Timothy F Geithner: Global economic integration – the opportunities and the challenges

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the conference organised by the European Commission and the Federal Reserve Bank of New York "The euro and the dollar: pillars in global finance", New York, 17 April 2007.

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Let me again welcome you to the New York Fed and to this conference. We are especially pleased to have so many of our European colleagues here today. You have spent the morning discussing some of the important economic and financial issues facing the United States and Europe. But this is essentially a conference on integration. I want to step back and make some broader observations about the process of global economic integration and the package of policies that need to accompany greater openness.

We are, as the IMF noted last week in its latest World Economic Outlook, in an unusually prolonged and widespread global expansion – the strongest in more than three decades. Economic integration and technological change have played a crucial part in driving this expansion and sustaining it in the face of recent shocks and some daunting longer-term economic policy challenges.

Yet there remains substantial ambivalence about the benefits of globalization. To many, the costs seem more compelling than the benefits. The sources of this ambivalence are varied. Some are familiar and some new.

Concerns about the distributional impact of trade have been given new force by the decline in labor's share of national income; the long-term trend of rising income inequality; the increase in the share of goods and services that are tradable, and therefore of the broader scope of the population affected by the pressure of competition; and the perceived acceleration in the pace of economic change.

The greater mobility of financial flows has increased the sense among policymakers in many countries that their jobs have become harder, that they are less the masters of their own fate than in the past, and that they have a diminished ability to shield their companies and citizens from volatility.

But do these changes in economic circumstances and in perceptions fundamentally change what we know about the broad economic merits of global integration? I do not believe the basic economics of that judgment have changed.

Few would argue that economic integration by itself is sufficient to achieve broad-based gains in income growth both within and across countries. The relative prosperity of nations reflects different choices made by governments about a range of policies and institutions beyond the realm of trade and financial restrictions. But integration is an essential ingredient for achieving sustained growth. Reasonable people can disagree on the magnitude of gains that can be attributed to trade rather than other economic policies. But the evidence in support of the broad consensus that openness and integration contribute significantly to better growth outcomes remains compelling.

Just as compelling is the evidence against the proposition that protection in the form of restrictions on trade increases growth or reduces inequality. The world has a lot of experience with different policies designed to slow the pace of integration or to insulate parts of the economy from its effects, and these policies have generally been associated with worse economic outcomes. The poor do not benefit from protectionism.

Although the balance of economic evidence has not fundamentally changed, the politics around globalization and integration have become more challenging.

The fact that the United States is now in the fifth consecutive year of expansion and that unemployment is now at 4.4 percent doesn't seem to have made trade any more popular. A recent Pew poll suggested that that nearly two-thirds of Americans feel less secure about their jobs than in earlier generations. And many attribute this increase in anxiety to trade.

This phenomenon of persistent and perhaps rising ambivalence about integration in the face of solid growth in average incomes is not unique to the United States. Here, as in many countries, the political consensus in favor of economic openness seems more fragile than it once was.

The debate about how to respond to this challenge tends to see the economic and political imperatives as in conflict. The most appealing political response – usually some form of selective restriction on trade or investment – is generally the option with the worst economic return. The typical political impulse is to try to address directly the source of the competitive pressure and to relieve it, but these measures cannot offer lasting relief. The economic price of protection, in terms of distorted incentives, reduced flexibility and broader costs on the economy as a whole, seem both more substantial and more enduring than any temporary political benefit.

The policy strategies that offer a better longer-term return do not try directly to relieve the pressures that come from economic and financial integration. Instead, they focus on the broader complement of policies and institutions that improve the capacity of economies to adapt to change and to absorb shocks. Those countries that have experienced the greatest gains as the world has become more integrated have been those with the type of policy and institutional infrastructure that facilitates economic flexibility and resilience in the face of change. The policies that offer the most promise in terms of broad-based income gains are not those that try to provide insulation from volatility, but those that make it easier to live with volatility.

In the realm of macroeconomic policy, this means further progress toward monetary policy credibility and fiscal sustainability, so that central banks and governments have the capacity to react to adverse shocks and mitigate the damage they can cause.

