Janet L Yellen: Fiscal responsibility and global rebalancing

Speech by Ms Janet L Yellen, Vice Chair of the Board of Governors of the Federal Reserve System, at the Committee for Economic Development 2010 International Counterparts Conference, New York, 1 December 2010.

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Good morning. Thank you for inviting me to be with you today. The Committee for Economic Development has a long and distinguished record in identifying and addressing crucial issues related to our nation's economic growth and productivity. And today's conference on fiscal sustainability and the global economy fits squarely within that tradition. My remarks will focus on the challenges faced by U.S. policymakers as they confront the need to put fiscal policy on a sustainable track in the long term while providing support to the economy in the near term. I will also offer some thoughts on the recent actions undertaken by the Federal Reserve and on the implications of our nation's fiscal and monetary policy choices for the global economy.[1]

The challenge of achieving fiscal sustainability in the United States

Charting a sensible course for the federal budget is an essential but formidable task for U.S. policymakers. Since the onset of the recent recession and financial crisis, the federal budget deficit has soared as the weak economy has depressed revenues and pushed up expenditures and as necessary policy actions have been taken to help ease the recession and shore up the financial system. At 9 percent of gross domestic product (GDP), the budget deficit in fiscal year 2010 was a little lower than it had been a year earlier, but it was still considerably above the average of 2 percent of GDP during the pre-crisis period from fiscal 2005 to 2007. As a result of the recent deficits, federal debt held by the public has increased to around 60 percent of GDP – a level not seen in 60 years.

For now, the budget deficit seems to have topped out. So long as the economy and financial markets continue to recover, the deficit should narrow relative to GDP over the next few years as a growing economy boosts revenues and reduces safety-net expenditures and as the policies put in place to provide economic stimulus and promote financial stability wind down. That said, the budget situation over the longer run presents some very difficult challenges, in part because the aging of the U.S. population implies a sizable and sustained increase in the share of the population receiving benefits from Social Security, Medicare, and Medicaid. Currently, there are about five individuals between the ages of 20 and 64 for each person aged 65 and older. This ratio is projected to decline to around three by the time most of the baby boomers have retired in 2030, and further increases in average life expectancies may push this ratio down a little more in the years after that. Moreover, the demographic pressures on the budget appear likely to be compounded by continued large increases in per capita spending on health care. Admittedly, the ability of budget analysts to forecast the trajectory of health-care spending is limited, but it is prudent to assume that federal health spending per beneficiary will continue to rise faster than per capita GDP for the foreseeable future.

In a nutshell, the problem is that, in the absence of significant policy changes, and under reasonable assumptions about economic growth, demographics, and medical costs, federal spending will rise significantly faster than federal tax revenues in coming years. As a result, if

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[1] My remarks reflect my own views and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).

current policy settings are maintained, the budget will be on an unsustainable path, with the ratio of federal debt held by the public to national income rising rapidly.

A failure to address these fiscal challenges would expose the United States to serious economic costs and risks. A high and rising level of government debt relative to national income is likely to eventually put upward pressure on interest rates, thereby restraining capital formation, productivity, and economic growth. Indeed, once the economy has recovered from its downturn, fiscal deficits will crowd out private spending. Large fiscal deficits will also likely put upward pressure on our current account deficits with the rest of the world; the associated greater reliance on borrowing from abroad means that an increasing share of our future income will be required to make interest payments on federal debt held abroad, thereby reducing the amount of income available for domestic spending and investment. A large federal debt will also limit the ability and flexibility of policymakers to address future economic stresses and other emergencies, a risk that is underscored by the critical fiscal policy actions that were taken to buffer the effects of the recent recession and stabilize financial markets in the wake of the crisis. And a prolonged failure by policymakers to address America's fiscal challenges could eventually undermine confidence in U.S. economic management.

I do not underestimate the difficulty of crafting a long-range budget plan that will both garner sufficient political support and have sound economic foundations. The reactions to the proposals offered by members of the President's National Commission on Fiscal Responsibility and Reform, as well as to those offered by other prominent groups, provide ample evidence of the differences that must be bridged. Nonetheless, I am encouraged that the debate seems to be moving forward and is starting to touch on some broad principles that – if followed – would improve economic growth and make achieving sustainable fiscal policies at least somewhat easier. Perhaps the most fundamental question that must be faced concerns the size and scope of the federal government – that is, how much of the nation's economic resources we will devote to federal programs, including transfer programs such as Social Security, Medicare, and Medicaid. Crucially, whatever size of government we choose, taxes must ultimately be set at a level sufficient to achieve an appropriate balance of spending and revenues.

We should not defer charting a course for fiscal consolidation. Timely enactment of a plan to eliminate future unsustainable budget gaps will make it easier for individuals and businesses to prepare for and adjust to the changes. Moreover, the sooner we start addressing the longer-term budget problem, the less wrenching the adjustment will have to be and the more control we – rather than market forces or international creditors – will have over the timing, size, and composition of the necessary adjustments.

That said, it is important to recognize that fiscal tightening, were it to occur prematurely, could retard an already tepid economic recovery. We need, and I believe there is scope for, an approach to fiscal policy that puts in place a well-timed and credible plan to bring deficits down to sustainable levels over the medium and long terms while also addressing the economy's short-term needs.

Unfortunately, U.S. economic performance continues to be impaired by the lingering effects of the financial crisis. The economy remains far from full employment even though a year and a half has elapsed since the trough of the business cycle. Job gains have continued to be subpar, and the unemployment rate remains near its highest level since the early 1980s; moreover, given the slow pace of economic growth, unemployment is likely to remain high for some time. Meanwhile, measures of underlying inflation have continued to trend lower and are now below the levels the Federal Open Market Committee (FOMC) judges to be consistent, over the longer run, with its statutory mandate of maximum employment and price stability.

