

## Timothy F Geithner: Further investments to strengthen the financial system

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Economic Club of Washington, Washington, 9 February 2005.

\* \* \*

Good evening. I am honored to be here. It's good to be back in Washington and to have a chance to talk with such a distinguished group.

Much of our nation's financial history and the history of our central bank is a story of contest for influence and over ideas between political leaders in Washington and the financial center of New York. I think it is important that ideas shuttle back and forth between our cities, and I am pleased to have a chance to share a few tonight.

My overall argument this evening is this. We face a delicate balance between genuinely positive near-term economic conditions, and some fundamental challenges. If we are to increase the likelihood of continued strong growth in living standards, we should use this time of relative prosperity to address the imbalances that hang over our economy. Even with good policy choices, and with considerable luck, these imbalances will take time to unwind. During this time we face some risk of a more volatile and less benign overall financial environment. This makes it important that we continue to invest in making our financial system stronger and more resilient.

Markets now reflect a fairly positive view about overall economic prospects. Global growth is reasonably strong and broad-based. Underlying inflation is low. Estimates of structural productivity growth in the United States remain high. The global economy has weathered the oil price shock and other recent shocks quite well. Most of the major emerging market economies look stronger than they have in some time. Overall volatility in output and inflation has moderated significantly in the United States and, to a lesser extent, in other economies as well.

These favorable fundamentals are reflected in low risk premia of many forms - low credit spreads, low and quite stable inflation expectations, and low actual and implied volatility. Market participants appear to believe that future macroeconomic shocks will be more moderate, less frequent, and less damaging than past shocks have been. To say this another way, the price of insurance against a less benign world is now quite low.

We face a number of significant challenges that threaten this positive outlook. I want to touch on the two that appear to me most important.

The first is the growing imbalances at the center of the global economy.

Fiscal policy in most of the major economies is on a path towards rising debt-to-GDP ratios; this trajectory gets dramatically worse as demographic changes reduce the ratio of workers to retirees.

At the same time, external imbalances have reached unprecedented levels, most dramatically in the case of the U.S. current account deficit, which is on a path to exceed six percent of GDP. These imbalances – fiscal and external – cannot be sustained indefinitely. Each magnifies the risk in the other.

The second broad challenge involves the rise of China and the other major emerging market economies. The process of integrating China and India into the world economy offers tremendous gains in global living standards. But the greater adjustment pressures that come with integrating the two most populous economies in the world will put a greater burden on the political sustainability of open trade policies. The framework of international institutions and arrangements for cooperation we now have will need to change to reflect the emerging importance of these economies.

One important dimension of this process of integration will be a necessary evolution in the global exchange rate system. The present system, where the major currencies adjust against each other, but many large emerging market economies tie their currencies to the dollar or shadow it closely, creates an awkward asymmetry. This system carries with it the seeds of future stress for the global economy.

These challenges - the challenges of unwinding large fiscal and external imbalances and of managing the integration of emerging market economies - are likely to dominate the economic policy agenda for a considerable period of time. If they are not managed well, we risk lower and less stable future growth and unwelcome shocks to financial prices.

These are two different types of risks. One is the risk of lower average rates of future growth in living standards if, for example, rising deficits and debt levels are left on a path that reduces future investment and productivity growth. Another is the risk of higher volatility in financial and economic outcomes, which could also limit future growth in investment and in living standards.

What are some of the things policy makers can do to mitigate the risks and challenges on the horizon?

Let me begin with monetary policy. In the present context, the Fed's most important contribution to sustaining the expansion is to preserve confidence that we will act to keep inflation and inflation expectations stable, at low levels.

Preserving the credibility of our commitment to price stability is vital. It is important because price stability is critical to giving enterprises confidence to invest in the future. It is more important at a time when we are running very large external deficits, because countries investing their savings here must remain confident that their investments will not be eroded by future inflation. And it is important because confidence in our commitment to price stability affords us more flexibility to act aggressively in the event of future shocks.

If the economy follows the present forecast of slightly above-trend growth, then it would be appropriate for monetary policy to continue to move the real fed funds rate higher. The pace at which we move and the distance we move will depend, of course, on how the economy performs and how the forecast evolves. But we need to be careful to give the world confidence that we will conduct policy in a manner that will keep inflation expectations stable, at low levels.

Second, to fiscal policy. We now face a substantial and unsustainable gap between our fiscal commitments and our resources, not just over the longer term with respect to Social Security and Medicare, but also with respect to budget projections for the coming ten years. Reducing this gap to a more sustainable level is vital. The decisions we make this year and over the next few years will be important to building more confidence that we have the will to act in a manner commensurate with the challenge.

Achieving a substantial and sustainable reduction in our fiscal imbalance is important to decrease the risk of lower future growth in private investment which could dampen future productivity gains. Reducing our fiscal imbalances is also important for reducing the risk of adverse shocks to financial markets, and for maintaining the willingness of investors to invest in our economic future. Improving the credibility of our commitment to this fiscal challenge is the most important contribution we can make towards improving the chance of a more benign adjustment in our external imbalance.

