2015 Financial Markets Conference: Interview with Robert Rubin

The former Treasury secretary explores shadow banking, risks to the economy, and living with uncertainty in this wide-ranging interview.

Dennis Lockhart: I'm Dennis Lockhart, the president of the Federal Reserve Bank of Atlanta, and I'm here with Robert Rubin, former secretary of the Treasury, cochair of Goldman Sachs, and now cochair of the Council on Foreign Relations. Bob, welcome to Atlanta.

Mr. Rubin will be speaking shortly to the participants in our annual Financial Markets Conference, and the subject of the conference this year is shadow banking. So we'll be talking a little bit about Bob Rubin's views on shadow banking.

Let me start out, I know in your remarks you're going to be explaining how you think about risk and uncertainty. Could you comment a little bit on just that framework for thinking?

Robert Rubin: Sure. For 26 years, Dennis, when I was with Goldman Sachs, I had responsibility first for part of and then ultimately for all of the trading operations. And I developed a deeply held sense that all decisions are complex, and all decisions are about probabilities, and not about certainties and absolutes. And secondly, even when you make judgments about probabilities, those *are* judgments, and judgments inherently have an uncertainty about them because of human fallibility, changes of circumstances, and the wide variety of variables that can affect what actually happens.

Lockhart: What do you see as the current set of uncertainties that a policymaker or a regulator has to think about?

Rubin: One of the great debates, as you know better than I right now, is how much slack is there in the labor markets. Some people think that the reported unemployment rate is probably pretty close to reflecting unemployment, and there are other people—and I'd put myself more in this camp—who feel that there probably is a lot more slack and that the true unemployment rate is probably significantly higher than the reported rate. But whatever judgment you may have, I think, in the relation to the discussion we're having, the important thing to recognize is that you're making a judgment. Yes, you're saying you think the most probable unemployment rate is whatever you think it is, but that's part of a spectrum, and there are probabilities that go obviously in both directions from the position you think most likely.

And secondly, what you should do is recognize that whatever your judgments may be, there inevitably is a lot of uncertainty about whether you're going to be right or you're going to be wrong and what are the various factors that might affect that that you can't even see at this point in time.

Lockhart: One more question on your thought process. You were trained as a lawyer but you ended up being an economic policymaker. So you've been around a lot of economists, as I have. They are trained to think in terms of models and sometimes very quantitative models, econometric models, and so forth. What do you think is the efficacy of that methodology in evaluating risk and uncertainty?

Rubin: I think models could be useful, Dennis, and I think they play a useful role in decision making. But I think that they are far from able to capture the complexities of reality like the psychology of markets, the psychology of business, the decisions that are made in Washington around policy, international events, geopolitical events, and an enormous number of other factors that could affect what actually happens. So I think the way to approach this is to use the models as one input but to recognize how much more complex reality is than the models are in what they capture, and then bring experience and all else to bear on making decisions.

Lockhart: Let's talk a little bit about shadow banking. What are your thoughts on, shall I say, the risks associated with shadow banking or the implications of the continued growth of shadow banking?

Rubin: I think shadow banking is growing very rapidly, in part, because of some of the constraints on banks. Under the Volcker Rule, they can't engage in proprietary trading anymore, and since it's impossible to distinguish between proprietary trading and market making, I think it really has diminished the market-making activity, and that's now moving into other platforms such as hedge funds but many other platforms also.

Similarly, with respect to lending to small and medium-size enterprises, because of the increase in capital charges—I think appropriate increase in capital charges—it's created a space for nonbanks to get involved and there is a very large growth, as you know, in that kind of activity. All these activities in these nonbanks create systemic risks, and yet there is no real regulatory framework to deal with them. I just barely touched on the full range of what I think are the systemic risks of the shadow banking system.

Lockhart: Do you think the situation calls for further regulation of shadow banking, and if so, how would you design a framework that makes sense, particularly given that it's such a fluid world?

Rubin: First, we need to define the contours of shadow banking to try to identify all of the instruments, the asset classes, the institutions, and the activities that are part of shadow banking, and nobody has done that in any comprehensive way, as far as I know. Secondly, we have to develop tools that we think can effectively regulate those activities or the complexity of the activities and the complexity of the tools as such, that we'll never get close to anything that is perfect in that regulatory sense, but at least try to have a much better handle on it than we have today. And thirdly, and this is a very difficult problem in our system, we have to find some way of implementing whatever it is that we design, and because there are so many regulatory agencies or regulatory bodies, rather, in the American system, that is a very difficult problem.

Lockhart: I've read a recent article that you coauthored, I believe you have some strong views on quantitative easing [QE], perhaps on maintaining a zero bound policy rate for now six years. You've touched on this a second ago, but could you elaborate a little further on QE2, QE3, and what you think of that?

Rubin: There is a lot of debate about how much benefit we derive from QE2 and QE3. Having heard enormous amounts of this debate, I guess my own judgment is probably not that much. Rates were very low below before and very low after QE3 was finished. But whatever you may think about the benefits, I don't think there is any question there were very serious risks associated. One risk is that there was a reaching for yield anyway because of low rates, and I don't think there's any question that the comfort that the markets took from the thought that the Fed could and would maintain low rates has exacerbated or heightened that reaching for yield.

And secondly, and I think this is a very troubling question, the Fed balance sheet has gone from under a trillion dollars to over four and a half trillion dollars. At some point, the Fed is going to want to begin tightening whatever that point should be. I think there's always room for policy error when the Fed makes decisions because of the imperfection or ability of anybody to make predictions about markets and economies and so forth. There are some who argue that the Fed can avoid those risks by keeping the balance sheet as they have it. That is, they keep the assets they have and increase the interest rates on excess reserves or use reverse repos. I think there's no magic wand. I think those are simply different ways of doing the same thing, and I think they will involve their own risk, albeit the dynamics may be different.

Lockhart: I'm sure you would agree that we've made a lot of progress since the depths of the recession in 2009 and the crisis in 2008. Where do you think our economy is?

Rubin: My sense would be exactly what you said; I think QE1 was courageous and absolutely imperative. And I think what we’ve had since is a relatively slow recovery by historical standards, but it's been steady and gradual, and I think we're going to continue. We have an unemployment rate that I, at least, think is probably considerably greater than the reported unemployment rate, but hopefully, as the slow recovery continues, if it does, hopefully, at some point the slack will come out of the labor markets, and wages will begin to rise. Now, there are risks; the strong dollar's clearly a risk, and the weakness in the rest of the world is a clear risk. And there's another set of risks that I worry a tremendous amount about, and the markets don't seem to care about, and that is the geopolitical conditions in the world and the effects that could occur if those threats materialize.

Lockhart: Let me ask you to elaborate on those.

Rubin: I think, Dennis, the geopolitical risks that we face are probably as serious as any set of threats that we've faced in my adult lifetime, and I think there are quite a few people who are far more expert in these matters than I am that have that view. And I think it's a mistake to think of this as separate from trying to gauge what the economy is going to do, because these are real risks, they are tail risks, they may be fat-tailed risks, which means that they may have a significant probability of materializing, and if they do, they could have very significant impacts on political stability in the Mideast. They could have significant impacts on oil prices, they—I think, very troublingly—could have significant ramifications of suspected terrorism, and all of that could very much affect our economy.

Lockhart: Thank you very much; congratulations on your most distinguished career, and you have much more to contribute. I'm sure you're staying very active in everything you're associated with. We've been here with Robert Rubin, former secretary of the Treasury, at the Atlanta Fed's Financial Markets Conference. Bob, thank you very much.