Alan Greenspan: Globalization

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the Council on Foreign Relations, New York, New York, 10 March 2005.

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The U.S. economy appears to have been pressing a number of historic limits in recent years without experiencing the types of financial disruption that almost surely would have arisen in decades past. This observation raises some key questions about the longer-term stability of the U.S. and global economies that bear significantly on future economic developments.

Among the limits that we have been pressing against are those in our external and budget balances. In the United States, we have been incurring ever-larger trade deficits, with the broader current account measure moving into the neighborhood of 6 percent of our gross domestic product. Yet the dollar's real exchange value, despite its recent decline, remains above its 1995 low. Meanwhile, we have moved from a budget surplus in 2000 to a deficit that is projected by the Congressional Budget Office to be around 3-1/4 percent of GDP this year. In addition, we have enacted commitments to our senior citizens that, given the impending retirement of our huge baby-boom generation, will create significant fiscal challenges in the years ahead. Yet the yields on Treasury notes maturing a decade from now remain at low levels. Nor are households experiencing inordinate financial pressures as a consequence of record-high levels of household debt relative to income.

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Has something fundamental happened to the U.S. economy that enables us to disregard all the time-tested criteria for assessing when economic imbalances become worrisome? Regrettably, the answer is no; the free lunch has still to be invented. We do, however, seem to be undergoing what is likely, in the end, to be a one-time shift in the degree of globalization and innovation that has temporarily altered the specific calibrations of those criteria.

Globalization has altered the economic frameworks of both advanced and developing nations in ways that are difficult to fully comprehend. Nonetheless, the largely unregulated global markets, with some notable exceptions, appear to move smoothly from one state of equilibrium to another. Adam Smith's "invisible hand" remains at work on a global scale.

Because of deregulation, increased innovation, and lower barriers to trade and investment, cross-border trade in recent decades has been expanding at a far faster pace than GDP. As a result, many economies are increasingly exposed to the rigors of international competition and comparative advantage. In the process, lower prices for some goods and services produced by our trading partners have competitively suppressed domestic price pressures.

Production of traded goods and services has expanded rapidly in economies with large, low-wage labor forces. Most prominent are China and India, which over the past decade have partly opened up to market forces, and the economies of central and eastern Europe, which were freed from central planning by the fall of the Soviet empire. The consequent significant additions to world production and trade have clearly put downward pressure on prices in the United States and in the economies of our trading partners.

Over the past two decades, inflation has fallen notably, virtually worldwide, as has economic volatility. Although a complete understanding of the reasons remains elusive, globalization and innovation would appear to be essential elements of any paradigm capable of explaining the events of the past ten years. If this is indeed the case, because the extent of globalization and the speed of innovation are limited, the current apparent rapid pace of structural shift cannot continue indefinitely. While the outlook for the next year or two seems reasonably bright, the outlook for the latter part of this decade remains opaque because it is uncertain whether this transitional paradigm, if that is what it is, is already far advanced and about to slow, or whether it remains in an early, still-vibrant stage of evolution.

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Globalization--the extension of the division of labor and specialization beyond national borders--is patently a key to understanding much of our recent economic history. With a deepening of specialization and a growing capacity to conduct transactions and take risks throughout the world, production has become increasingly international.[1]

The pronounced structural shift over the past decade to a far more vigorous and competitive world economy than that which existed in earlier post-World War II decades apparently has been adding significant stimulus to world economic activity. This stimulus, like that which resulted from similar structural changes in the past, is likely a function of the rate of increase of globalization and not its level. If so, such impetus would tend to peter out as we approach the practical limits of globalization.

Full globalization, in which production, trade, and finance are driven solely by risk-adjusted rates of return and in which risk is indifferent to distance and national borders, will likely never be achieved. The inherent risk aversion of people, and the home bias that is one manifestation of that aversion, will limit how far globalization can proceed. But because so much of our recent experience has little precedent, as I noted earlier, we cannot fully determine how long the current globalization dynamic will take to play out. And even then we have to be careful not to fall into the trap of equating the achievement of full globalization with the exhaustion of opportunities for new investment. The closing of our frontier at the end of the nineteenth century, for example, did not signal the onset of a new era of economic stagnation.

