

**TESTIMONY OF  
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JOINT ECONOMIC COMMITTEE HEARING  
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Thank you Mr. Chairman. I believe that you are holding this hearing at an historic juncture with respect to the longer-term outlook of the American economy, and that your Committee is exceedingly well positioned to catalyze serious public discussion and to develop sound approaches with respect to the issues that face us.

The American economy has enormous strengths: the dynamism of our society, the willingness to take risk, our flexible labor markets, and much else. On the other hand we also face hugely consequential longer-term challenges, which I'll touch on briefly in a moment. Moreover, the global economy is undergoing change of historic proportions, including technological developments, globalization, effective productivity policies

like education and market-based economics in a number of emerging market economies, and, as a consequence of all this, the emergence of China and India as potentially large markets but more immediately as powerful competitors. We can thrive in this transforming environment, but to do so it is imperative that we meet our challenges, and failure to meet our challenges could lead to serious difficulty.

Currently, in my judgment, we are far from being where we need to be on almost every front, independently of how you allocate the political responsibility. This contributes substantially both to the unsound fundamentals underlying our economy despite good GDP growth, which could augur trouble for the future, and to the struggle that many if not most Americans are having economically. As to this latter, median real wages and median real compensation have been roughly stagnant for the last 5 years, and grew relatively slowly for the last 30 years, except for the last 5

years of the 1990s, while income inequality, focusing on a very small top tier, has increased substantially. Moreover, economic dislocation and economic insecurity have increased substantially.

As we address all of these conditions, I believe strongly in markets as the most effective organizing principal for economic activity; but government has a critical role in providing the requisites for economic success that markets, by their very nature, will not provide. Moreover, the objectives of policy should be growth, but also broad participation in that growth and improved economic security, both as a matter of values and also because these objectives can be mutually reinforcing.

More specifically, sustained growth is the single most effective way of promoting broad income growth and economic security – through the effect of sustained tight labor markets. And, broad income growth and increased security are critical to growth for two reasons. First, they provide

workers with the resources to access education, training, rapid redeployment into the economic stream when dislocated, and other contributors to productivity, and, second, because sound economic policies around trade and market based economics will only have broad public support if the great preponderance of the people expect to benefit from these policies.

I think we can most effectively achieve the three objectives I set out – growth, broad distribution of that growth, and greater economic security – by meeting the challenges I mentioned earlier, which I think of as falling into four baskets: 1) our multiple financial imbalances; 2) serious shortfalls in education, infrastructure, basic research, energy policy, health care policy, inner-city programs and so much else that are critical requisites for economic success; 3) the cost/benefit imbalances in our regulatory and litigation regimes; and 4) international economic policy, including trade, relatively open immigration, and working toward flexible exchange rates.

These all occur alongside of economically significant exogenous risks, including terrorism, oil shock and others.

Addressing our challenges will require a dramatic change in our strategic orientation and commensurate change in our policies. In my limited time, I won't try to describe the relationship between each of our challenges and the three objectives I set out, but just comment briefly on two of those challenges.

As to financial imbalances, current economic conditions rest on high levels of borrowing at multiple levels in our society. These include significant projected fiscal deficits over the ten-year federal budget window – assuming the '01 and '03 tax cuts are made permanent as proposed – instead of the surpluses we should have had in a time of healthy GDP growth; a net national savings rate of about two percent of GDP; a projected increase in Social Security, Medicare and Medicaid entitlements as a

percentage of GDP over the next fifteen years of fifty percent; a current account deficit of almost seven percent of GDP, caused partly by our fiscal deficits, and heavy overweighting of dollar denominated holdings in many foreign portfolios. The combination of these factors is a deep and multi-faceted threat to job creation, to standards of living, and to our economy. The vast capital flows from abroad that have sustained us are exceedingly unlikely to continue indefinitely, though the timing of trouble – whether in the near term or years out – is unpredictable.

I believe that we should establish a fiscal path that systematically reduces the debt to GDP ratio year-by-year and leads to balance, and at the same time makes room for critical public investments. These critical public investments – and other key domestic policy issues – also will require change that will be very difficult, substantively and politically, but that are imperative.

As to globalization and trade, let me start by saying again that many Americans are experiencing real difficulty economically, and the pressures from globalization on wages and economic security are one of the factors – including, far more significantly, technological change – contributing to this.

Thoughtful people on this committee and your colleagues in both chambers are working to find effective policy responses to these difficulties, a search made more complicated by the transformative change taking place in the global economy.

There is an understandable temptation to erect trade barriers. However, I believe that would be deeply harmful: that path would lead to higher consumer prices, higher input costs for our producers vs. foreign competitors, loss of the benefits of comparative advantage, loss of pressure of open markets on business to increase productivity, and finally, likely

retaliation of the countries to which we export and possible disruptive effects on the dollar. Moreover, other countries are continuing to move forward on trade liberalization; the only question is whether we will be in or out of the net of preferential arrangements.

However, trade liberalization – which I believe on net still greatly benefits our economy and the great preponderance of our people – must be combined with a powerful domestic agenda to promote productivity, broad-based income growth, and greater security, along the lines I already discussed, and drawing on past experience but also innovative and creative thought.

Mr. Chairman, we can have a bright future, but we have much substantively and politically difficult work to do, and this committee can contribute greatly to achieving those purposes.