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INTERVIEW

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Approach with caution

Dr Robert J Shapiro was US Under Secretary of Commerce for Economic Affairs under Bill Clinton. Now co-founder and chairman of economic advisory firm Sonecon, he has also advised the Obama administration and is chair of the US Climate Task Force. He tells Business Spectator's Isabelle Oderberg:

- ***The Australian government and RBA should be taking a cautious outlook on economic policy***
- ***For a self-sustaining recovery, the US needs strength in consumer spending, business investment and construction, not GDP inflated by stimulus***
- ***He admits the climate change debate has taken a back seat to the economic crisis, but he still has faith in the idea of a carbon tax.***

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Isabelle Oderberg: Earlier this year you were the keynote speaker at the CEDA/AusTrade Trade 2020 conference. Do you have any opinions on the Australian economy and the Australian situation? We've actually moved into an upward interest rate trajectory. Do you think we're moving too quickly , that this is part of the wishful thinking, or whether we've got nothing to lose because we can always bring them back down again?

Robert Shapiro: The damage done to different economies by this crisis was the result of two factors. One was how close they were to the eye of the storm, which was the US and how integrated their financial markets were with US financial institutions. The second element was how sound their economy was before the crisis.

The Chinese financial system, for example, was almost entirely insulated from this crisis. They suffered collateral damage from the decline in global trade. But they responded with very, very stimulative measures, incredibly stimulative measures, plus currency manipulation to maintain exports as much as they could and they've come out of this very quickly and in a pretty strong fashion.

Australia's financial institutions were not as isolated from ours as China, but much more so than the Brits for example or other Europeans. So I think the damage to your financial system was less and that means you have a stronger basis for a recovery in business investment. Are you going too quickly? I have to say I don't see signs anywhere in the world of inflation, but I have to tell you I have not studied your macro economy in that way. I've looked at it much more with respect to trade and with respect to climate, so I can't say, but I will say that as a general proposition when you're coming out of a very serious crisis I think that it is better to err on the side of caution about shifting policy than to anticipate it.

The global economy remains weak and vulnerable to additional shocks from the United States and perhaps other places as well.

After a period like this it is usually best to adopt worst case scenario thinking for a while and not best case scenario thinking.

IO: In relation to some of the recent US economic data, you've said that there's not a strong enough argument that we're in a self sustaining recovery.

RS: Correct.

IO: What sort of indicators would you need to see before you could pronounce a self-sustaining recovery?

RS: Some significant strength in consumer spending and I'd look for some strength in business investment. That is what we have today - an increase in GDP in the third quarter, and I'm sure in the fourth quarter that reflects mainly the direct effects of very large stimulus, plus what's happening in inventories. What's happening in inventories is that they have been declining, but they are now down to such low levels that they're not declining anymore. We're not seeing any rebuilding of inventories, but the fact that inventories have reached a level where they really can't go much lower takes a negative away from GDP. In none of the critical areas do we see the kinds of behaviour that would tell you that consumers have regained some confidence and are prepared to spend again, in particular on larger items without a particular stimulus, without a government subsidy that will expire, in any event. Businesses are responding to this by beginning to expand investment. I would also like to see, alternatively, gains in construction and certainly we're not seeing that either.

IO: You also say that the US economy needs help, but a lot of the US based economists that I've spoken to seem to think that there's not much the US government can actually do at this stage. When you say that it needs help, what should the government be doing or perhaps what should it be doing differently?

RS: I think there are some things government can do right now. In particular I think that we need to extend unemployment benefits to try to maintain incomes of people who have lost their jobs and had been out of work for a long time. We need to probably provide some additional support to state and local governments who face balanced budget constraints and are being forced to cut back on both employment and services in order to keep their budgets balanced, which is not what you would want. It's not what you want in a serious downturn, but they have legal balanced budget requirements. The fact is that most of what we're seeing shows that there isn't anything we can do much about in the short term.

I would like to see additional assistance to homeowners facing difficulty with their mortgages, because mortgage foreclosures are continuing to rise. As they do they pull down mortgage-backed securities that continue to be held by the financial system and the credit default swaps associated with those mortgage backed securities and that makes it all the harder to get business lending going again once there is a macroeconomic basis for that for business borrowing. But the fact is that we are in a very negative economic cycle and in the short run there's probably not much we can do. This is the result of a sustained mismanagement and sustained perverse dynamics in the financial system.

IO: Can I pick up on something you said about foreclosures on homes? I've heard time and time again that part of the reason for this crisis is that there was a culture dependent on overextension and reliance on debt. Is there not an argument to say that unless the foreclosures are allowed to go ahead that people won't learn? That they can't overextend especially not in the period where a property market has, for instance, overheated?

RS: Well look, the most overleveraged area of the economy was finance and not homeowners, but the entire economy was overleveraged. That's absolutely correct. But it's like if a smoker gets cancer, you don't withhold treatment to make sure that he understands that he must never smoke again.

IO: Now, I feel like a horrible person.

RS: No, don't feel like a horrible person. There are people who continue to believe that financial markets are inherently efficient and optimal. We have a whole theory of efficient market theory which was used and believed by many people, including in periods myself, to suggest or tell us that regulation of financial markets should really be directed towards preventing fraud and enhancing transparency and not much else. But that view was correct in a previous period, it is demonstrably wrong in this period.

The markets were inefficient over a sustained period, over very long periods of time. That was in the housing market and it was true of many parts of the capital markets. We can understand some of the reasons why, but the fact of the matter is those are the results and they've cost the economy trillions and trillions of dollars in lost value. I would ask those who say that we shouldn't provide any assistance to homeowners, where they were with respect to assistance to financial giants. They were more overleveraged than most homeowners.

IO: In some areas of the market there appears to be a cautious optimism; the worst is behind us, it can only get better. Do you think there is too much wishful thinking around?

