Timothy F Geithner: The economic dynamics of global integration

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Forum on Global Leadership: US Competitiveness in a Globally Integrated Economy, Washington DC, 25 July 2007.

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We are meeting at a time of relatively favorable U.S. economic performance, but also of growing concern about our relative position in the world and our longer-term economic prospects at home.

On a wide range of measures, the American economy and American business are performing well. We are in the fifth year of expansion in the United States and in the midst of the strongest global economic expansion in more than three decades. Corporate profits as a share of GDP are close to the highest level in four decades.

Corporate balance sheets are healthy. The six-month trailing bond default rate has stayed near zero this year, and the delinquency rate on commercial and industrial loans at banks remains extremely low.

We have seen a substantial acceleration in trend productivity growth over the past decade. And although productivity gains have slowed recently, as they typically do as expansions mature, U.S. companies remain at the forefront of changes in science and technology—and in the application of those innovations to business processes across a range of industries.

Overall, the U.S. economy continues to display remarkable resilience and flexibility, despite a range of adverse shocks. This is a remarkably favorable picture; and yet there is growing concern about the long-term challenges for the U.S. economy and their implications for future prosperity.

In parts of the business community, there is growing anxiety about a perceived shift in the locus of dynamism and growth away from the United States toward Asia and other parts of the world.

Public opinion surveys report increased concern among Americans about economic security; about the prospects for future income growth and economic mobility; and about the implications of the long-term increase in income inequality.

And there we can see growing concern among the general public and in the business community about the struggle to find a political consensus to support reforms to help us meet these challenges.

The United States has long been one of the most open of the major economies. This basic policy choice, along with a range of other actions that have made our economy relatively flexible, has allowed us to be a substantial beneficiary of the rapid increase in global economic integration and in the growing economic success of the rest of the world.

Globalization has brought challenges as well as benefits, however. The combined forces of technological change, immigration, and the rapid integration of China, India, and other economies into the world economy are altering the dynamics of competitive pressures on U.S. companies. The pace of change seems to be increasing, and more things we produce, and more of our services, are becoming tradable. And this seems to have fed anxiety, among firms and their employees, about the challenges in coping with these forces.

These changes have taken place in the context of a longer-term increase in income inequality in the United States. Incomes have grown more rapidly for the richer and better educated than for those at lower points of the income scale.

These changes have, in turn, contributed to some erosion in the strength of the political center in the United States on a range of economic policy issues. Surveys suggest diminished support for global trade. And there is more divisiveness on a range of issues such as tax policy and the appropriate role for government in the regulation of economic activity.

Over the last half century and more, the U.S. economy has enjoyed some substantial and important relative advantages. Among the most important of these are the quality of our best universities; our openness to change; the incentives provided for innovation; the strength of property rights; the depth and liquidity of our world-class financial markets; and a record of stability in macroeconomic policy.

These relative strengths of the U.S. economy remain significant and substantial. But the rest of the world is getting better at establishing the important conditions for dynamism and innovation. These improvements are not a reflection of U.S. weakness, nor are they themselves a threat to U.S. competitiveness. We will benefit from more rapid growth in the rest of the world, but at the same time we need to be more attentive to addressing a range of challenges that could ultimately damage the prospect for future growth in living standards here at home.

I want to talk about challenges we face in four areas:

- sustaining support for global economic integration,
- the role of public policy in education and other areas that are critical to our capacity to adapt to change,
- regulation and the role of the market, and
- macroeconomic policy.

Let me start with openness.

The pressures that have come with globalization and technological change have led many to suggest that we should become less open as a country, that we should slow the pace of integration, or that we should provide greater insulation or protection from competition for selective parts of the U.S. economy.

Moving in this direction would, I believe, be a fundamental mistake. More than ever before our fortunes are linked to those of the global economy. If anything, we need to become more open, not less; more open to trade in goods and services, but also to investment, to people and to ideas.

Global integration is not the solution to all our problems, but acting to restrict it or to insulate us from its consequences would damage our capacity to grow and to adapt to change, and these costs would make it harder, not easier, to deal with our longer-term challenges. To the extent we are reluctant to remove restrictions or subsidies in the United States, we make it easier for the forces in other countries to block reforms from which we would benefit.

The world has a lot of experience with the costs and benefits of protection, and the balance of judgment on those questions has not significantly changed even with all the changes that technology and policy have brought to global trade. Economies that are more open have generally seen more rapid growth, both in incomes and in employment. Economies that are less open have generally grown less rapidly.

Openness itself, of course, is not enough.

Our capacity to adapt to change depends in part on the effectiveness of government policy in a range of important areas. Education seems the most obvious of these, but policy in health care, in public infrastructure, and many other areas will also play an increasingly important role in determining the relative strength of the U.S. economy in this more integrated world.

