



The Economic Outlook and Current Policy Issues

Robert E. Rubin

Introduction by Louis W. Cabot

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Louis W. Cabot

From the beginning of Robert Rubin's career at Goldman Sachs through his years of public service in the Clinton administration to his current position as chairman of the executive committee at Citigroup, Bob has been a major figure at the center of the American financial system. He once said that "public service is an essential calling for the well-being of America" and he carried out that responsibility with consummate skill and integrity. In Washington, Bob guided the newly created National Economic Council as it oversaw and coordinated economic policy making at the domestic and international level. As the seventieth secretary of the treasury, he worked with both parties to achieve landmark legislation balancing the federal budget. He was an aggressive advocate

for opening domestic and foreign markets to trade and for maintaining America's commitment to multilateral financial institutions. Now, as chairman of the Local Initiative Support Corporation, he continues his long-standing efforts to foster business investments in depressed urban and rural areas.

When Bob resigned his position as secretary of the treasury, President Clinton said: "He built a spirit and a belief that we could actually make this economy what it ought to be for our people. That will be his endearing achievement – along with the fact that everybody believed that as long as he was secretary of the treasury nothing bad could happen." I am proud to introduce Mr. Secretary, Robert Rubin.

Robert E. Rubin

I was asked to comment this evening on the U.S. economy and on some of the policy issues that we face. But I would like to start on a slightly different tack, which will quickly lead back into – and in my view usefully frame – this discussion.

During my sophomore year in college, I took a philosophy course from an elderly Greek professor who started each class by turning over a wastebasket on top of the desk in front of the room and then he used that wastebasket as a podium for his notes. To me that gesture symbolized the simplicity – in the best sense of the word – of this insightful man's thinking. The underlying theme that I took from his year-long course, as he deconstructed philosopher after philosopher, was that there is no provable certainty. When I mentioned this to my father, he told me that he too had enrolled in a philosophy course at Columbia many years before, and that at the opening lecture his professor had also made the point that nothing could be proven with certainty. At the end of the class, my father went up to the front of the room, banged on the hardwood table, concluded that the table existed, and dropped the course. I had a very different reaction. In the skeptical Harvard environment of that day, Professor Demos's course crystallized a train of thinking about certainty that has stayed with me ever since and has enormously important ramifications.

If you accept the view that there is no provable certainty – and that is the view of modern science – then you are quickly led to the conclusion that reality is complex and uncertain and that decisions are about probabilities and trade-offs.

I believe that only with that mind-set can a policymaker – or for that matter someone running a business or investing – thoughtfully come to grips with the immense uncertainties and complexities of the economic environment. In an effort to capture that mind-set and to explore policy issues that I think will be central to our nation's economic well-being in the years ahead, I started working on a book about three years ago. The book, titled *In an Uncertain World: Tough Choices from Wall Street to Washington*, describes my experiences from Washington and Wall Street as well as discusses policy issues – but also investment and business issues – that in my judgment are central to our future.

As you can tell from the book's title, I believe that we are in one of those times when the economic outlook, which is always uncertain, is especially uncertain. There are powerful, competing forces that will determine the economic conditions in the years ahead, and what happens will be enormously affected by the policy choices we make in the face of these competing forces. Moreover, as the book describes, many of the policy issues we face are not only substantively difficult but also politically difficult. Unfortunately, at least in my view, the

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American people have too little understanding of most of these issues, and that makes the politics of moving forward very tough and obfuscation relatively easy. Our country would benefit enormously from a more economically literate electorate.

To illustrate this very serious problem and its effects, I remember once being in the Oval Office with President Clinton and he said to me that one of his greatest regrets of his time in office was that he was never able – despite his tremendous skills – to get the American people to better understand the benefits of trade, with the result that trade, which has dislocations that are keenly felt but benefits that are more diffuse and less well understood, has remained a very difficult political issue. I also remember, and I describe this in the book too, that Diane Feinstein told me that in her 1994 Senate campaign 42 percent of the people in a California poll thought their income taxes had been increased by the 1993 deficit reduction program. In fact, that program increased income taxes for only the top 1.2 percent of taxpayers, but the distortion of the program by opponents had been so effective that a near majority in that California poll believed that their income taxes had been increased.

Let me now turn to a brief discussion of the economic outlook and the policy issues before us.