Third, the U.S. and the major economies have an important role to play in guiding 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 more flexibility in their exchange rate regimes. The challenge ahead is to help manage the transition to a monetary system that provides flexibility in the exchange rates of all the major economic areas, and this has to be handled with care.

Even with good policy choices here and in other countries, bringing these imbalances down to a more sustainable level will take time. During this period of adjustment, despite our fundamental economic strengths, we will be vulnerable to an elevated risk of volatility in financial markets.

This prospect makes this a good time to examine the health of the financial system. The strength of the financial system is a major factor in determining how well economies respond to shocks - weak financial systems amplify the damage to growth.

The stronger the financial system, the more effective policy - monetary policy in particular - can be in cushioning the effects of those shocks and helping to restore expansion.

We are fortunate in the United States today to have a strong financial system. This system has a tremendous capacity to match capital to ideas, reward innovation, and channel savings to the highest return. And it has demonstrated a capacity for very considerable resilience and stability in face of shocks.

What are the main sources of these strengths? Our banks are stronger than they have been in the past. Their larger earnings capacity, higher capital cushions, and the greater diversity of their activities help shield them from a broader range and greater magnitude of shocks than in the past. Capital markets play a comparatively larger role in our financial system. As a consequence, shocks get

diffused more broadly, and weakness in traditional intermediation channels can be offset by the strength in other channels.

Here in the United States, financial innovation has advanced farther and more rapidly than elsewhere. This reflects a regulatory model that is more supportive of competition, of financial innovation, and of market-driven improvements in risk management. The U.S. financial system has embraced opportunities for risk transfer much more rapidly and extensively than other systems.

Finally, we have larger and more developed venture capital, private equity, and hedge fund segments within our financial system. These are important sources of liquidity, they add depth and breadth to capital markets, and they play a valuable arbitrage role in reducing or eliminating mispricing in the financial markets.

However, no system is invulnerable to stress and crisis. Recent U.S. financial history is not a history of the uninterrupted achievement of ever higher returns. The stock market crash of '87, the stress that surrounded the Russian default and the collapse of Long Term Capital Management, and the more recent fall in equity prices that came with the collapse of the technology boom all posed significant potential threats to financial stability. In each case, however, with a swift monetary policy response and other actions the process of recovery and repair was reasonably quick.

The relative ease with which we managed through these events has reinforced confidence in the stability of the system. This confidence is justified. But one of the consequences of the resilience of the system in the face of past shocks is a higher degree of confidence in a benign and stable future. And this confidence itself can increase the risk of future instability.

It is critically important, then, that we continue to strengthen our financial system. The most important dimension of this challenge is to ensure that the size and the quality of the cushions maintained by financial institutions against the risk of adverse outcomes are sufficiently strong.

This is particularly important in the case of the relatively small number of bank-centered financial institutions that now play a much more central role in our financial system. Their extraordinary size and diversity diminishes their vulnerability to shocks. However, it also exposes them to a broader array of potential shocks, and magnifies the potential damage to the system should one of these institutions stumble or fail.

We need to ensure that the level of insurance these core institutions maintain against risk – insurance in the form of their capital and liquidity cushions, their operational resilience, and the quality of their risk management and control systems – are calibrated to reflect their greater systemic significance and the greater complexity of the challenges they face in managing more diverse businesses.

This is true not only for the largest banks, but also for GSEs like Fannie Mae and Freddie Mac, and also for those non-bank financial institutions that play a critical role in the wholesale financial markets.

The payments system we live with today is a complex mix of national and cross border systems originally designed for a safer, slower, less complex, more segmented financial world. While many improvements have been made to this system over time, it is important that we work to strengthen further the core infrastructure of the payments system.

We also need to promote further evolution in the framework of supervision and regulation of our more complex and integrated global financial system. To paraphrase Bob Rubin in a different context, we need a framework for supervision and regulation that is “as modern as the markets” and that stays abreast of the pace of change and innovation.

Perhaps the greatest challenge we face – in macroeconomic policy and in financial supervision - is a challenge of imagination: How do we best prepare for the low probability of an extreme event; a crisis not captured by past experience? How do we generate the will today to build a greater degree of insurance against a more uncertain future, particularly if the risk of adversity seems remote and the immediate future looks strong?

We can take considerable reassurance from apparent moderation in overall macroeconomic volatility recently, and from the ease with which our system has handled recent stress.

Prudent macroeconomic policy actions will increase the likelihood that these beneficial circumstances will continue. But we cannot know with confidence that the future will bring an enduring reduction in volatility and risk, and it would be imprudent to plan for such a world.

All this suggests we should complement sensible macroeconomic policy choices with further investments to strengthen the financial system.

Let me end by thanking Vernon Jordan and the Economic Club of Washington for providing a forum for thinking about the economic agenda of the country, and for giving me the opportunity to share a few thoughts with you tonight.

Thank you.