The U.S. educational system combines the strengths of high completion rates for secondary education, a rich variety of post-secondary school educational options, and exceptionally strong elite universities, with the weaknesses of substantial unevenness in the quality of public education, and large disparities in the educational opportunities available to those of modest income and the relatively rich. By some estimates, students from families in the bottom half of the income distribution account for only 10 percent of all places in our elite universities.

An education system should be judged by how it serves the majority of the population, not just the performance of its best institutions. And as technological progress continues and global integration increases, our system will be judged by how good a job it does equipping a broader range of students with the skills commensurate with these challenges. In communities across the country, there are encouraging efforts at experimentation and reform. Progress is probably going to require more substantial public investments in education going forward.

Health care does not usually make the agenda of conferences on competitiveness, but we're seeing a welcome wave of attention in the business community to the broader economic imperative of health care reform. The U.S. system has compelling strengths in the quality of care and the choices available to much of the population. But our system is also remarkable for the magnitude of the costs, the incidence of those costs across the economy, the number of uninsured, and our poor performance on health outcomes even compared with less wealthy economies. To cite just one example, infant mortality rates in the United States are more than two times the level in Japan.

In a world in which economic performance depends increasingly on flexibility and adaptability to change, we probably need to move to a system in which a change in employer or profession does not carry the substantial uncertainty it does today about how one will provide for one's health and that of one's family. This seems fundamental to the willingness of Americans to support the level of openness to trade and to change that is an essential part of our present and our future.

A defining feature of the American economy has been our embrace of the market, and the recognition that market forces are, in general, the most effective way of allocating resources. But markets cannot solve all problems, and government policy plays an important role in how well markets function. The test of policy is not just in the incentives we create for competition and innovation, but also in the clarity and stability offered by the regulatory framework and in the quality of public goods that governments deliver.

Any one who travels outside the United States today returns with an appreciation about how rapidly public infrastructure is improving in many parts of the world, relative to what is evident in many parts of the United States.

As global markets become more integrated and companies and capital can move more freely across borders, policymakers will face new challenges in the design of regulations. They will have to look more carefully at the balance of benefits and costs, when companies have more choice about where to invest. They will have to find ways for regulations to evolve more quickly in response to developments in markets. They will have to explore ways to cooperate more closely with other governments, where national approaches alone cannot be effective.

We need to get used to a world in which we will see, in many areas, less willingness to adopt a U.S. model or to defer to a U.S. view on the appropriate global standard.

You can see some of these dynamics in the financial arena, and concern about the erosion in the relative position of the U.S. financial system.

Financial markets outside the United States are now deeper and more liquid than they used to be, making it easier for companies to raise capital domestically at reasonable cost. These financial markets are at an earlier stage in the process of capital market development, and they will therefore experience rapid growth in securitization and the role of derivatives.

These factors, more than other differences in tax, accounting, or legal regulatory regimes, account for the bulk of the declines' share of equity and debt raised in the United States by companies around the world. And this shift is something that we benefit from, not just in the direct sense that U.S. financial institutions play an important role in those markets, but in the broader sense that we will gain from the improvements in economic growth that come from financial market development around the world.

But in this context, we need to be more attentive to the risk that specific aspects of our system, regulations or other constraints, create a greater disincentive to locate a financial business here, or to invest here, or to raise capital here, than would have been the case five or ten years ago. We need to take a careful look at how we regulate financial activity in a world where capital is more mobile, and the structure of the financial system has diverged substantially from the system for which our regulatory framework was designed.

That does not mean we should contemplate weaker regulation or lower standards. The strength of the U.S. system is in part the result of the confidence we have developed in the integrity and resilience of our markets, in part by establishing strong standards for investor protection, market practices, and safety and soundness. Sustaining this confidence will be critical to the future strength of our financial system.

To complete this list of policy challenges that are important to U.S. competitiveness, let me conclude with a few brief points on the broader imperatives of macroeconomic policy.

The United States faces very substantial gaps between our fiscal resources and our expenditure commitments. The size of these gaps, these deficits, have been masked in recent years by a substantial, unanticipated and probably transitory surge in revenues, and by an unusually long period of unusually low long-term interest rates, in part the consequence of foreign official capital flows.

But these gaps remain substantial and the U.S. fiscal position is unsustainable. Time does not help. We are going to have to begin to develop a political consensus on the mix of policy changes that can bring our commitment and resources more into balance, if we are to preserve confidence in our market and our long-term economic prospects.

One of the most important roles for public policy is the maintenance of a stable macroeconomic framework that enables firms to make long-term investment decisions. In this sense, the fiscal policy choices ahead for this country will be critically important to the overall environment in which U.S. enterprises operate.

The business community will play an important role in shaping the policy response to these longer-term economic challenges. These reforms will have a long fuse. The benefits will be shared broadly, rather than captured specifically by particular sectors of the economy.

American companies have a strong collective interest in sustaining public support for global integration, improving the quality of public goods the government provides in education, health care and infrastructure, and in preserving confidence in U.S. fiscal sustainability.

Thank you.