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The increasing globalization of the post-World War II era was fostered at its beginnings by the judgment that burgeoning prewar protectionism was among the primary causes of the depth of the Great Depression of the 1930s. As a consequence, trade barriers began to fall after the war. Globalization was enhanced further when the inflation-ridden 1970s provoked a rethinking of the philosophy of economic policy, the roots of which were still planted in the Depression era. In the United States, that rethinking led to a wave of bipartisan deregulation of transportation, energy, and finance. With respect to macropolicies, there was a growing recognition that inflation impaired economic performance.[2] Moreover, a tightening of monetary policy, and not increased regulation, came to be seen by the end of that decade as the only viable solution to taming inflation.[3] Of course, the startling recovery of war-ravaged West Germany following Ludwig Erhard's postwar reforms, and Japan's embrace of global trade, were early examples of the policy reevaluation process.

It has taken several decades of experience with markets and competition to achieve an unwinding of regulatory rigidities. Today, privatization and deregulation have become almost synonymous with "reform."

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By any number of measures, globalization has expanded markedly in recent decades. Not only has the ratio of international trade in goods and services to world GDP risen steadily over the past half-

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1 Much of what is assembled in final salable form in the United States, for example, may consist of components from many continents. Companies seek out the lowest costs of inputs to effectively compete for their customers' dollars. This international competition, left unfettered, history suggests, would tend to direct output to the comparatively most efficient producers of specific products or services and, hence, maximize standards of living of all participants in trade. Given the skills and education of its workforce and a number of institutional factors, such as its legal structure, each economy will achieve its maximum possible average living standard.

2 Indeed, the Group of Seven leaders, at their 1977 economic summit, identified inflation as a cause of unemployment.

3 This had not always been the case. For example, wage and price controls were imposed in the United States in 1971 as a substitute for a tighter monetary policy and higher interest rates to address rising inflation.

century, but a related measure--the extent to which savers reach beyond their national borders to invest in foreign assets--has also risen.

Through much of the post-World War II years, domestic saving for each country was invested predominantly in its domestic capital assets, even when there existed the potential for superior risk-adjusted returns from abroad. Because a country's domestic saving less its domestic investment is essentially equal to its current account balance, such balances, positive or negative, were therefore generally modest, with the exception of the mid-1980s. But in the early 1990s, "home bias" began to diminish appreciably, and, hence, the dispersion of current account balances among countries has increased markedly. The widening current account deficit in the United States has come to dominate the tail of the distribution of external balances across countries. Nonetheless, the worldwide dispersion of current account balances has risen since the early 1990s, even excluding the United States. [4]

Thus, the decline in home bias, or its equivalent, expanding globalization, has apparently enabled the United States to finance and, hence, incur so large a current account deficit. As a result of these capital inflows, the ratio of foreign net claims against U.S. residents to our annual GDP has risen to approximately one-fourth. While some other countries are far more in debt to foreigners, at least relative to their GDPs, they do not face the scale of international financing that we require.

A U.S. current account deficit of 6 percent of GDP would probably not have been readily fundable a half-century ago or perhaps even a couple of decades ago.[5] The ability to move that much of world saving to the United States in response to relative rates of return almost surely would have been hindered by the far-lesser degree of both globalization and international financial flexibility that existed at the time. Such large transfers would presumably have induced changes in the prices of assets that would have proved inhibiting.

