Timothy Geithner: US and the global economy

Remarks by Mr Timothy Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Asia Society's CEO Forum, New York, 19 October 2005.

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I want to focus my remarks today on the imbalances in the world economy and their implications for the United States and Asia. These imbalances, which are most visible in the U.S. current account deficit, present challenges—and risks—for the world economy. How we manage these challenges will have significant implications for our economic future and for the rest of the world.

The sources of these imbalances are varied and complex. They are the result of fundamental changes in the world economy, changes not anticipated and not fully understood. They involve economic forces across the global economy, some transitory and some probably more enduring. The imbalances took a long time to build up and they will probably take a long time to unwind.

The magnitude and persistence of these imbalances seems to be the result of the interaction of two forces. The first involves a decline in U.S. savings relative to domestic investment, matched by an increase in savings relative to investment in parts of the rest of the world, principally in emerging Asia and the major oil exporters.

In the United States, public savings and household savings fell, while investment spending stayed reasonably strong and housing investment very strong, even during the latest recession. In the economies that became large net savers, the pattern differed across countries. In some countries, including much of emerging Asia and Japan, savings has been flat or fallen somewhat, while investment has fallen by more. In China and in the major oil exporters, investment spending is rising, but not by as much as savings is increasing. Europe's net external position has not changed much over this period, and is in rough external balance overall, with substantial differences across the member states.

The second feature of this dynamic has been an increase in the willingness of the rest of the world to invest its savings in the United States. In those parts of the world where savings are high, they have become more globally mobile. And a greater share of those savings found its way to the United States. This phenomenon is due in part to the perceived attractiveness of relative returns in the United States arising from the acceleration of productivity growth here, and in part due to the dynamics associated with exchange rate regimes linked in one way or another to the dollar.

Together these forces have produced larger imbalances—deficits here and surpluses abroad—that have been sustained longer and financed more easily than conventional wisdom would have thought possible a decade or even five years ago.

Why does this pattern of imbalances matter and why should it concern us?

It matters because of the size of the U.S. imbalance. Our current account deficit is now running at a rate of above 6 percent of GDP, a level without precedent for a major economy.

It matters because of the composition of the imbalance. Our trade deficit is now roughly the size of the current account deficit, and very large relative to our export base. And our net investment income balances are now likely to move into deficit.

It matters because of the trajectory of the U.S. imbalance. On reasonable assumptions about its likely near term path, this deficit will produce a very large net deterioration in our net external liabilities relative to national income, with progressively larger net transfers of income to the rest of the world.

This pattern should concern us because it is not simply the result of the savings and investment decisions of the private sector. The fact that we are using a substantial part of the savings we are borrowing from the rest of the world to finance an unsustainable level of public borrowing leaves us more vulnerable than if those savings were being used for productive private investment. Large structural fiscal deficits limit the size of the sustainable external imbalance for any country, even the United States, and they necessarily increase concern about the terms on which we are likely to finance the present imbalance.

It should concern us because of how the imbalance has been financed. A substantial portion of the capital inflows that finance our current account deficit has come from foreign central banks—which have been accumulating dollar reserves to preserve exchange rate arrangements that are unlikely to be sustainable and are already in the process of change. The impact of a reduction in the scale of official accumulation of dollar assets could be fully offset by increases in purchases by private investors. But even in the context of a continued high degree of confidence in the relative return on claims on the United States, it is hard to know with confidence how the preferences of private savers might respond to the process of gradual evolution in their nation's exchange rate regimes now underway.

And most importantly, perhaps, these imbalances matter because at some point they will have to reverse. Market forces will at some point induce an adjustment. And that inevitable process of adjustment will bring with it the risk of large movements in relative prices, greater volatility in asset prices and slower growth in the United States and in the rest of the world.

The magnitude of this risk is difficult to measure with any confidence. Past episodes of external adjustment offer some reassurance, but the present circumstances seem sufficiently different from historical precedent that history may not be a particularly useful guide.

The size of the imbalances and the persistence of the forces supporting them probably mean that we will be living for a prolonged period of time with the tensions that could come with the need for adjustment.

The risks associated with this adjustment process may be magnified by changes in the household balance sheet in the United States. The average household in the United States today has a higher level of debt to income and is somewhat more exposed to interest rate risk than in the past. The sustained rise in housing prices and the scale of borrowing against housing assets raises the possibility that a rise in risk premia could have a greater impact on household spending that would have been true in the past.

The adjustment process is also complicated by the fact that the rest of the world does not appear likely, even over the medium term, to be in a position to provide a sufficiently strong offsetting source of demand growth to compensate for the necessary slowing in U.S. domestic demand. Policy actions to promote structural reform in the labor, product and financial markets could potentially change this, but the policy changes required are politically difficult, and their effects on net savings over time might be offset by demographic and other forces working the other direction.

