Chatham House, 10 St James's Square, London SW1Y 4LE
T: +44 (0)20 7957 5700 E: contact@chathamhouse.org
F: +44 (0)20 7957 5710 www.chathamhouse.org
Charity Registration Number: 208223

Transcript

Critical Economic Challenges and Whether Democracies Can Meet Them

Robert E Rubin

Co-Chairman, Council on Foreign Relations; US Treasury Secretary (1995-99)

Chair: Dr Robin Niblett

Director, Chatham House

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Robin Niblett:

Gentlemen, welcome to Chatham House. I'm Robin Niblett, director of the institute and it's my great pleasure to welcome you all here for the 2013 John C Whitehead lecture – on Anglo-American relations I might add, although speakers before have always just kind of elided a little bit the Anglo-American bit and tended to, anything involves – and the Q&A will definitely get some questions as to whether you reckon the UK and US are collaborating effectively on the title that you have picked which I've got here which hopefully is the same as yours, 'Critical Economic Challenges and Whether Democracies Can Meet Them', does that sound right?

Robert E Rubin:

More or less.

Robin Niblett:

That's good. It's what I've got down here.

Robert E Rubin:

And you could give the speech.

Robin Niblett:

The second part maybe, definitely not the first part, but John Whitehead's been a longstanding supporter of Chatham House and we've been delighted to host now for a number of years a lecture in his honour, and the value of the lecture is that it gives us a chance to invite distinguished speakers, principally from the US, occasionally those who've been involved on this side of the Atlantic in negotiations with the US, on a major topic of interest to transatlantic relations. The great thing about John Whitehead is that he exemplified that mix you can achieve in the US of somebody who achieved great career achievements in the private sector and then was able to blend it in to the public sector, and John was chairman, a co-senior partner of Goldman Sachs, chairman of the board of the New York Fed, but he was also deputy secretary of state for a while under George Shultz.

In that context to have Bob Rubin here, who's taken a kind of similar track in the sense of having had a longstanding career, as everyone would know here, at Goldman Sachs, been vice chairman and co-chief operating officer and then also becoming a senior partner and co-chairman from 1990 to 1992, but then also made the move over into the government sector and joined the Clinton administration as the first director of the National Economic Council in the White House as a chief economic adviser to the president, President Clinton and then as secretary of the treasury. After leaving the secretary of treasury he became the co-chairman of the Council of Foreign Relations, he served on the board of Citigroup – and we're just saying, CFR is our sister institute here at Chatham House, we're absolutely delighted to be able to welcome you here not just as somebody who's followed the path with John Whitehead and therefore perfectly in that position, but also somebody who is deeply engaged in the think-tank community as well. So Bob thank you very much for joining us, we look forward to your remarks and to engaging in a Q&A afterwards.

Robert E Rubin:

Thank you Robin. This, by the way, is on the record I'm told and I didn't know that until I got here and then I was told well I'd better be a little careful what I said and the person who told me that said don't worry about it, you're too old, it doesn't matter. So she then very quickly reframed – no, it wasn't you Robin – and was quickly reframed in some other way. In any event, be that as it may, here I am. Let me start by saying that I very much appreciate being here – John Whitehead was senior partner of Goldman Sachs for many of the years that I was there and he really was a visionary leader for our firm in recognizing globalization and many other factors in a rapidly changing world, and I think it's fair to say that, in many respects that the modern Goldman Sachs was a function of John's vision.

I spoke to John the other day and we talked about this lecture, and I asked him why he endowed it – it's sort of similar to what Robin just said. He said that he felt that – not that he felt, he said that when we was deputy secretary of state he worked closely with his counterparts in the UK and it was that common set of values, that common set of perspectives that was of enormous practical significance dealing with the Soviet Union and so much else that they did. When I was at the Treasury it was a very similar situation; we worked with successive chancellors too and had a very common bond around, a common sense how economy should work, and that was enormously useful to us – and I would suggest that that special relationship is at least equally if not more important today as both of our countries face a remarkably changed and rapidly developing world with many risks and hazards that are unlike those that our countries have faced before.

