terms of the average inflation model, in order to sort of reset the system and indeed get that wage growth through to parts of the economy that perhaps have not seen it over the last few years, and that that could be more politically sustainable long term. So, Ray, do you see that that is an argument that the Fed could make, that it's worth some short-term risk to achieve that more sustainable outcome?

RAY DALIO
As I mentioned, I think if you see breakeven inflation rates go above 3% or something like that, and you see that spurt, then you have the dilemma of the tightening of the monetary policy. As I said, I'm not particularly worried about that particular inflation, but the other things that worry me are the whole shift in terms of the quantity of debt money that's being produced that goes in to create bubbles, creates an enormous amount of liquidity, and that I think will be manifest by either a rate rise tracing inflation or a dollar decline. And I think, then, we also have to deal with the changes in the political situation, the wealth gap situation.

With the wealth gap is the left-right question. There's a lot of conflict in terms of the left-right politics. There's a big move, pretty much, probably to more left politics, believing that there's not enough fair share of incomes and so on. And those will create structural changes that will have effects. The amount of money that has gone to profits has increased from about 6% of revenue to about 14% of revenue, and that's decreased the share that's gone to incomes.

Those things could be structural changes that shift the wealth and income—I think that we're here—to those that are going to be more beneficial, let's say, to workers than to capitalists, I think, in general. That's particularly a US issue. It is a European issue, too, although it's a world issue, but it differs around the world. So, I think those are the bigger issues, that and the rise of China and what the rise of China means. Those I think are the bigger issues.

STEPHANIE FLANDERS
Larry, when you say the globalization, it's an interesting point about us becoming more like a single country responding to things. But one could argue that the things that globalization was associated structurally with falling inflation for a long time, at a period where you also had central banks focusing more on inflation and you had this sort of shift in bargaining power away from workers. If all of those things are going into reverse, that is potentially more inflationary but also a better world for workers or a more inclusive world, more sustainable politically?

LARRY SUMMERS
Let me take your question a moment ago and then come to that, Stephanie. Look, I think the arguments about average inflation targeting and so forth, they kind of have their place. But I think we need to recognize when you declare victory. When we've got a record labor shortage, the Fed probably shouldn't be obsessing about making sure there are opportunities available. When we've now got average inflation over the last two or three years, up to 2%, we don't have the problem of needing more inflation in order to get to some kind of level of average. So I just think we need to recognize the new reality is very different from the secular stagnation reality of two years ago.

Look, I am all for a strengthening on a variety of dimensions of the hand of workers. I think we need to raise the minimum wage. I think we need to re-empower the ability to organize unions. I think that we can't read the stories about working conditions at Amazon and not think that something should be happening to rebalance things.

At the same time, I think you have to recognize that doing all of those things is going to bear on the inflation process. It's going to bear on what economists call the natural rate of unemployment. And you're going to have it have a set of consequences, and you need to factor those in in setting macroeconomic policy.

I mean, we had a moment very much like the current moment, coming after a long period of no inflation. We had a government that had very expansive desires for what it was going to do. We had a progressive tide sweeping through the country, changing attitudes on very many fronts. We had that in the 1960s. And what we saw was that inflation rose more rapidly than anybody anticipated, that a right-wing tide in politics was ushered in with the successive elections with lags of Richard Nixon and Ronald Reagan, and that what happened ultimately did not serve the interests of the progressives who supported it. And you saw a big upsurge with the way in which the United States went off gold and imposed tariffs universally 50 years ago this summer.

So, a return to that does not seem to me to be what we should be targeting, and my concern is that I see too much in the current trajectory of economic policy. The Lyndon Johnson/John Connally axis of economic policy making doesn't seem to me to be a healthy guide.

Chapter 4. Inflation in Financial Assets

Ray and Larry discuss how high levels of liquidity have contributed to high financial asset prices and lower future expected returns.

STEPHANIE FLANDERS
We lost Larry, briefly. But yeah, Ray?

RAY DALIO
I think Larry and I agree that this is looking more like the late '60s transitioning to the early '70s. And then I'll also say though—and that has implications for the balance of payments and the dollar. And so, we've covered that.

I'm more worried about the inflation in financial assets and what that means for returns and bubbles that are developing, because there's a massive amount of liquidity around, and it's being thrown around so that it's a difficult environment for those returns to be justified. I think we're building kind of a bubble. So, I think inflation in financial assets and so on is an issue related to liquidity.

