

Timothy F Geithner: Economic policy and the sustainability of US productivity growth

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Puerto Rico Bankers Association Luncheon, New York, 12 April 2005.

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Thank you for the opportunity to speak to you today and to support the important work of improving economic and financial education.

I am going to focus my remarks on two important dimensions of our economic future - the acceleration in the rate of growth in productivity of the past decade and the more recent decline in our net national savings rate. The former offers considerable promise for future growth in the living standards in the United States. The latter presents some risk and challenges to that brighter prospect. Both are areas where education, education in general and financial education in particular, can make an important contribution.

The United States has been through an exceptionally good decade of economic performance. While growth in most mature economies slowed, we averaged a respectable 3.5 percent growth in real GDP a year. Inflation moderated to a rate of around 2 percent, and long term inflation expectations stayed stable for some time at quite moderate levels. The volatility of U.S. output, which declined significantly in the mid-1980s, remained low, meaning growth was smoother, with recessions less frequent, shorter and shallower.

Perhaps the most important dimension of this experience was the doubling of productivity growth, from about 1.5 percent a year in the two decades up to 1995 to more than 3 percent a year in the decade since. Productivity growth is important because it is the primary driver of long term gains in living standards. And this acceleration in the United States seems more remarkable in part because most other large mature economies experienced a slowdown in productivity growth during the same period.

This doubling of productivity growth in the United States can be broken down into several important elements. One was rapid improvement in the productivity of the relatively small part of the economy that produces information technology, including computers and computer software and telecommunications equipment. Also important was very substantial growth in investment in information technology by the rest of the economy. And alongside these changes, U.S. firms became significantly more efficient in their use of equipment and labor.

The sources of these improvements in productivity are varied and complex. Economists do not fully understand what drove them, but they seem to agree on several contributing factors.

We experienced a very large and positive technology shock, a dramatic increase in innovation, which improved the power of technology, reduced its cost, and made possible a revolution in production and business processes.

The skills and knowledge of the United States workforce played a critical role in contributing to the extent and spread of innovation.

The U.S. economy became substantially more open, with trade increasing substantially as a share of GDP. Deregulation in the 1980s (telecom, transportation, finance) and since then have helped make the U.S. economy more dynamic and flexible. The U.S. financial system became stronger, more resilient, better at matching capital to ideas, and better at spreading and managing risk.

And finally, U.S. macroeconomic policy was very supportive. Good fiscal policy choices in the 1990s helped produce significant surpluses, freeing private savings for private investment. The gains in price stability delivered by the Fed under two chairmen provided a critical foundation for the sustained increase in private investment that helped translate a shift in the technological frontier into accelerating productivity.

These forces reinforced each other. None would have been as powerful without the impact of the others. Globalization, deregulation and changes in the financial structure all worked together to produce a more competitive business environment, motivating major improvements in investment and in efficiency. Good monetary policy and fiscal policy provided a supportive environment, with higher public savings and low inflation.

Luck seems to have played some role, too. The strategic environment seemed in some ways more stable and secure. The size and frequency of external shocks that hit the United States and the world economy during this period were in some ways less acute and easier to manage.

Are these improvements in underlying or structural productivity growth sustainable? This is a hard question to answer. History doesn't seem to offer much of a guide, though we've seen other periods of sustained productivity booms. We did not anticipate this acceleration, which itself suggests we need to be somewhat tentative in forecasting its future.

Dale Jorgenson, Mun Ho, and Kevin Stiroh have concluded in some recent research that there's a reasonable prospect that structural productivity growth will average just over 2.5 percent a year for the next decade. And they think the probability of growth exceeding that pretty favorable forecast is higher than the odds we'll be disappointed.

In support of that view, they make essentially two points. First, they do not see evidence of deceleration in the pace of advancement in technological innovation; nor do they see signs of diminishing marginal returns to IT investment or evidence that we are coming close to fully exploiting the potential of past innovations to improve productivity. And second, they argue that the improved competitive environment - in all its dimensions - is likely to continue to be a spur to further innovation, to further investment in technology and further adoption of technology.

These are reasonably compelling arguments. Their forecast is close to that of the Council of Economic Advisers, the Congressional Budget Office and the consensus of private forecasters. They may prove to be right. But the overall environment for investment and innovation could be materially affected by the disposition of our fiscal and external imbalances and our exceptionally low net national savings rate.

A few key points about the dimensions of these imbalances. Our fiscal deficit, now between 3 and 4 percent of GDP, is in the zone of unsustainability. Our external imbalance - the current account deficit - is now between 6 and 7 percent of GDP, a level without precedent in U.S. economic experience.