As Robin said, Chatham House and the Council of Foreign Relations were founded by British and American citizens at the same time, in 1920 I might add, with the thought that after the horrors of World War I – of course it was called the World War then not World War I – that it would be very useful to have companion organizations in our two countries that were focused on constructive foreign policy, and I think that mission of our two institutions is every bit as important today as it was then given, as I said a moment ago, the complexities that we all face.

One personal note, I was a student at London School of Economics for a year and, well, I didn't spend much time at the LSE, mostly I spent it wandering around London and it was really a wonderful experience. I'd always hoped to live in London one day; that never happened, but my wife and I have had the good fortune of having many very good friends in your country, including two who became home secretaries, and we've always felt very much at home here. Finally, I have spoken, as I said to Robin, at many, many places where the rule has been 'Chatham House rules', though it turned out it's not for me in this instance, but in any event – because I didn't realize till I got here, but now that I'm at this age I get told not to worry about it. Any event, it is very nice to be at Chatham House itself.

I was asked to provide a bird's eye view of global economic matters and, in that context, what I'm going to do is focus on the United States, which is obviously the economy I know best, and the eurozone, whose troubles continue and I think without question have enormous importance to all of us, both because of effects on current demand and the like and also because of what I at least think is a pretty serious tail risk, a pretty serious possibility of destabilization that could be deeply consequential to all of us. But a real possibility doesn't suggest a particular probability versus another, but just a possibility. I'm not going to discuss the UK as such because all of you know a lot more about your economy than I do, but I do think the issues I discuss probably would be seen in various respects as relevant to debates that you're having in this country.

Let me make two framing observations. As Robin suggested, I've been around markets, I've been around economic issues for a long, long time in both the public and the private sectors and I remain very involved in my country and in the public policy debate and also as an investor. I believe that the economic outlook for the US, for the global economy, are probably at the very least as complex and uncertain, and maybe even more so, than any time in my adult lifetime. And that obviously creates an extremely difficult environment for decision-makers and policy-makers and investors and just all of us who are involved in the economy in one way or another.

Secondly, having given a lot of thought to this over the last few years for the same reasons probably a lot of you have, because I stayed very much involved with these issues, I believe it is entirely possible that the largest industrial democracies are in a period of truly historic importance, and perhaps even at a crossroads with respect to their social cohesion, the social conditions, their economies, their geopolitical position in the world and maybe even their political systems themselves.

The three largest industrial democracies – the United States, the eurozone and Japan – have for quite some time now failed to address their critical policy challenges, are mired in highly consequential political dysfunctionality and face serious difficulty now and questions about their economic future. I believe that the objectives of economic policy should be threefold: growth, widespread increases in incomes combined with reduced inequality, and economic security. At a very basic level I don’t believe that you can accomplish any one of these without accomplishing all of them, and that stands in contrast to those who believe that these objectives are antithetical to each other.

From the perspective of growth for example, market-based economics and globalization, which are central to growth, are almost surely only going to have broad-based public and political support if the predominance of a population feels that they will benefit from those policies, and rising wages enable everyone – or at least not everyone but a great preponderance of population, they have greater access to education, healthcare and so many other factors that contribute to productivity. At the same time, if you look at this from the prospect of bettering wages and reducing inequality growth increases the pie, as we all know, and as it did in our administration in the 1990s; it can tighten labour markets and that in turn will increase or should increase wages and should reduce inequality.

Having said all that with respect to increasing wages and reducing inequality, although I think growth is absolutely necessary and the single most important determinant, it is certainly far from sufficient. As Michael Spence, a Nobel Laureate, wrote in *Foreign Affairs*, our magazine, in early 2011, this issue of distribution is extremely complex for the industrial countries because the very factors that are driving growth, technological development, globalization and market-based economics also are at the heart in many ways of the distribution issues, because while there's some who benefit enormously from these developments there are many others who are experiencing wage pressure. The conclusion from all of that is that if we're going to keep our societies together and have our economies work, I think all of us need to find better ways of dealing with this set of distributional issues. But it is a very complex set of matters.

