

Timothy F Geithner: Key challenges in risk management

Keynote address by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the RMA/Risk Business KRI's Global Operational Risk Forum, New York, 13 January 2005.

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Thank you for giving me the opportunity to speak to you today.

I want to talk about the mix of forces at work on the broader macroeconomic front and what that may imply for risk and for financial stability.

By many measures, the economic landscape looks reasonably good. The qualified optimism that now seems to prevail about the global expansion is reflected in low risk premia, unusually low credit spreads, low and quite stable inflation expectations, and low actual and implied volatility.

But the global economy faces a set of pressing macroeconomic policy challenges. How should we think about the risks presented by these broader macroeconomic forces, and their implications for the sustainability of this recent period of stable economic performance, and low volatility and risk premia?

The U.S. expansion has proven quite resilient. We enter the new year with what appears to be a pretty solid underlying pace of growth. Core inflation is moderate, and various measures of inflation expectations suggest confidence in the outlook for price stability. Estimates of structural productivity growth remain high, although there has been some moderation recently.

The pace of global growth has moderated a bit, but most forecasts anticipate a quite strong and broad based expansion. The IMF's projection is just over four percent for real global GDP growth. The consensus of private forecasters sees growth in Europe and Japan close to estimates of potential, or in the neighborhood of two percent.

Growth in the major emerging markets looks impressive, reflecting not only the benefits of a positive external environment, but also the impact of better economic leadership and policies more supportive of macroeconomic stability and reduced external vulnerability. In China, officials now seem more confident that they have induced the desired moderation in growth to a more sustainable, but still high pace of growth.

The global economy has weathered the oil price shock quite well. If the long term futures prices are right, we need to be prepared to live with the possibility of a sustained period of higher oil prices, and perhaps more volatility in oil prices, and the world seems to be getting itself more prepared for that prospect.

In the financial markets, this broadly positive outlook has been accompanied by a dramatic reduction in risk premia, leaving the price of insurance unusually low against a less favorable or more volatile environment.

These developments imply a view among market participants that future macroeconomic shocks will be more moderate than in the past and more likely to be absorbed without broader damage to economic performance or the financial system. They reflect a general increase in confidence that monetary authorities here and in other countries can keep inflation stable at appropriately moderate levels. They reflect diminished uncertainty about the expected path of monetary policy in the United States. And they imply that the imbalances in the global economy will be diffused smoothly.

Of course, not much is certain in economics and finance. One cannot know with confidence whether future economic policies and outcomes will justify the confidence in the benign outlook now reflected in risk premia.

What are the broader challenges and forces that will dominate the policy agenda and affect economic outcomes? I want to touch on four, though this is a selective list.

First, all of the major economies face difficult fiscal sustainability issues, and these will be exacerbated by the approaching demographic cliff. Fiscal policy in most of the major economies is on a path that will lead to increasing, rather than stable or falling debt-to-GDP ratios. In virtually all the major economies, the cost of committed benefits substantially exceeds the stream of tax resources available under current policies. If one were to produce a ten year forecast of the U.S. fiscal position using the

fan charts to illustrate uncertainty that are a feature of the inflation reports of many central banks, the size of the fan would be very wide, indicating a substantial probability of deficits significantly worse than the already troubling central path for the deficit predicted given current policies.

Alongside these fiscal challenges, the size and concentration of external imbalances in the system are at an unprecedented scale, between five to six percent of GDP in the case of the U.S. current account deficit. This imbalance is the result of a combination of a sharp decline in U.S. net national savings, driven by increased public sector borrowing and a large rise in household debt, and a sustained increase in the relative strength of U.S. demand growth compared with Europe and Japan. The counterpart of this deficit is a large inflow of capital from the world's private savers and foreign central banks. The expected trajectory for this imbalance produces a dramatic deterioration in our net international position and cannot be sustained indefinitely.

These two broad forces coincide with the increasingly rapid integration of China and India into the global economy and financial system. Their impact on the world economy already seems substantially greater than their shares of global GDP. This process of integration has a long way to go. It offers tremendous potential gains in income growth, not just for their 2.5 billion citizens, but also for those who trade with them, through lower prices and further impetus to productivity gains. But it also brings greater adjustment pressures for producers of tradable goods and services, generating greater demands on political leaders to provide protection against those competitive pressures. This dynamic will test the ability of governments to sustain commitment to an open multilateral trading system, and the manner in which this plays out will have an important impact on future productivity gains.

A fourth challenge involves prospective changes in the global exchange rate regime. The international monetary system now incorporates an uncomfortable disparity in the extent to which real effective exchange rates vary across regions. The monetary authorities of the United States and Europe allow considerable variability in their real exchange rates, though they are not indifferent to movements in exchange rates. Japan has somewhat less enthusiasm for flexibility and runs a regime in which it seeks to avoid large swings in the value of their currency. Emerging market economies run a mix of regimes from those that permit significant flexibility to those that run essentially fixed pegs or regimes that seek to contain variations to relatively small degrees around implicit targets for their currencies against the dollar or a basket of the currencies of their major trading partners.

The world has lived with this system for some time. But this is not an ideal mix, either for the monetary system as a whole, or for those countries which permit very little variability in their real effective exchange rates, and it's probably not sustainable over time.