Nonetheless, we have little evidence that the economic forces that are fostering international specialization, and hence cross-border trade and increasing dispersion of current account balances, are as yet diminishing. To be sure, as I pointed out earlier this year, we may be approaching a point, if we are not already there, at which exporters to the United States, should the dollar decline further, would no longer choose to absorb a further reduction in profit margins. An acceleration of U.S. import prices, of course, would impede imports and give traction to the process of adjustment in our trade balance. Moreover, international investors, private and official, faced with an increasing concentration of dollar assets in their portfolios, will at some point choose greater balance in their asset accumulation. That shift, over time, would likely induce contractions in both the U.S. current account deficit and the corresponding current account surpluses of other nations. To date the proportional shift out of dollars from the total of official and private sector foreign currency accounts has been modest, when adjusted for exchange rate changes.[6] Of course, the shift has been larger on an unadjusted dollar equivalent basis. However, the market has absorbed this change in an orderly manner.

The more-rapid aging of European and Japanese populations relative to the aging of the U.S. population should slow the flow of foreign saving available to the United States. Although those population dynamics are already in train, little evidence as yet of slowed savings transfers has surfaced.

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[4] The correlation coefficient between paired domestic saving and domestic investment, a conventional measure of the propensity to invest at home for OECD countries constituting four-fifths of world GDP, fell from 0.97 in 1990 to less than 0.8 in 2003. This correlation coefficient has been even lower recently when the United States is excluded from the sample. With rare exceptions, a decline in the correlation of countries' paired domestic saving and domestic investment implies an increased dispersion of current account balances.

[5] It is true that estimates of the ratios of the current account to GDP for many countries in the nineteenth century are estimated to have been as large as, or larger, than we have experienced in recent years. However, the substantial net flows of capital financing for those earlier deficits were likely motivated in large part by specific major development projects (for example, railroads) bearing high expected rates of return. By contrast, diversification appears to be a more salient motivation for today's large net capital flows. Moreover, gross capital flows are believed to be considerably greater relative to GDP in recent years than in the nineteenth century. (See Alan M. Taylor (2002), "A Century of Current Account Dynamics," *Journal of International Money and Finance*, vol. 21 (November), pp. 725-48, and Maurice Obstfeld and Alan M. Taylor (2002),"Globalization and Capital Markets," NBER Working Paper 8846 (March).)

[6] Based on data provided by the Bank for International Settlements for cross-border bank liabilities and international bonds outstanding.

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Can market forces incrementally defuse a buildup in a nation's current account deficit and net external debt before a crisis more abruptly does so? The answer seems to lie with the degree of market flexibility. In a world economy that is sufficiently flexible, as debt projections rise, product and equity prices, interest rates, and exchange rates presumably would change to reestablish global balance.

We may not be able to usefully determine at what point foreign accumulation of net claims on the United States will slow or even reverse, but it is evident that the greater the degree of international flexibility, the less the risk of a crisis.[7]

Should globalization continue unfettered and thereby create an ever-more flexible international financial system, history suggests that current account imbalances will be defused with modest risk of disruption. Two Federal Reserve studies of large current account adjustments in developed countries, the results of which are presumably applicable to the United States, suggest that market forces are likely to restore a more long-term sustainable current account balance here without substantial disruption.[8] Indeed, this was the case in the second half of the 1980s.

I say this with one major caveat. Protectionism, some signs of which have emerged in recent years, could significantly erode global flexibility and, hence, undermine the global adjustment process. We are already experiencing pressure to slow down the expansion of trade. The current Doha Round of trade negotiations has faced difficulties largely because the low-hanging fruit available through negotiation has already been picked in the trade liberalizations that have occurred since the Kennedy Round. On a more encouraging note, some recent indications of progress may be pointing to a heightened probability of completion of the Doha Round.

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The remarkable technological advances of recent decades have doubtless augmented and fostered the dramatic effect of increased globalization on economic growth. In particular, information and communication technologies have propelled the processing and transmission of data and ideas to a level far beyond our capabilities a decade or two ago.