Let me now turn to a policy debate that is raging, though expressed in different terms, on both sides of the Atlantic. The American version is about jobs and growth versus deficit reduction, the European version is about growth versus austerity. Both versions, in my view, pose the same false choice and that false choice in my judgement is usually counterproductive because it distorts and prejudices policy decisions, political discussions and the like, and that in turn distracts policy-makers from taking the constructive actions that need to be taken.

In the US I believe both of these objectives, both objectives in the debate, that is to say growth and deficit reduction, would best be served by the same programme: a sound and well-constructed deficit reduction regime that stabilizes the relationship between debt and GDP in our country over the next 10 years, but with implementation either phased in or deferred for a year or two to provide macroeconomic room for growth to take place. And you could attach to that if you wanted to a moderate stimulus. That regime would meet the first phase, if you will, the next 10 year phase of the imperative to establish sound fiscal regimes with, of course, the decades beyond posing even greater challenges, and at the same time I think could contribute significantly to job growth and growth more generally right now.

As to this question of promoting jobs and growth, right now we have in place, as you may know, a measure called sequestration under which there have just begun, or put into effect, substantial across-the-board cuts in spending that has created significant fiscal drag. What the programme I just suggested would do would be to eliminate the sequestration and relieve us of that fiscal drag and then put us in a place where we could either phase in or defer the fiscal reduction of deficits.

More fundamentally, I don't think there's any question that if we had a sound fiscal regime that would contribute substantially to business confidence. Because a part of what I do with my life – I meet with business leaders a lot in our country and I don't think there is any question that our current fiscal outlook is substantially undermining business confidence, both by creating uncertainty about future policy conditions and by creating, or heightening I should say, concerns about whether our government can work.

In the eurozone version the debate is similar, but further distorted by the terms that are used. The term austerity, it seems to me, loads the dice. It seems to me the right way to refer to this is the same way I do with respect to the United States, which is the question of what should fiscal policy be? The advocates on both sides of that debate, as is true in the United States, in my judgement are posing a false choice.

Each troubled country in eurozone is mired in three related crises: a growth crisis, a fiscal crisis and a banking crisis. If you looked at the fiscal piece, what each of these countries should do, in my view, is to get on a deficit reduction path that is sustainable over time, that wins market and business confidence and at the same time leaves enough macroeconomic room for growth. In other words a balance must be found that serves all of these purposes at the same time and the purposes themselves are intertwined. Then of course the question in each country is whether having not done what should have been done for so long that balance can still be achieved.

In addition, while attention and political debate focus on these macro issues, I think it is also essential that there be strong action in the micro arena, which is to say labour law reform or undue labour law restrictions, under restrictions and protecting various segments of an economy, under requirements for government approval and much else. And to go along with that I do believe that the eurozone would benefit greatly from Germany focusing more on domestic demand-led growth and thereby creating a better market for the other countries.

There's a lot else you could discuss with respect to the eurozone, but let me focus for one moment and finish, with respect to these substantive issues, on the banking systems. These have obviously been a source of great vulnerability and that remains so. They create actual or potential requirements for fiscal support from countries that are already weak fiscally and the vulnerability of these banks reduce the ability to banks to extend the credit that's so much needed for the economies. Many analysts, as you know, think that it is this vulnerability, the vulnerability of the banks, that is probably the greatest single danger, or poses the greatest single danger of destabilization in the eurozone. The eurozone, as we all remember, proposed a mechanism some time ago to provide outside capital to troubled banking systems subject to a number of conditions, but then, as has happened too often in the eurozone, the proposals were first watered down and now they're more or less in limbo. I think that some effective banking programme is urgently needed.

Repairing stability through the combination of micro and macroeconomic measures is certainly – or has been at least – certainly substantively doable and hopefully and presumably still is, although as I've said, as time goes on the hole has become deeper, the difficulties recovering confidence rise and the risk that this is no longer doable increases. But my judgement would be that on balance and hopefully by a very large probability this is still doable, though there are no guarantees.