Anyway, if you think about it, what's happened is the net worth of Americans and most people in developed countries is higher than it's ever been. I mean, all of a sudden, it was a big boost to net income, but yet production isn't. So, what you've seen is a lot of people got a lot of money, which they're still holding, and they put it into the stock market and everything. And interest rates go down and they borrow, and that is a dynamic that creates a bubble, and that's what I would say is the main issue.

STEPHANIE FLANDERS
Just briefly on China, Ray, just to come back to you, I know that you—sorry, Larry, do you want to jump in?

LARRY SUMMERS
Let me just say that there's some division of labor on this panel, and Ray has talked more about financial assets. But I share his concern about asset-price inflation. And I would say the idea that lower returns have led to higher asset prices—of course, while that transition is taking place, everybody's enjoying wonderful capital gains—there's been a tendency for people like me and Ray to warn for some years now that long-term returns are going to be lower on assets. We've been saying that for some years, and people who've been in asset markets have done very, very well because even higher capitalization ratios, price-to-earnings ratios, asset-price-to-rent ratios have been taking place. I suppose some people are probably concluding that the warnings are unwarranted. As a consequence of that, nobody knows for sure, but my feeling would be that the warnings are now even more valid because the conditions precedent or the basis for the warnings have become even more true with the passage of time.

Chapter 5. How Should Policy Makers Respond to Current Conditions?

Ray and Larry discuss how they think policy makers should respond to strengthening economic conditions—and why even a small Fed tightening could have a big effect on the market.

RAY DALIO
I'm just saying the mechanics—when you have the liquidity and you drive down real rates and you drive asset prices up, that doesn't mean they come down. It just means liquidity drives those for their particular future returns.

STEPHANIE FLANDERS
We're going to run out of time. So, I want to make sure that we can end on a sort of action point. Both of you have come at it from different perspectives, you may put different shades on it, but you clearly think that there's some potential bumps coming down the road or risks that we need to be much more concerned about.

Given where we are—in case of Larry, I know you wish that stimulus in the US had been spent on different things at the beginning of the year that might actually support the supply side of the US economy and other things. Mistakes, if you like, have already been made in your view. But what's the best response if—assuming that the Fed and indeed other policy makers accept your analysis, what's the most constructive response now that wouldn't itself cause a lot of volatility and upset? Larry first, I guess.

LARRY SUMMERS
The necessary responses probably will, in the short run, cause some volatility and upset, but I'd like to see signals that overheating liquidity and bubbles are now seen as major risks facing the American economy. And I'd like to see a program of structural improvement for the supply side that is fully paid for by tax increases as the response, and a reduction in the amount of populist transferring of cash to large groups in the economy.

STEPHANIE FLANDERS
Ray? Assuming they get it, what is the best thing they can do?

RAY DALIO
I think we know that probably Larry and I agree on just saying it very simply. There's a ton of money around, and the value of money goes down. And how much it goes down relative to goods and services, and how much it goes down to financial assets—it's going to go down to both. And that really raises financial assets and it changes capital flows in important ways. I think that it's easy to say that the Fed should tighten. And I think that they should; they've put on the brakes a little bit.

But I think you'll see a very sensitive market and a very sensitive economy because the duration of assets has gone very, very long. And just the slightest touching on those brakes has the effect of hurting markets because of where they're priced and also passing through to the economy.

We have to keep in mind, since the cyclical peak in 1980-81, every cyclical peak in interest rates and every cyclical trough has gone steadily below the one before it until we've hit zero. And then, every quantitative easing—in other words, purchasing of money, buying of money and purchasing the bonds—has been greater than the one before it. That is a debasement of the value of the currency in one way or another. So, I think the challenge of the Fed is going to be able to balance those in a highly political sensitive environment because of this wealth clash. So, it's a difficult position for the Fed, I think.

STEPHANIE FLANDERS
Well, that's two perspectives we've had on what leadership in a post-pandemic world looks like. And I know we've focused a lot on this financial piece, but it clearly has huge global implications, as well as implications for the path the US economy is on for the next few years. So, thank you very much to both of you, Ray Dalio and Lawrence Summers. We appreciate you joining us. Thanks to our listeners.

LARRY SUMMERS
Thank you.

RAY DALIO
My pleasure.