Each of these imbalances magnifies the risk in the other. One might be less troubled by a fiscal imbalance of this size if it was not accompanied by a substantial increase in our reliance on the savings of the rest of the world. The external imbalance might be less troubling if the government was in balance and those substantial capital inflows were going to finance private investment.

Together, however, these imbalances raise the potential for higher risk premia on U.S. financial assets and more uncertainty about future returns on claims on the United States. This in turn could reduce expected future investment, productivity growth and U.S. growth potential. This could reduce the willingness of the world's savers to put their capital to work in the United States. And this could mean lower growth outcomes and slower growth in future incomes.

These are risks, not certainties. And there are a number of reasons why the probability of a destabilizing adjustment to these imbalances is likely to be low. These explanations are worth some attention.

There is a reasonable case to make that the U.S. fiscal deficit, although a problem, is a problem of manageable dimensions for the medium term, provided we deliver modest changes to the paths of expenditures and revenues. The more daunting problems we face of bringing our healthcare and social security commitments and resources into balance come later and are less acute than those facing most other large mature economies.

These facts provide some perspective but they are not a compelling argument for deferring policy action to address them.

Another argument for perspective is that our current account deficit reflects in part the relative attractiveness of the United States as a place for the world to invest its apparently ample present supply of savings. It is true that much of the cause of our imbalance seems to lie in optimism about future U.S. economic performance reflected in the willingness of non-Americans to put their savings to work here rather than in their own countries or in Europe or Japan. In this sense, our external deficit may reflect relative strength, rather than weakness.

This argument would be more reassuring if we were facing a lower and more sustainable current account deficit. And it would be more powerful if the capital inflows that are the counterpart of our

current account imbalance were going to finance private rather than public investment, and if a larger share of those flows were private rather than official.

Another argument that is important to weighing the risk in running an external imbalance of this magnitude is the very large increase in the share of the world's savings that now seem to move more comfortably across borders. This decline in home bias - as Alan Greenspan has spoken about extensively - seems to have made it easier for countries to sustain larger current account deficits than might have been possible in the past.

However, we don't know much about how much further room there is to run in this phenomenon. We don't know much about the present degree of concentration in the exposure of private savers to the United States relative to their longer term preferences, or how stable those preference are likely to be. And, therefore, we don't know how likely it is that those outside the United States are going to be willing to continue to acquire claims on the United States at the recent pace.

Finally, a number of observers have suggested that the present imbalances reflect what could be called a balance of interests, and that this balance is likely to endure for sometime. On one side of the balance is the substantial part of the world economy that has an interest in shadowing the dollar closely, as they absorb excess capacity, and that these governments are likely to continue to want to acquire dollars to make that exchange rate objective possible. On the other side of the balance is the United States, which is able to sustain higher rates of private spending and larger government deficits than it could if others were not willing to lend us their savings.

This is an uncomfortable basis for a forecast of a benign adjustment process, not least because at some point the interests of those on one side of the balance may change.

I think this mix of challenges in our fiscal and external positions deserve concern and attention. They may end up being diffused gradually and benignly, but they necessarily bring with them a greater risk of higher risk premia, a more adverse investment environment and poorer growth outcomes. Under some circumstances, this could undermine an important foundation of the environment for innovation that has delivered our productivity acceleration.

What can we do to mitigate the risks in this constellation of forces?

We can work to keep monetary policy credible, to preserve confidence we will act to keep inflation and inflation expectations stable at moderate levels.

We can act to raise public sector savings, begin to bring our entitlement commitments and our resources closer into balance and build a greater financial cushion into our financial future against the risk of a less benign world.

We can make sure we keep our markets open, and to support rather than resist the integration of China and India into the world economy.

We can work to make sure that our financial system remains strong, with a substantial capital and liquidity cushion, a more resilient infrastructure and continued rapid innovation in financial intermediation.

And we can work to improve educational opportunities in this country, to improve educational achievement and to improve public awareness of economics and finance. Nurturing a sophisticated, technologically advanced workforce that is capable of contributing to the competitiveness of our society has to be one of our highest goals and most rewarding objectives.

These are achievable ambitions. They would not guarantee that the future will look as good as the recent past, but they will improve the probability it will.

The hardest of these are those where the politics are hard. And this is why it's so important that we work to strengthen the constituency in the United States for good fiscal choices and good trade policy choices. Education is an important part of this. And the work of the Economic and Financial Education Alliance of Puerto Rico can play a valuable part in creating a stronger foundation for future economic growth in Puerto Rico and in the country.

Thank you.