The advent of real-time information systems has enabled managers to organize a workforce without the redundancy required in earlier decades to ensure against the type of human error that technology has now made far less prevalent. Real-time information, by eliminating much human intervention, has markedly reduced scrappage rates on production lines, lead times on purchases, and errors in many forms of recordkeeping. Much data transfer is now electronic and far more accurate than possible in earlier times.

The long-term path of technology and growth is difficult to discern. Indeed, innovation, by definition, is not forecastable. In the United States, we have always employed technologies at, or close to, the cutting edge, and we have created many innovative technologies ourselves. The opportunities of many developing economies to borrow innovation is not readily available to us. Thus, even though the longer-term prospects for innovation and respectable U.S. productivity growth are encouraging, our productivity growth has rarely exceeded an average rate of 3 percent annually for any protracted period.

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7 Although increased flexibility apparently promotes resolution of current account imbalances without significant disruption, it may also allow larger deficits to emerge before markets are required to address them. Moreover, the apparent ability of the U.S. economy to withstand the stock market plunge of 2000, the terrorist attacks of September 11, 2001, corporate governance scandals, and wars in Afghanistan and Iraq indicates a greater degree of economic flexibility than was apparent in the 1970s and earlier.

8 Caroline Freund (2000), "Current Account Adjustment in Industrialized Countries," Board of Governors of the Federal Reserve System, International Finance Discussion Paper 692 (December); Hilary Croke, Steven B. Kamin, and Sylvain Leduc (2005), "Financial Market Developments and Economic Activity during Current Account Adjustments in Industrial Economies," Board of Governors of the Federal Reserve System, International Finance Discussion Paper 827 (February).

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We have, I believe, a reasonably good understanding of why Americans have been able to reach farther into global markets, incur significant increases in debt, and yet not suffer the disruptions so often observed as a consequence. However, a widely held alternative view of the past decade cannot readily be dismissed. That view holds that the postwar paradigm is still largely in place, and key financial ratios, rather than suggesting an evolving economic structure, reflect extreme values that have materialized within an unchanged structure and must eventually adjust, perhaps abruptly.

To be sure, even with the increased flexibility implied in a paradigm of expanding globalization and innovation, the combination of exceptionally low saving rates and historically high ratios of household debt to income can be a concern if incomes unexpectedly fall. Indeed, virtually any debt burden doubtless will become oppressive if incomes fall significantly.

But rising debt-to-income ratios can be somewhat misleading as an indicator of stress. Indeed the ratio of household debt to income has been rising sporadically for more than a half-century, a trend that partly reflects the increased capacity of ever-wealthier households to service debt. Moreover, a significant part of the recent rise in the debt-to-income ratio reflects the remarkable gain in homeownership. Over the past decade, for example, the share of households that own homes has risen from 64 percent to 69 percent. During the decade, a significant number of renters bought homes, thus increasing the asset side of their balance sheets as well as increasing their debt. It can scarcely be argued that the substitutions of debt service for rent materially impaired the financial state of the new homeowner. Yet the process over the past decade added more than 10 percent to outstanding mortgage debt and accounted for more than one-seventh of the increase in total household debt over that period.[9]

Thus, short of a period of appreciable overall economic weakness, households, with the exception of some highly leveraged subprime borrowers, do not appear to be faced with significant financial strain. With interest rates low, debt service costs for households have been essentially stable for the past few years. Accounting for other fixed charges such as rent, utilities, and auto-leasing costs does not materially alter this assessment of stability.

Even should interest rates rise materially further, the effect on household expenses will be stretched out because four-fifths of debt is at fixed rates and varying maturities, and it will take time for debt to mature and reflect the higher rates. Despite the almost 2-percentage-point rise in mortgage rates on new originations from mid-1999 to mid-2000, the average interest rate on outstanding mortgage debt rose only slightly, as did debt service.

In a related concern, a number of analysts have conjectured that the extended period of low interest rates is spawning a bubble in housing prices in the United States that will, at some point, implode. Their concern is that, if this were to occur, highly leveraged homeowners would be forced to sharply curtail their spending. To be sure, indexes of house prices based on repeat sales of existing homes have significantly outstripped increases in rents, suggesting at least the possibility of price misalignment in some housing markets.