The 1990s were a remarkable period economically – the longest expansion in U.S. economic history, with high growth, low inflation, greatly increased productivity, over 20 million new jobs in the private sector, and rising incomes across the spectrum. Many factors contributed but I don't think there is any question that policy was central and indispensable, especially a dramatic change in fiscal policy but also a continuation of trade liberalization and much else. However, as seems inevitable with extended good times, imbalances also developed during that period, including high levels of corporate and consumer debt, large current account deficits, a stock market that went to excess by conventional standards, and the development of substantial excess capacity. Those imbalances created the virtual inevitability of a difficult period, though the difficulties were lessened

by strengths carried forward from the 1990s, including a low unemployment rate, high productivity growth, and a sound fiscal position now thoroughly dissipated. Moreover, at least in my view, once the difficult conditions began the policy decisions in response to those conditions – leaving aside the Fed – were far from optimal with respect to minimizing the duration and severity of the difficult period and with respect to positioning the country for the long term. Most fundamentally we could have accomplished whatever fiscal stimulative purposes we wanted with temporary stimulative measures, not tax cuts that had large costs and great deficit effects in later years, and the tax cuts would have been more efficient if they had been focused predominantly on low- and middle-income people who have the highest propensity to spend. A greater jobs' impact might also have been possible through more aid to state and local government for current spending in schools, homeland security, information, and the like.

Looking forward, most Wall Street economists feel that growth will be healthy through the second quarter of next year, due to accommodative monetary policy and massive stimulus from defense, homeland security spending, and tax cuts – however badly those tax cuts were designed for that purpose. This forecast seems to me likely to be correct, albeit not certain. And it is not clear whether this growth will be accompanied by strong job growth, which is important economically and politically. In any case, assuming that this short-term forecast does turn out to be correct, the big question is, once a strong stimulus has worked its way through the system by mid next year, does the recovery continue and become a sustainable expansion or do we go back to a more sluggish economy?

I think the answer could readily go either way. What I would like to do now is to look at some of the risks that are relevant to that question – risks that even if we do enter a more sustained period of growth could continue to overhang the economy and pose an overall significant risk for the longer term.

I focus on these risks not necessarily because I have a judgment as to their likelihood, although I do think they are serious, but because they are either ignored or underweighted in almost all forecasts by economists, investors, and the like – perhaps because they are not quantifiable and therefore don't fit neatly into models – and because they pose policy challenges that are absolutely critical to our economic future.

To start, the imbalances that I mentioned before for the most part have continued and some have even worsened. Consumer debt is at roughly record levels as a percentage of the economy, and despite lower debt service due to interest rates, it seems to me likely at some point to constrain consumption. Excess capacity in the United States is still substantial, though the effect of that on investment could be balanced against the deterioration in the capital stock from three years of low investment. Very significantly, the current account deficit is at very high levels. That may not matter for some time, but at some point, if not corrected, our currency is likely either to gradually decline – which could be readily absorbed as an orderly adjustment – or to have a sharp

Enormous and never ending deficits greatly reduce our flexibility in responding to future emergencies – geopolitical or economic.

decline, which could hurt our economy through higher interest rates and possibly a lower stock market. The long-term fiscal mess now in place adds to this risk of a sharp decline because it too can undermine foreign confidence in our currency – especially in conjunction with our large current account deficit. It increases the vulnerability to a diminution of foreign confidence because we have a large fiscal deficit to fund, and, while the explanation is complicated, the fiscal mess contributes to the size of the current account deficit.

Geopolitical conditions are obviously another very serious problem: Iraq, North Korea, the Middle East conflict, nuclear proliferation, terrorism – all of this is very relevant to our economy. In our administration, we had to deal first with the Mexican financial crisis and then the so-called Asian financial crisis. There is no question that strong American leadership was needed in order to deal with these matters but we very quickly learned that we also had to work cooperatively with the rest of the world if we were going to succeed. I believe that the same is true with respect to today's geopolitical challenges: leadership and true cooperative endeavor together are the keys to most effectively achieving our purposes.

There is also a backlash against trade liberalization both in the United States and around the world. When I was at treasury, I testified before

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the House Ways and Means Committee that not only exports but imports were good, because of lower inflation and lower interest rates, traditional comparative advantage theory, and competitive pressure on domestic industry to be productive. A conservative on the committee said that I was the first public official that he could remember testifying to the benefit of imports. Unfortunately, as I mentioned a moment ago, the dislocations created by trade are highly visible, and the benefits are diffuse and not well recognized by the American people. That makes trade a very difficult issue politically, and I think trade will be a major focus in the 2004 election with both parties playing to this issue. Moreover, the politics are now made more difficult because the range of goods and services subject to the pressures of trade has expanded enormously. It is not only traditional manufacturing but software development, processing, call centers, and now even legal research and investment banking research that are being outsourced due to the new technologies that create real-time connection across the globe and to the hundreds of millions of people now well educated in China and India available to work at pay levels way below those in the United States.