However, that leads us to the politics of the eurozone. I believe that the eurozone leaders have been behind the curve from the absolute very beginning in Greece to the present moment. Some will argue, in fact I was having that discussion just before I got here, that much has been done in the last year, I think that's right but the fact remains that debt-to-GDP ratios have continued to worsen, the troubled countries are still having negative growth and the banking systems – though there are no reliable numbers so you can't tell – but one would guess the banking systems are probably worse given the conditions of the economies.

Moreover, the politics, as you all know, have become more complicated. Italy obviously has a somewhat confused situation and the policy direction in France is, to say the least, uncertain. So once again, on the hopefully highly likely assumption that in fact all this is substantively doable, the question is whether or not governments will be effective in doing what is needed. My own view has consistently been that the eurozone leaders probably will do what they have to do when the conditions no longer give them any choice, because there you could have such serious ramifications. But in a number of respects I would say that their actions so far have not been totally encouraging, and if you look at how the Cyprus situation was addressed, both with respect to substance and process, that would probably add to the concern.

I might add incidentally that the concern about the eurozone has, I would say, from the very beginning been greater on my side of the Atlantic than it has been on this side of the Atlantic and, with all due respect to this side of the Atlantic, I would say that the concern to my side of the Atlantic so far at least has proven to be more correct.

Even if the immediate crises are resolved, as hopefully they will be, this will create temporary stability until the structural problems in the eurozone can be resolved, the very problems that were inherent in its creation: a single monetary system, a single currency, but national fiscal and banking regimes.

Doing so is obviously going to be very complicated, because it involves significant surrender of sovereignty and that has to be of immense political complexity and it will certainly take an extended period of time. Absent that, the eurozone – it seems to me there are at least significant questions with respect to how the eurozone will continue indefinitely, however, unless those structure reforms are accomplished. Once again you get back to the effectiveness of political systems, but in this case in the face of what in some ways, I suppose, is the most daunting challenge in this whole discussion, which is surrender of sovereignty in some fair measure especially in respect of fiscal matters.

Let me now turn to the long-term prospects for United States, partly because it is of great consequence to the global economy still and also because our geopolitical involvement will inevitably depend on our fiscal base. Mike Mullen, who when he was chairman of Joint Chiefs of Staff, was asked what is the greatest national security threat to United States and his answer was the deficit. Like your country, our country has real strengths. We have a dynamic society, we have an entrepreneurial spirit, we have flexible labour and capital markets, we have the rule of law – based on your laws – and we have an effective balance between market-based economics and a strong role for government to do what markets cannot do.

But we have real policy challenges that have to be met if we're going to realize our potential. We have to, as I've already suggested, establish a sound fiscal regime, we have to invest that public investment in the many areas that are absolutely central to an effective economy – infrastructure, basic research and so much else – and we need reform in non-budgetary areas like K-12 education, energy, our healthcare cost increases – although some has already been done in that direction – the regulatory system, in the sense that I don't think there's any question we must have strong regulatory protection but, as President Obama incorporated in his executive order on this, it needs to be combined with a consideration of benefits versus costs.

Let me expand on these challenges in one respect, and that is the fiscal issue. I think the probability is very, very high that if we do not deal with our fiscal situation then at some point or points that are unpredictable in time this will lead to severe destabilization, and let me quickly say my belief and hope, as I mentioned a moment ago, is that we in fact will deal with our fiscal situation before crisis occurs, but if we don't then I believe the probabilities are very high that it will lead to severe destabilization. That destabilization could take many forms: a fiscal crisis, a long period of slow growth with high interest rates, high and increasing inflation or some combination of the two.

Let me make one technical point if I may, and I know this is very technical but just so that what I'm saying is not at odds with what you read in the papers. It is true that if you look at our current fiscal projections for the next 10 years they come close to – they don't get to but they come close to – this stabilization that I've mentioned of debt to GDP. But that is dependent on the sequestration measure which I mentioned earlier, which is a terrible, terrible piece of legislation and also, because it is onerous, it's thought by many – and I'm including myself on this – as likely not to be sustained over time but rather to erode in one fashion or another simply because it isn't a liveable proposition for our federal government. And then you're back into where we were fiscally without it. I also believe that if we had a well-constructed plan of the kind that I mentioned before, it would not only serve the purpose I suggested but would also provide for public investment and would begin to address the even larger deficits that we have after this decade.