It also is not ideal because it limits the extent to which markets work to facilitate adjustment. It creates the risk of larger moves in the major currencies than might otherwise be the case. In the national economies of those not yet prepared to allow more flexibility in their effective exchange rates, it creates the risk of growing distortions in the allocation of resources, conflict with domestic monetary policy objectives, and the risk of larger and more abrupt future movements in the exchange rate.

These four broad forces will have substantial implications for the macroeconomic performance of the world economy over the medium term.

This combination of fiscal sustainability problems, large external imbalances, and the tension in the existing exchange rate system creates the risk of unanticipated shocks to financial prices, even in a context where monetary policy credibility is strong. The probability of these shocks may be low, but it is higher than it has been, and higher than we should be comfortable with. These shocks could be large enough to lower future growth outcomes. The world's economies have very different capacities to comfortably manage the inevitable adjustments. Without policy action commensurate with the challenges, we face some risk, it may not be high, but it is material, of a world with somewhat lower growth performance and higher volatility.

Although the United States has the distinction of presiding over the more awkward combination of imbalances, it is in many ways in a better position than other countries to manage successfully through this period.

Our underlying fiscal position is stronger, our debt to GDP burden lower, our demographic cliff more moderate, and our trend growth rate substantially higher than that of the other major economies.

We have a more flexible economy, which is evident in the speed with which enterprises adjust and the relative ease with which labor and capital move to their most productive uses.

Our financial system provides a strong combination of bank-centered financial groups that are capable of withstanding larger shocks than was possible in the past, a more diverse mix of other financial intermediaries, and deeper and more liquid capital markets than exist in the other major financial centers. Together these factors seem to have produced a more stable and resilient financial system, one that is better able to withstand stress.

These are important strengths for the United States, and they are formidable even in comparison with the scale of the broader challenges ahead for the world economy.

What are the most important actions policy makers can take to mitigate the risks and challenges on the horizon? Here's a list of actions the U.S. can take on its own or initiate in cooperation with others.

First, with respect to monetary policy. We need to preserve confidence that policy will move toward a positive real fed funds rate at a pace sufficient to keep inflation expectations stable at a low level. How far policy moves and the pace at which it moves will depend on how the outlook evolves. Preserving the credibility of our commitment to price stability is vitally important, not least because of the flexibility it affords us to confront future shocks that have the potential to cause damage to the financial system and the economy.

Second, it is important that the United States work to build more confidence that it will act on the fiscal front to achieve a better balance between our commitments and our resources, both with respect to the medium term and the longer term. Given the inherent uncertainty surrounding long-term growth forecasts, the formidable rise in costs associated with providing for an aging population with longer life expectancy, and a potentially protracted elevation in national security costs, it makes sense to build a stronger financial position into our fiscal future. The present fiscal trajectory entails an uncomfortable scale of borrowing and little insurance against possible adverse outcomes in an uncertain world. Building a stronger fiscal cushion can help reduce the risk of adverse outcomes - those that might come in the form of a decline in the willingness of foreigners to acquire claims on the United States on the present scale, as well as those that might take the form of a reduction in private investment and lower future productivity gains. Strengthening confidence in our fiscal management and fiscal sustainability is critical to reducing the risk in the size of our external imbalance.

Third, the U.S. and the major economies have an important role to play in encouraging further evolution in the international monetary system. Policy makers in Asia are well aware of the complications and costs involved in sustaining their current regimes. Many are moving toward permitting more flexibility against the dollar, and even in their effective exchange rates. Few however are comfortable with the prospect of accepting large short-term volatility and large movements over time in their effective exchange rates. They are looking for a world in which they can have more monetary policy independence, progressively more financial integration with the globe, and face less risk of large destabilizing moves in the major currencies and less vulnerability to acute pressure on their own currencies.

The exchange rate system among the major currencies provides a desirable degree of flexibility in real exchange rates. Although the process of cooperation among the G-7 has not eliminated the large swings in exchange rates associated with large changes in fundamentals among the major economies, it has had some modest success in avoiding more damaging movements. This cooperative framework, characterized by a pragmatic approach to promoting greater stability in exchange markets, offers a reasonable model for cooperation among the major currencies and those of the emerging world. The challenge ahead is to help manage the transition to the monetary system that provides for more flexibility in the exchange rates of all the major economic areas, and this has to be handled with care.

Finally, it is important that the world's major private financial institutions run themselves with a sufficiently strong financial cushion, a cushion calibrated not just against the risks they confront in this uncertain world, but to the much more central role they play in many markets. Particularly for those institutions whose size and scope make them systemically important, capital, liquidity, and the overall risk management and control architecture need to be exceptionally strong, stronger than would be necessary and appropriate for smaller institutions. The consequence of size is not just that failure or the perceived risk of failure at one of these institutions has larger negative implications for the financial system today than would be the case in a less consolidated world. It is also the case that their greater relative size limits their ability to take actions that would reduce their exposure in the event of a shock without creating the risk of magnifying the shock.

Let me conclude by noting the overwhelming significance of the economic policy decisions we make here in the United States to the world's capacity to deal with these broader challenges. Our impact on global economic activity and on international financial stability is greater than simple measures of our share of GDP. When we are strong economically, the world can more easily tolerate economic weakness outside the United States. When we are less strong, the impact on the world economy is powerful. This has been true for some time. What's new is that we are significantly more dependent today on the confidence of the rest of the world in U.S. economic policy and the safety and stability of our financial markets. This gives us, along with the rest of the world, a compelling interest in sustaining credibility and confidence in U.S. financial management and the strength of our financial system.

Thank you.