But a destabilizing contraction in nationwide house prices does not seem the most probable outcome. To be sure, the recent marked increase in the investor share of home purchases suggests rising speculation in homes. (Owner occupants are rarely home speculators because to sell, they must move.)[10] However, nominal house prices in the aggregate have rarely fallen and certainly not by very much. And even should more-than-average price weakness occur, the increase in home equity as a consequence of the recent sharp rise in prices should buffer the vast majority of homeowners.

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[9] For statistical methodology see Karen Dynan, Kathleen Johnson, and Karen Pence (2003),"Recent Changes to a Measure of U.S. Household Debt Service," *Federal Reserve Bulletin*, vol. 89 (October), pp. 417-26.

[10] A new survey by the National Association of Realtors reports that purchases of vacation homes and homes for investment amounted to more than a third of total existing home purchases last year. Mortgage originations data reported under the Home Mortgage Disclosure Act (HMDA) indicate that the share has been rising significantly since 1998.

House prices, however, like those of many other assets, are difficult to predict, and movements in those prices can be of macroeconomic significance.

There appears, at the moment, to be little concern about corporate financial imbalances. Debt-to-equity ratios are well within historical ranges, and the recent prolonged period of low long-term interest rates has enabled corporations to refinance liabilities and stretch out bond maturities.

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The resolution of our current account deficit and household debt burdens does not strike me as overly worrisome, but that is certainly not the case for our fiscal deficit, which, according to the Congressional Budget Office, will rise significantly as the baby boomers start to retire in 2008. Our fiscal prospects are, in my judgment, a significant obstacle to long-term stability because the budget deficit is not readily subject to correction by market forces that stabilize other imbalances.

One issue that concerns most analysts, especially in the context of a widening structural federal deficit, is inadequate national saving. Fortunately, our meager domestic savings, and those attracted from abroad, are being very effectively invested in domestic capital assets. The efficiency of our capital stock thus has been an important offset to what, by any standard, has been an exceptionally low domestic saving rate in the United States.

Although saving is a necessary condition for financing the capital investment required to engender productivity, it is not a sufficient condition. The very high saving rates of the Soviet Union, of China, and of India in earlier decades often did not foster significant productivity growth in those countries. Saving squandered in financing inefficient technologies does not advance living standards. In light of the uncertain link between saving and productivity growth, it is difficult to measure the exact extent to which our relatively low gross national saving rate will limit the future growth of an efficient capital stock. What we know for sure, however, is that the 30 million baby boomers who will reach 65 years of age over the next quarter-century are going to place enormous pressures on the ability of our economy to supply the real benefits promised to retirees under current law, and our success in attracting savings from abroad may be masking the full effect on investment of deficient domestic saving.

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Our day-by-day experiences with the effectiveness of flexible markets as they adjust to, and correct, imbalances can readily lead us to the mistaken conclusion that once markets are purged of rigidities, macroeconomic disturbances will become a historical relic. However, the penchant of humans for quirky, often irrational behavior gets in the way of this conclusion. A discontinuity in valuation judgments, often the cause or consequence of the building and bursting of a bubble, can occasionally destabilize even the most liquid and flexible of markets. I do not have much to add on this issue except to reiterate our need to better understand it.

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The last three decades have witnessed a significant coalescing of economic policy philosophies. Central planning has been judged as ineffective and is now generally avoided. Market flexibility has become the focus, albeit often hesitant focus, of reform in most countries. All policymakers are struggling to understand global and technological changes that appear to have profoundly altered world economic developments. For most economic participants, these changes appear to have had positive effects on their economic well-being. But a significant minority, trapped on the adverse side of the market's process of creative destruction, are suffering. This is an issue that needs to be more fully addressed if globalization is to sustain the public support it requires to make further progress.