Timothy F Geithner: Reflections on the changing global economy

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the 46th ACI Financial Markets Association World Congress, Montreal, Quebec, 4 May 2007.

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Good morning. I am pleased to be able to join you today. And it is a privilege to be here today with Canada's accomplished central bank governor, David Dodge. There are few people in central banks or in governments around the world today that have presided over as far reaching and successful a set of macroeconomic policy reforms as has David Dodge.

I want to offer some reflections about the challenges managing macroeconomic policy in a more open and integrated world economy. And I want to say something about how the international monetary system, and the current framework of exchange rate regimes, might develop in the coming years.

For the past century or more, choices about exchange rate regimes have played an important role in economic outcomes across countries. From the Gold Standard of the late 19th and early 20th centuries through the Bretton Woods system and the episodes of exchange rate cooperation among the G5 and the G7 in the 1980s and after, the desire to achieve exchange rate stability was a major preoccupation of policymakers. The economic damage inflicted by the disastrous competitive devaluations among the major economies in the 1930s had a profound influence on thinking during much of the postwar period. And for governments and enterprises around the world today, the aversion to large fluctuations in exchange rates remains strong.

As the world has become more open to trade and more closely integrated, this sensitivity to exchange rate variability has intensified. And yet, experience suggests that resisting variability makes the adjustment to changing economic conditions more painful. In an increasingly open world economy, the ability to cope with change becomes more important, and for a large fraction of the world economic, exchange rate flexibility is a necessary condition for sustained favorable economic performance.

Changes in fundamental factors such as productivity growth and the inevitable shocks to demand and supply require changes in relative prices, both domestically and internationally. A flexible exchange rate regime makes it easier for relative prices to move rapidly and effectively in the appropriate direction, and this generally eases the cost of that adjustment.

Even in a fixed rate regime, this adjustment in response to changing circumstances will ultimately have to take place, of course. But if relative prices cannot adjust through the exchange rate, domestic output and employment will have to bear the brunt of adjustment instead.

Since the collapse of the Bretton Woods system, we have seen the emergence of a diverse range of exchange rate arrangements. The large industrial economies have, by and large, decided to let their currencies adjust to changing circumstances without official intervention in exchange markets. Japan aside, it is now close to seven years since the last episode of concerted intervention among the major economies; and there has been no Japanese intervention for two years.

Among emerging economies, too, we have seen a marked trend toward more flexible exchange rate regimes. This is particularly pronounced in parts of Latin America. At the other end of the spectrum, some of the newer members of the European Union are gearing up to adopt the euro. Somewhere in the middle between these extremes of flexible exchange rate regimes and full monetary integration are the emerging market economies, mostly in Asia and among the major oil exporters in the Gulf, that still sustain fixed or partially fixed exchange rate regimes. Most of these countries link their currencies to the dollar, though we see varying degrees of flexibility in the closeness of that link.

How has the world fared under this diverse mixed of flexible and fixed exchange rate regimes? In general, I think, the costs of living with exchange rate volatility have been less than feared and attempts to limit volatility have been more damaging and less effective than expected.

Take the experience of the major economies. Despite periods of very substantial swings in exchange rates, and the amplitude of the changes in exchange rates among the major currencies since 1973 have been exceptionally large, economic growth in the major economies have become more stable, not less. Quarterly GDP volatility in the United States, for example, has fallen by more than half since the mid 1980s. And average rates of inflation and the variability of inflation outcomes have of course declined substantially as well. This is not to say that these swings in exchange rates have not come with pain and trauma, only that overall economic performance has fared better than many would have expected three decades ago when contemplating life under flexible exchange rates.

Among emerging markets, experience with exchange rate flexibility has been more limited, and the record has been more mixed. Chile probably has one of the longest record of successful performance under a flexible regime, success due in large part of course to a strong record of prudent macroeconomic policy management and strong institutions. But there are many more examples today – Brazil and Mexico are two – of emerging economies with sustained periods of improved growth and inflation outcomes under more flexible exchange rate regimes.

Emerging market economies face substantially greater challenges than the less open major economies in adjusting to a more integrated world and to the greater exposure to real and financial volatility that comes with integration. Large movements in capital flows can complicate the task of achieving sustainable growth, low inflation and financial stability. This is obvious for those countries experiencing sharp net outflows of capital, but the challenges are formidable even for those countries experiencing sustained periods of large inflows. And even those countries with more flexible exchange rates can see competitiveness eroded if their major trading partners resist exchange rate appreciation. For most countries, though, these challenges would be exacerbated rather than eased by a policy designed to try to sustain a fixed rate or to narrowly constrain variability in the exchange rate. Although it may seem counterintuitive, small open economies, even more than larger less open economies, need the flexibility that floating exchange rates bring.

Changes in exchange rate regimes were present at the scene of most of the major emerging market financial crises of the last decade, and many have argued that the decisions to let the exchange rate adjust was a major source of the trauma that followed. But that's not a fair reading of the evidence. In general, the crises were the consequence of fundamental economic problems, often manifested in the buildup of substantial balance sheet problems, with excessive borrowing in foreign currency by the sovereign, the banking system, or both.

