COMMENT: The contradictions at the heart of Rubinomics

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By Glenn Hubbard

Robert Rubin is a bright and earnest man, a success in business and government. *In An Uncertain World* documents his 6½-year tenure in Washington as the first head of the National Economic Council and, later, as Treasury secretary and offers an important glimpse into the Clinton administration.

Rubin notes accurately that he had "come to personify the [economic] policies of the Clinton era". Indeed, "Rubinomics" is now a moniker for economic policy of the late 1990s - the sort of coinage usually reserved for presidents. I had hoped for insights into Rubin the man and his economic world view. Rubin's educational experience and rise in the world of finance at Goldman Sachs make interesting reading. His "probabilistic" instincts in business foreshadow an ability at the top of government to recognize uncertainty and trade-offs.

Rubin's "rules" for the Treasury state that a policymaker cannot blindly follow economic models. He notes the success of Alan Greenspan, chairman of the Federal Reserve, whose masterful discretion at times differed from conventional economic wisdom, to the betterment of policy.

It is at this point that the reader starts to experience disappointment. While Mr Greenspan's discretion is legendary, his objective is clear - promoting price stability and financial stability. Rubin does offer insight into his own economic philosophy - explaining his emphasis on deficit reduction and his views on international financial stability. The problem is not one of exposition. On closer scrutiny it is economic glue that is lacking.

Rubin's story of the salutary effect of deficit reduction on interest rates, investment and growth gave birth to Rubinomics. To be sure, this "virtuous cycle" explanation for the 1990s boom has been disputed by non-economists (Robert Reich) and economists (Joseph Stiglitz) in the Clinton administration. But Rubin clarifies his world view, inviting close examination of the deficit-reduction/growth thesis.

Rubin's argument has two steps. The first is that an increase in the federal budget surplus, credited to Clinton's 1993 tax increase, reduced US real interest rates, affecting investment decisions. There is something to this story: a decline in government borrowing by a large open economy like the US should exert modest downward pressure on the world's real interest rate. The key word is "modest". Calculations by the Clinton Council of Economic Advisers suggest an effect that is an order of magnitude smaller than Rubin argues. But here he asserts that the current real interest rate on 10-year Treasury bonds would be *90 per cent* lower without the recent deficits. There is no sign the author questions the plausibility of this outcome.

Moreover, as even Rubin acknowledges, surplus-enhancing measures signed by George Bush Sr, a decline in defence spending, and congressional spending restraint played a leading role in deficit reduction. According to 1996 numbers from the

Congressional Budget Office, only $26bn of deficit reduction between 1992 and 1995 was the result of Clinton policies (and even this was after the "stimulus package" and healthcare plan had died in Congress).

More troubling is the second step in Rubin's explanation of the 1990s boom - the effect of interest rates on investment and growth - which exposes internal contradictions in the argument. Investment is importantly affected by the cost of capital, which depends on tax factors, the cost of financing and depreciation. But Rubin dismisses effects of changes in tax rates on behavior and stresses the effects of interest rates: companies respond if interest rates drop and lower their cost of capital, but they do not respond if taxes drop. This view is unusual, to say the least. Most economic research suggests that both interest rates and taxes should matter, a few papers suggest that neither should, but no analysis documents Rubin's hypothesized asymmetric response. Such is the foundation of Rubinomics.

What did cause the long boom? There were some policy influences - such as the Fed's successful battle against inflation - but the seeds of success lay mainly in the miracles in the US private economy. First, faster economic growth since the mid-1990s was made possible by effective institutions for allocating capital, labor and risk. Second, American business and consumers were resilient in the face of shocks such as the stock market collapse September 11 and corporate scandals.

Against this backdrop, President George W. Bush championed tax cuts. These offered long-term benefits, but also helped consumers and business manage risk at a time when the extent of the downturn was uncertain - precisely the framework Rubin seems to have in mind.

We cannot know how the deficit emphasis in a Rubin tax policy would have worked in 2001-2003, but the mild downturn and emerging recovery permit an observation of the effect of the Bush tax cuts on spending and balance sheets.

But what about future deficits? The question is important, but in the context of future tax increases or spending cuts that persistent budget deficits imply. Restraint, especially in entitlement programs, is essential, although Rubin offers no indication of how we could rein in such spending.

To judge by the author's animated discussion, international financial crisis management also lies at the core of the Rubin economic legacy. Rubin argues that, in Mexico or south-east Asia, action was required to limit financial contagion. Opponents of this view worried about whether the benefits of global taxpayer assistance were accruing principally to bondholders, who had already received a risk premium. Rubin now draws a lesson about the need to stress reforms in finance, corporate governance and the structure of public finances, but such topics received relatively little attention at the time.

Rubin now acknowledges the importance of "moral hazard" - that Treasury or International Monetary Fund lending policy could make private sector lenders less careful about assessing risk. But the specific criticisms of the Meltzer commission's 2000 report to the Congress on international financial institutions are largely unaddressed. I sought the answer to two questions. When would an intervention approved by the Treasury in a foreign financial crisis not be warranted? Should such intervention be

limited to cases in which a global-taxpayer-financed program could lead to a sustainable path for economic growth and public finances? I found few clues to the answers.

Policymaking always takes place "in an uncertain world". As Rubin notes near the end of his book: "There is no finality about any of these [policy] questions." True, but an economic lens - a world view - for organizing those questions is an essential component of policy success. After 402 pages, I could not bring the lens into focus.

The writer is professor of economics and finance at Columbia University and was chairman of President George W. Bush's Council of Economic Advisers until March this year