That takes us to monetary policy. In the absence of sound macroeconomic policy, as we all know, the US Federal Reserve Board and the ECB have taken extraordinary measures. In the United States the Federal Reserve Board had QE1, which I think was absolutely necessary and hugely courageous to deal with the financial crisis, and that prevented it from going over an abyss and did help begin a repair process. Then there was QE2, which was explained as an effort to deal with and prevent inflation, and now we're at QE3. The advocates of QE3 say that we need this because we have high unemployment, great hardship and no other policy tools available. I absolutely agree that we should do everything that makes sense to deal with what in fact is a much too high unemployment rate and a great deal of hardship among many of the American people. But the criterion for any action, it seems to me, should not be that nothing else was available but rather it should be a measure of the benefits versus the costs.

Without getting into all of the details that are involved in this, I think if you look at the various pieces of the QE3 impact, I think you would probably reach the same conclusion that the great preponderance American economists have, which is that while there have been some effects that on the whole the beneficial effect of QE3 on the economy has still been quite limited. Just as one little example: mortgage rates and bond interest rates were very low before QE3 was pushed out and announced, I don't believe they were much affected by QE3 and remained at very low levels up this present day.

Very little affected I think, as I said a moment ago, by QE3. There's been a recovery in housing and in housing prices but if you take the view that I just had, this QE3 hasn't had much effect on these rates, and I think that lies predominantly with the overhang that has now been to some extent eliminated, and also a tremendous amount of pent-up demand.

Thus, as I said, most economists think the beneficial effects have been limited, but the risks are real. One moral hazard is if elected officials come to feel, as I think they do, that the Fed is going to maintain a low interest rate regime for a long time. Two: even if QE3 has not had much effect on the bond market, which I don't think it has, I do think as you go out the risk curve – I think the comfort that the markets have taken in the Fed continuing this policy probably have contributed to creating or heightening excesses. But most important is the question of: what is the level of risk in navigating a future exit from the unchartered waters that we are now in with respect to expanding the Fed balance sheet and creating new money supply – using that term loosely, not technically.

That's a very complex question, but the bottom line is that you have this immense increase in the balance sheet, this immense increase in the money supply – how will the Fed manoeuvre with all of this when the time comes to exit? One possibility is they begin the exit roughly at the appropriate time, but with the vast increases in the money supply and balance sheet, can they do that without creating a serious problem in the bond market and the possibility, a real possibility I would say, of a material downturn in the economy? On the other hand, if they don't do it they then fall behind the inflationary curve and you run into not mild inflation, which might actually be healthy, but rather substantial and increasing inflation.

Furthermore – without getting too technical, but I think it's important to mention this, because it's so much part of the debate at home – one possibility, as I think I said a moment ago, is the way to exit is to sell bonds that are on the balance sheet. Another way would be to hold all the bonds, don't sell them, just hold them, but take supply, keep money supply out of the system to the extent you want to by raising interest rates on reserves. Like I said, this gets very technical, the only reason I'm saying this is because it's very much part of our debate. I think the only point that's important here is either way I believe you run at approximately the same difficulty and risks around the exit that I just mentioned, although the dynamics are somewhat different.

A central question analysing all of this – which happens to be of particularly interest me because of the life I've led – is how effective are macroeconomic models in predicting what's going to happen? I've been around this for a long time and my view is that models cannot begin to capture the complexity of reality, including the psychology of markets and economies, and while they can be useful to inform judgements they are far from all that is needed to make judgements. And the best evidence of that is the lack of success and reliability of people using these models in terms of predicting what's going to happen in the future.

Let me briefly touch on the eurozone. Mario Draghi I think is – I mean I guess I should in full disclosure he's a very good personal friend, but leaving that aside I think he is just enormously capable. But I think the markets have – may, I should be careful about this – may have misjudged what his actions so far have meant because, as you remember, he announced on a Thursday that he was going to do whatever was necessary, the markets rallied, they've still been calm, but he announced the next Monday I think it was, or maybe Tuesday, I think it was Monday, that all that was going to be conditional on reform, that is to say the use of that capability of the ECB's condition on reform.