These balance sheet problems were one reason many governments chose to postpone currency adjustment for as long as possible, and these delays ensured that the cost of adjustment, when it was forced on these governments, was far higher than if action had been taken earlier. But this is not the whole story since the fixed exchange rate regime itself had contributed to the initial currency mismatch and associated balance sheet problems. By engineering artificial expectations of stability, the regime had led market participants to disregard the possibility of exchange rate devaluations, leading to mispricing of risk, insufficient hedging and ultimately to misallocation of financial and real resources.

Governments that found themselves in this position had very limited ability to mitigate the economic damage that was to come, but the policy choices that accompanied the exchange rate change often compounded the problem.

Japan's experience provides another example, though the context was different. There is a perception in parts of Asia that the Japanese government's decision to let the yen appreciate in the late 1980s was principally responsible for Japan's so-called “lost decade” of low growth. And, Japan, viewed through this prism, is cited as an example of the perils of letting an exchange rate move up in response to changing fundamentals. The reality is more complex. The problems of the Japanese economy in the 1990s were largely due to the aftereffects of the collapse of the real estate and asset price boom of the preceding decade, a boom fueled in part by efforts by the monetary authorities to limit the appreciation of the yen.

The size of the negative shock to demand from the collapse of the bubble was very substantial, and the capacity of the government and the central bank to mitigate the damage was constrained by the weakness in the banking system. A more forceful macroeconomic policy response, however, might have brought about a quicker recovery. In any case, the problem with the exchange rate choice was not the decision to let the rate adjust, but the decision to resist it and the role that played in magnifying the bubble, and thereby the subsequent damage from the fall.

Given where we are today, and what we know about the relative merits of flexible and fixed exchange rate regimes, what is the likely evolution of the current monetary system going forward? A few concluding observations.

First, I think it is unlikely that we will see a substantial move toward monetary integration involving the major emerging market economies, in Asia or in the Western Hemisphere. As the economist Peter

Kenen writes in his latest book, it is difficult today to envisage a substantial reduction in national currencies though the emergence of large regional monetary unions where they do not already exist.

Within Europe, we may yet see a further enlargement of the euro area. There may be other circumstances in which individual economies can derive benefit from a currency board system or from dollarization or euroization. Countries trying to emerge from a period of high inflation may in the future, as they have in the past, adopt a fixed exchange rate as a nominal external anchor for a disinflation strategy. These seem likely to be exceptions, however, to a general move toward more flexible exchange rate regimes.

Even as regional economic integration increases in Asia and other parts of the world, these economies seem a long way from the point where economic, or political conditions, will make a compelling case for monetary integration. In Europe, of course, the political case for monetary integration to a large extent preceded the economic case. And the architects of the European Union integration worked consciously to induce a level of economic integration in Europe that would induce conditions that more closely met the economist's test for an optimal currency area.

For most of the emerging markets today, in contrast, the challenge is to establish the conditions that will enable them to live more comfortably in a world where their exchange rates will adjust more freely in response to changing fundamentals. As these economies become more open to capital flows, they will necessarily find it more difficult to occupy the tenuous middle ground with an exchange rate regime that is neither fully fixed nor flexible, but managed in a way that closely tracks the value of the dollar or carefully constrains fluctuations against the dollar.

This does not mean that these countries can be indifferent to exchange rate movements or that the exchange rate is irrelevant to the conduct of monetary policy. For many small open emerging economies, price stability and exchange rate stability are obviously intertwined, and a monetary rule that responds effectively to inflation pressure cannot afford to overlook the signals coming from the foreign exchange market. But attempts to target a particular level for the exchange rate or the slope of the change in the rate in response to different conditions will, as the capital account becomes more open, inevitably, come with substantial risks to monetary and financial stability.

Managing the transition to a more open capital account and a more flexible exchange rate regime is not a simple task. These transitions need to be handled with care and attention to the development of a strong institutional framework for monetary policy and the financial system. The more successful transitions came in contexts where the monetary authorities were independent of political constraint, where balance sheet problems and currency mismatches in the government and the financial system were not acute, where the prevailing legal framework provided reasonable protections for property rights and the enforcement of contract, and where there was effective supervision of the banking system. Where these conditions were weaker, the transitions from fixed exchange rate regimes were more traumatic.

These conditions seem exacting, and the understandable need for caution often is invoked in defense of protracted and very gradual transitions. A certain degree of caution is wise: there is a great deal of risk in a poorly managed and premature shift toward flexibility. But there is risk in gradualism too. Delay magnifies the costs of living with the distortions caused by a managed rate.

Once relaxed, exchange and capital controls are both difficult and costly to reintroduce, and even relatively modest steps back from an open regime can be damaging to confidence and credibility, without buying much in the way of lasting stability.

The policy responses to the challenges that come with economic and financial integration principally involve choices for governments at the national level. International cooperation can in some circumstances help provide a more supportive environment, but there are no feasible changes to the architecture of the international financial system that offer the prospect of a durably stable external economic and financial environment for nations, large or small. Fundamentally, the only realistic choice for policymakers is to equip their economies with the flexibility to cope more successfully in this increasingly integrated global economy. And this means preparing for a world of more rather than less flexibility in exchange rate regimes.

Thank you.