There is also the substantive question of whether these new developments in any way change the traditional case for trade liberalization. I have spent a fair bit of time discussing this with people I view as deeply thoughtful on these matters, and they certainly believe the answer to that question is no – and that seems to me highly likely to be right. However, since the dislocations have become much broader, greater, and quicker, some believe there may be a time gap for adjustment – which corresponds to the more worried view some business people have – and a gap could have significant economic and political consequences. In any case, these developments place an even higher premium on equipping our people to be productive and competitive in the global economy through a strong public education system, through effective retraining and placement assistance to address dislocations in our inner cities, and through fiscal discipline to provide low interest rates conducive to a robust invest-

ment environment. And protectionism would only make matters worse. Consumers, interest rates, and inflation would suffer, competitive nations would be able to receive inputs to their production processes more cheaply than we could, and our trading partners would likely retaliate. More flexible exchange rates in China and Japan might help, but I suspect that that likely effect is overestimated. What would help a lot would be more robust economies in Europe and Japan. Unfortunately, neither area is likely to have anything more than modest growth, even after expected improvement next year, and neither area seems likely to me in the near future to do enough to address the structural issues that have led to sluggish economies.

There are a number of other significant risks and issues that I could discuss, but I would like to wind up this discussion of risks with U.S. fiscal policy, our politically caused Achilles' heel. In January 2001, the bipartisan Congressional Budget Office projected a ten-year surplus of \$5.6 trillion. Goldman Sachs & Co. a few weeks ago projected a ten-year deficit of \$5.5 trillion. That is a deterioration of about \$11 trillion, or allowing for adjustments for comparability, about \$9 trillion – and that is the number to keep in mind. The 2001 and 2003 tax cuts, assuming, as their opponents argued, that those tax cuts scheduled to expire will instead be made permanent, account directly for roughly one-third of the \$9 trillion deterioration and over 50 percent of the \$5.5 trillion deficit itself, and indirectly for far more because those tax cuts act to undermine the fragile political consensus that existed around fiscal discipline.

On January 7, 1993, during the transition, the new economic team met with President Clinton to discuss strategy to restore sustained growth. Shortly into the meeting President Clinton said, "I got it – the deficit is a threshold issue," and he opted for the politically difficult path of restoring fiscal discipline to promote recovery through lower interest rates.

Supply-side critics, like Newt Gingrich and Dick Armey, said that tax increases involved in our 1993 deficit reduction program would lead to recession. Instead we had the remarkable economic conditions that I described a few moments ago. That was due in part to favorable interest rate effects and in part to something we had not fully anticipated. In the minds of many people, the deficits had become a symbol of a much broader inability to manage our economic affairs, and so had damaged consumer and business confidence. Restoring fiscal discipline not only promoted lower interest

rates but it also promoted consumer and business confidence, as well as confidence in international capital markets. All of this is described in my book as part of what we call "the great fiscal debate," which has long raged in different forms and will be front and center for years to come.

Understanding the morass of the early 1990s, and then the sustained recovery, provides useful guidance in projecting the consequences of today's fiscal position – never ending and substantial long-term deficits that will get worse with the passage of each year because of the rapidly increasing retirement of the baby-boomer generation around the end of this decade. In the book, I go into a quantitative analysis of the interest rate effects that these deficits are likely to have, but suffice to say for this discussion that those effects are serious. And they could be far more severe if the markets come to believe that the government may give up on fiscal discipline and attempt to deal with its debt problem through inflation, and even more if they undermine foreign confidence in our currency. In addition, as I mentioned a few moments ago, our long-term fiscal morass can have substantial adverse impacts on the more general level of confidence of consumers and business.

Finally, these enormous and never ending deficits greatly reduce our flexibility in responding to future emergencies – geopolitical or economic. For example, our ability to respond to the tragic attack of 9/11 with a massive defense and homeland security effort without creating a sharp upward spike in interest rates was possible because of the large fiscal surplus that we then enjoyed. Also, the capacity of the federal government to perform the functions that the American people desire of government will be greatly reduced by our future fiscal conditions.

All of this is an enormous threat to our future economic well-being. When these effects may occur, however, is not predictable. As long as private demand for capital is relatively low – as has been the case for the last three years – interest rates will be low and the markets will be relatively unlikely to look forward to long-term fiscal conditions. But once private demand for capital becomes robust, that demand will collide with the government's need to fund its fiscal deficits, the markets will look forward to the fiscal morass, and at some point the severe threats to our economy from our fiscal mess are highly likely to become a reality.

To conclude, I focused this evening primarily on risks because I believe that while our economic potential is strong, given the many ad-

vantages we have in the economic arena, realizing that potential will depend heavily on the policy choices we make. Unsound choices can lead to real difficulty, and I think we are on the wrong track on many important fronts. The first requisite for making good policy choices is to recognize the complexities and uncertainties inherent in the issues we face. A group as distinguished as the American Academy of Arts and Sciences and dedicated to thought can help promulgate that realization, as well as better public understanding of the issues themselves, as I hope my book will do on a very modest scale. Though my focus has been on policy, it seems to me that investors and business people also need to be fully cognizant of these risks and need to try to find the right bal-

ance between being aggressive to realize the benefits, if conditions turn out to be favorable, and careful in order to weather difficult times should they occur. Our country has a history of resilience in overcoming difficulties and mistakes, and on the theory that past is prelude, that, as well as our natural advantages, could bode well for a good future, but it is going to take a lot of work by all of us to get there. ■

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