In this context, the Federal Reserve decided at its November meeting to undertake additional monetary policy actions to satisfy its dual mandate. After weighing carefully the uncertainties and risks, the FOMC decided to further expand the Federal Reserve's holdings of longer-term Treasury securities. The objective of this action is to reduce longer-term interest rates, thereby promoting a stronger pace of economic growth. The purchase of longer-term securities, while in some ways "unconventional," is actually quite similar to the Fed's traditional approach to monetary policy, which involves lowering the overnight federal funds rate by increasing the supply of reserve balances. With the federal funds rate now effectively pinned at zero, purchases of longer-term securities are intended to push down rates further out the yield curve. By bolstering activity in the United States and mitigating risks that could threaten the recovery, this policy should also provide support for a sustained expansion of the global economy.

In announcing its intention to purchase an additional $600 billion of longer-term Treasury securities, the FOMC committed to review the purchase program regularly in light of incoming information and to make adjustments as needed to meet our objectives. The Committee, of course, recognizes that at the appropriate time, as the economy more fully recovers, the Federal Reserve will need to remove this extraordinary monetary accommodation in order to maintain price stability and keep inflation expectations well anchored. I am confident that the Federal Reserve has both the commitment and the tools to achieve this unwinding.

I strongly supported the Federal Reserve's recent action because I believe it will be helpful in strengthening the recovery. But it is hardly a panacea. Thus, a fiscal program that combines a focus on pro-growth policies in the near term with concrete steps to reduce longer-term budget deficits could be a valuable complement to our efforts. Indeed, some budget experts are exploring the idea of explicitly coupling fiscal stimulus in the near term, when unemployment is high and resource utilization is low, with specific deficit-reducing actions that take effect at scheduled future times, when output and employment are expected to have moved closer to their potential. Although a plan of this type might be challenging to develop and implement, it could provide an effective means to support economic activity in the short run while moving toward fiscal sustainability over time.

International implications of US policy choices

Because the focus of this conference is on fiscal adjustments and the global economy, let me now try to place this discussion of U.S. fiscal and monetary policies into the current international context. The process of long-run fiscal consolidation in the United States would likely entail higher national saving relative to investment, which should have the direct effect of restraining U.S. imports and shrinking the U.S. trade deficit. More generally, by lowering interest rates, fiscal consolidation should diminish net capital inflows into the United States, thereby reducing the current account *deficit* in this country and current account *surpluses* elsewhere. The resulting pattern of international debt accumulation and capital flows would be more balanced than at present, promoting a more sustainable pattern of growth in the global economy. Indeed, such a rebalancing program was strongly endorsed by the leaders of the Group of Twenty at their recent meeting in Seoul.

Although the fiscal consolidation process is just beginning, the weakness of private demand in the United States and other advanced economies, combined with robust growth in the emerging market economies, has led to a two-speed global recovery that already is creating pressures toward rebalancing. The advanced economies started their recoveries in 2009, but economic growth has barely exceeded the growth rate of potential output; as a result, the level of output in most advanced economies, including the United States, is still well below its potential. Forecasts suggest that growth and resource utilization will remain lackluster in the advanced economies for some time. Furthermore, inflation pressures in most other advanced countries, as in the United States, remain quite low, reflecting the existence of substantial economic slack.

In contrast to the subdued pace of recovery in the advanced economies, economic activity in the emerging market economies has rebounded sharply, and the level of output in most of those economies now well exceeds pre-crisis levels. The consequence is that policymakers in emerging market countries have turned their attention to the threat of rising inflation and have begun tightening monetary policy.

The stronger growth prospects in the emerging market economies, coupled with the tightening stance of their monetary policies, appear to be contributing to a resurgence of capital inflows to these economies. Sizeable differentials in expected returns between advanced and emerging market economies also seem to be reinforcing these flows and causing emerging market currencies to rise. In light of their increasing concerns about inflation, a case can be made that emerging market policymakers should welcome currency appreciation because it reduces inflation pressures and, over time, aids global rebalancing. However, some of them have argued that unduly large and rapid capital inflows may lead to asset-price bubbles and expose the financial sectors in their economies to a subsequent reversal of these flows, while rapid currency appreciation could derail the growth of their export sectors. A number of emerging market economies have accordingly attempted to counter the effects of financial inflows through a range of policies, including foreign exchange intervention and capital controls.

The U.S. fiscal program that I discussed earlier might also moderate the pressures emerging market economies are experiencing at present. Stronger U.S. growth would boost our demand for foreign goods and reduce the incentives for capital flows to emerging markets, thereby diminishing some of the upward pressure on emerging market currencies. Thus, the U.S. fiscal program would lessen for a time the natural mechanisms pushing the emerging markets to rebalance their economies toward domestic demand, even as it helped put the global economy as a whole on a more solid footing. However, such developments would in no way diminish the need for such rebalancing in the medium term. It is also important for both advanced and emerging market economies to begin planning now for the structural reforms that will eventually be needed to promote rebalancing.

Conclusion

As I hope I’ve made clear, the challenge for U.S. policymakers will be to craft a strategy that puts our fiscal policy on a sustainable path in the longer term while helping support the recovery in economic activity in the near term. These goals are challenging to achieve but not inconsistent. Moreover, making progress on them would not only provide important benefits to the United States; it would also help foster a stronger world economy in the near term and a better global balance in spending, production, saving, and borrowing over time.