Even with the remarkable improvements in the conduct of monetary policy around the world over the past two decades, central banks in many countries do not have institutional independence, in law or in practice. And many still operate under policy regimes directed at limiting exchange rate changes – objectives that will necessarily conflict with their ability to achieve price stability, as their capital accounts become progressively more open. Economies with flexible exchange rate regimes generally fare better in the face of adverse external shocks. And in countries where central bank credibility is more firmly established, monetary authorities are better able to react to a sharp fall in asset prices or a negative demand shock.

In fiscal policy, the same basic point applies. Where fiscal sustainability is more firmly established, governments have more scope to respond to adverse demand shocks by reducing taxes or increasing expenditures. Where deficits are high and debt to GDP ratios are high and rising, government have less scope for countercyclical fiscal policy. In these cases fiscal stimulus is more likely to be met by a rise in risk premia, reducing, if not fully offsetting, the desired benefits to growth. Even in those emerging markets that have seen the most impressive progress toward fiscal sustainability, few have reached the point where they have built much of a cushion against future shocks. And in the United States and many other economies, the demographic changes now working their way through the economy entail very large future deficits and consequently very limited fiscal room for maneuver.

The right macroeconomic policy framework is crucial. But we have come to recognize that other issues, traditionally the province of microeconomics, have a vital role in contributing to effective macroeconomic policy. A critical factor distinguishing long-term economic performance among countries with relatively good monetary and fiscal policies is the degree of overall flexibility they exhibit in labor, product and financial markets. This is not simply about the presence or absence of regulation. It is a function of the incentives regulation creates and the extent to which it gets in the way of competition, impedes the allocation of labor and capital to industries with a higher return, favors established firms, and creates barriers to new entrants.

As the substantial body of research on structural reforms by the OECD has demonstrated, where regulation is more compatible with flexibility, productive growth has generally been higher, as technological advances have been diffused and adopted more rapidly. The IMF's latest World Economic Outlook reports that, among the major economies, those with more flexible labor markets have seen smaller declines in labor's share of income.

Open economies, of course, need strong and resilient financial systems. As financial systems develop and capital markets become more open and integrated, savings should be allocated more efficiently and risks distributed more broadly, both within and across countries. This process, however, is messy and very challenging to manage well. The history of economic crises over the last two decades is a history not just of fiscal profligacy and monetary policy mistakes, but of financial system weakness – often the result of rapid deregulation and capital account liberalization in a context of weak supervision and a broad government guarantee of bank liabilities.

The development of deeper and more resilient financial markets is important for economies to be able to cope better with exchange rate flexibility and capital mobility. And financial strength is an important part of the arsenal of macro policy tools, for monetary policy is less effective in cushioning the effects of asset price and demand shocks in circumstances where the banking sector is impaired.

A final and critical dimension of the policy framework that is important to the successful management of economic integration is the design of the public or social infrastructure. Raising the quality of educational outcomes is vital, as is the design of the network of insurance mechanisms, from unemployment insurance and training support, to health care and pension schemes. As progressively larger shares of the population become more exposed to the pressures of competition, as economies become more flexible, governments have to do a better job of designing programs of assistance that can ease the costs of adjustment.

These policies and institutional reforms are fundamentally the responsibility of national governments. International institutions can help, with technical assistance and financial support, but these challenges are essentially national challenges. The reforms of the international institutions now underway to make them more representative of the changing balance of economic activity in the world are laudable. And we share a common interest in a broad range of informal mechanisms for cooperation on policies in the financial arena. But ultimately it is the quality of the choices national governments make that will determine how their economies fare in a more open global economy.

Global integration is not the primary source of the world's economic problems, nor can it be the primary solution to them. But economic integration can contribute significantly to sustained growth, rising incomes and declining poverty rates. The most effective policy response to the concerns of those who fear the consequences of further integration is to direct more political capital to the challenge of developing the economic and institutional infrastructure that will enable governments and their citizens to adapt more readily to change.

Thank you.