And I think that gets to the heart of the problem. The ECB's action by itself does not have substantive effect; the only answer to these crises is political action by the countries themselves. And in fact if the ECB were to try to act without political action I think ultimately it could not succeed and the problems would simply be worse, because the countries will be far more indebted. There are some who will say, 'well the ECB can just continue buying bonds indefinitely if they want to'. I would say that that would at some point highly likely create capital flight, broad-based capital flight – deposits, private sector debt, etc. – either from a troubled country or maybe even the eurozone altogether, and no central bank would use sufficient resources to try to stem that and if they did it would be ruinous.

Let me make one comment on markets. I referred several times now to the risk of market destabilization. I've spent my whole adult life around markets. Markets can remain calm for a long, long time, or a far, far longer time than one might think looking at the underlying fundamentals. Then at some unpredictable time, if in fact they're out of sync with fundamentals – and that's obviously a difficult judgement – if they're out of sync with fundamentals they then can react and will react rapidly or slowly, but with very substantial downward adjustment. And the lesson I draw from that is not to look at markets and trying to make judgements as to what's happening, but rather looking at the underlying fundamentals. There are innumerable cases of people who've got lulled into participating in very strong markets and then found at some point that in fact the markets were out of sync with fundamentals and they get caught in large downdrafts. Let me say, I'm not making a prediction – I want to be very careful here – I'm not making a prediction about any markets or anything, I'm just describing how markets work.

Let me close my comments on the eurozone, but also really my comments overall, by saying that these policy issues – and now I'm going to go back to the US actually and close with that, but then go into a final closing moment. The policy issues I've discussed in the United States are very complex, but they can all be addressed substantively. A friend of mine who was one of America's best-known economists, he's very conservative and he's a Republican, he said to me not long ago that if he sat down with a Democrat who was a counterparty [*sic*] and very liberal they could solve every one of these problems in an afternoon. I think it's little bit of hyperbole but, nevertheless, the point is the same – that these problems are solvable, the question is politics. And our system has been massively or substantially dysfunctional now for quite some time – it's been getting worse as time goes on. I believe that the historic resilience of our political system and the dynamism of our society suggests that we will get back on track.

The path to recovery is not clear, but there's really a lot going on right now, there is intense focus on this in our country and the consequence is all kinds of efforts of different kinds to find ways to improve our system. And I think that very activity itself is one reason to be hopeful. Let me say as an aside – and I think a very important one at least on our side of the Atlantic, and less focus here maybe – is that it's not just industrial countries who have problems. Many of the emerging market countries have been enormously successful economically but they too face great economic, social and political challenges, and I think we very often tend to underestimate those, at least we in the United States do when we look out at the rest of the world.

Alright, now let me finish where I started. The industrial democracies may – as I said at the beginning – may well be at a period of historic importance. Many factors affect economies, but sound policy is critical and sound policy in turn depends on an effective government, and that effective government is in turn absolutely indispensable for economic success in any country. As President Clinton used to say to us, all the good policy thinking in the world doesn't matter if the politics don't work, because it'll never go into place.

I would only want to live in a democracy; I suspect that that's true for all of you. As all you well know, Winston Churchill famously said democracy is the worst form of government except all others that have been tried. And Sir Winston didn't – I guess he was Sir Winston – didn't address this: that does leave the vital question of whether democracy will succeed in providing effective government and economic success in the 21st century.

You may not agree with the views I've expressed, or at least all the views that I've expressed, but I do believe that each of us has to reach our own conclusions on every one of these issues if we are going to reach and make informed judgements on all matters relating to the economy. I also believe that since we live in an interdependent global economy we're all vitally affected by policy decisions everywhere and as a consequence we should all get involved in any way we can in promoting sound policy and strengthening the democracies to do that which they have to do if we're going to have the kind of future we would like to have. Thank you all very much.