RS: I think there probably is, but the truth is we don't know. We are operating under a set of conditions that we can't really draw very many modern parallels to and so we don't really know how this is going to develop. We look at the past and we apply the models in our head and the models in our computers, but the fact is that the models didn't predict the crisis. The crisis took most, almost all, economists by surprise. They really didn't believe that financial markets could be as distorted as they turned out to be.

I tend to be pessimistic, because I don't see any strength in the economy and because I am not convinced that we've addressed a number of the underlying issues in this crisis that produced the crisis. The effort to get the financial institutions to get rid of their toxic assets, that kind of fell on its face; they're still holding the assets. They're waiting and hoping that the assets are going to recover. Lending is very slow in part because of that and in part because there's been such a blow to both consumer and business confidence.

I just don't see the source of growth and there is some short-term optimism based on temporary factors. In particular, we had what looked to no economists at least like a good GDP report, for the third quarter. But when you looked inside it, all the strength was coming from temporary measures by government and the stock market rose briefly on that, but the day after that we had another report that showed consumer spending declining in September at a six per cent rate.

IO: Do you think that perhaps part of the problem is people that aren't qualified giving commentary in the media?

RS: Well, the media, television at least, cable television, their economic commentary is a form of entertainment. You need changes in story lines and they produce those changes and they tend to exaggerate whatever are the conditions; either they're good or bad. But the truth is, if you ask serious economists what they think is certainly going to happen over the next year, most of them will say, 'Well, we really don't know, we're concerned that there could be a double dip'.

IO: Do you think that climate change has been put on the backburner while we deal with this?

RS: Yes. Yes. You see that in US polls where for the first time in many years the number of people who say this is a problem we need to address right away, who say this is a serious problem that needs to be addressed quickly, those percentages of people fell fairly sharply.

IO: And when I speak to economists like Lacy Hunt from Hoisington, he tells me that this is a case of debt deflation and the US is going to be in this hole for ten or fifteen years. Does that mean that action on climate change is going to be put on hold for ten or fifteen years?

RS: Well, I don't believe that the United States is going to be in this hole for ten or fifteen years. I think we're in a hole for another year and I think we could have a slow recovery for a couple of years after that.

I think we can take policy measures that can rebuild a lot of the strength of this economy. After all, the underlying strengths of the economy have not been affected at all. We haven't lost human capital. We haven't lost physical capital. It hasn't been blown up. It's still there. The sources of innovation in the economy are intact. In the entrepreneurial culture and the access to financing for new ventures is still decent; it's not great, but it's decent.

So, the ability of the economy to absorb innovations hasn't been impaired. The basic strengths of the US economy, the underlying strengths, are intact. The financial system is badly damaged and unfortunately I don't think we've done enough to repair it, but that is something that can be repaired. Consumers need to rebuild their wealth, so the saving rate has been higher. A little lower last month than it had been the month before, but the saving rate is significantly higher than it was before the crisis. People are trying to rebuild wealth. That's one of the reasons the economy is slow, right now. People are consuming less because they're saving more.

The only way you get a very extended period of economic stagnation or decline in a modern economy is sustained policy error. That's what happened to Japan. It had a sustained policy error. It refused to address it's financial crisis and refused to make a lot of reforms in the real economy that were called for. Sustained policy error is also the difference between a terrible recession and a depression.

IO: So, you have faith that the Obama administration isn't going to make sustained policy errors?

RS: I have faith in the political system that the American public does not stand for sustained mistakes, for sustained pain. The American public doesn't like pain and nor do the people in many cultures, but they throw people out of office when they preside over economic pain. It's one of the things that happened to the Republicans in the last two elections and the Obama administration is a very pragmatic administration. It believes in trying lots of different things. Sometimes I advise them and I know they've reached out to me and they're reaching out to a lot of people for new ideas about what to do about jobs which is a large structural problem now and one I have written about at some length. I think they'll keep on trying until they get it right.

IO: Is a carbon tax something you still believe in? Because there seems to have been a popular shift towards carbon trading.

RS: Oh absolutely, absolutely. The United States was not going to pass systemic climate legislation this year under any conditions. There is no sustained political consensus for cap and trade and there's no current consensus for a carbon tax either. So, the debate was going to continue because there simply are not the votes particularly in the Senate to pass anything right now, but ultimately addressing climate change in a serious way is a responsibility of every advanced government and a particular responsibility of the United States because we produce so much greenhouse gases.

It's also, frankly, the kind of challenge the United States usually does particularly well in and that is a set of circumstances in which one of the things you need is sustained technological innovation, which is one thing that climate change calls for and something which a carbon based tax is particularly adept at stimulating. So, I think the United States will take action, but at the same time there aren't very many societies in which political leaders can convince a public which can hold them accountable at the polls to absorb any short term costs when their general economic conditions are deteriorating.

IO: At what point do you accept defeat in terms of a carbon tax being abandoned? Are you still hoping that carbon tax would be the way to go?

RS: I actually believe that we're seeing the kind of decline of cap and trade of carbon trading right now. It's failed twice in the US Senate and it's on the verge of failing for a third time, plus the legislation which passed the US House of Representatives has been an enormous disappointment to most environmentalists, because it was so weak.

I spent a lot of time talking to a lot of groups and businesses about this and what I am hearing is that if cap and trade fails again in the Senate this year, they're then prepared to shift over to a carbon based tax and from other people that then they want to shift to direct regulation by our environmental protection agency. I think the debate could very well shift next year to a new set of choices and the choice being direct regulation versus a carbon based tax. How many times will cap and trade lose? It's lost twice and it's on the verge of losing in the Senate for a third time.

IO: Thank you so much for your time. I really appreciate it.

RS: My pleasure.