A number of observers have suggested that we can live comfortably with these imbalances for a long time, with very little risk to the U.S. and world economy. The rise in the surplus savings of the rest of the world, the relative ease with which those savings now move across borders, and the increase in the relative attractiveness of claims on the United States together may suggest the world can sustain larger imbalances, more easily, for a longer period of time.

These factors, however, do not alter the fundamental judgment that our external position is unsustainable and the adjustment process ahead could materially affect future economic outcomes. The fact that these imbalances might be sustained for some time shouldn't make us more confident that they will be. Even if we could be confident that the world would be comfortable financing the United States on these terms going forward, that would not make it prudent for the U.S. to continue borrowing on this scale.

Time doesn't necessarily help. The longer these gaps continue to build, the greater the risks, and the more difficult their resolution.

What can we do to mitigate these risks?

For the United States, these challenges put a premium on putting in place a more credible fiscal policy framework, maintaining as strong and resilient a financial sector as possible, and preserving an open and flexible economy. These things are all important and desirable, but they are more important, and we can less afford to tolerate any erosion, than would be the case if we were closer to a sustainable external position.

Improving our fiscal position is the most effective means we have available to reduce our vulnerability during this prolonged period of adjustment. We need to produce a substantial reduction in our structural deficit over the medium term and begin to reduce the more dramatic longer term gap between our resources and commitments. And we need to restore a reasonable cushion in our structural budget balance to help us deal with future shocks.

If we are unable to begin to generate more confidence in the capacity of the U.S. political system to produce these improvements, we would face a greater risk of future increases in risk premia. And even though substantial fiscal consolidation would not by itself bring the external imbalance down to a more sustainable level, it would improve the prospect for a smoother adjustment to that outcome.

The general risk inherent in these imbalances—the risk of more adverse growth outcomes and asset price volatility—reinforces the importance of sustaining the strength and resilience of the U.S. financial system. Our financial system today is in substantially stronger shape than it was even in the recent past, and the major institutions now appear to be managed so that they are less vulnerable to the type and magnitude of shocks they've experienced in the past couple decades.

Our challenge, however, it to make sure they are as well positioned to deal with the full range of potential future risks. And this requires an investment in risk management and controls commensurate with the increasing complexity of these challenges, and it requires a cushion of capital and liquidity large enough to capture the potential risk of losses in a less favorable macroeconomic environment.

The increase in the flexibility and resilience of the U.S. economy over the past two decades has a lot to do with the increased openness of the U.S. economy. And sustaining this flexibility, which is so important to our capacity to adjust to shocks, requires that we continue to support the process of openness and economic integration. We jeopardize future income gains if we are unable to sustain support in the United States for what has been a relatively open trade policy. How effective we are in meeting this political challenge is likely to depend significantly on how effective we are in improving educational opportunity and achievement in this country, and perhaps also in improving the design of the temporary assistance we provide individuals who bear the brunt of the adjustment costs than come with greater global economic integration.

These policies by the United States would help improve the prospects of a more benign adjustment process. But they would not be sufficient to produce a more favorable adjustment path. A more favorable adjustment scenario would require a complex mix of policies and action in each of the major economic areas, sustained over a considerable period of time.

For global growth to be sustained at a reasonably strong pace during this period of adjustment, the desirable increase in U.S. savings and the necessary slowing in U.S. domestic demand growth relative to growth of U.S. output would have to be complemented by stronger domestic demand growth outside the United States, absorbing a larger share of national savings. Exchange rate regimes, where they are currently closely tied to the dollar, will have to become more flexible, allowing exchange rates to adjust in response to changing fundamentals.

The global nature of these requirements does not imply that the United States can put the principal burden for adjustment on others, or that we can expect the broader global adjustment imperative to easily alter the forces in countries outside the United States that have contributed to these imbalances. If we focus adequate political capital on the factors within our control, we will have more credibility internationally in encouraging policy changes outside the United States that might reduce our collective risks in the adjustment process ahead.

The increase in macroeconomic stability in the United States over the past two decades, or the reduction in the volatility of growth and inflation, has contributed to what seems to be a significant reduction in expected future volatility of asset prices. And the U.S. economy is in many ways in a relatively favorable position to manage through the risks in the adjustment process ahead. The apparent strength in U.S. productivity growth, our greater overall flexibility as an economy and the resilience of our financial system puts us in a stronger position to deal with the challenges in the transition ahead. But we face a number of difficult long-term challenges as a nation—in our fiscal position, in how well we equip our citizens to prosper in a more competitive world and in our ability to sustain political support for the policies, including our relatively open trade policy, that have been an important source of the improvement in U.S. prosperity. Our external imbalances make it more important that we invest in meeting those challenges.

Thank you.