William C Dudley: US economic policy in a global context

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Foreign Policy Association Corporate Dinner, New York, 7 June 2011.

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It is a pleasure to have the opportunity to speak here this evening and I would like to thank the Foreign Policy Association for inviting me. The Association has served for decades as a catalyst for developing awareness and understanding of global issues and for providing nonpartisan forums for informed discussion. Your mission is clearly a worthy one – now more than ever.

In this discussion I will highlight how the recent financial crisis and its aftermath have accelerated the shift in the relative importance of the so-called developed and emerging market economies.

I will then discuss how the global economic system needs to adapt in light of the growing relative importance of the EMEs in the global economy. I will explore the implications of these changes for U.S. economic policy and I will also touch on some of the challenges the EMEs face as they seek to consolidate their gains and sustain their success.

I will argue that the developed countries and the EMEs need to adjust in mutually supportive ways. In my view, the current relationship between the EMEs and the United States is not sustainable for either side. Not only has an unusually wide divergence in cyclical positions opened up that creates immediate strains, but there are also important structural imbalances that have developed that must be addressed.

I will close by turning my attention to what can be done to address these cyclical and secular challenges. Although I will discuss the role of U.S. monetary policy in this context, I will also discuss what other steps can be taken to strengthen the relationship and make it more sustainable.

As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

Over the past few decades, the most salient feature of the global economy has been the growing importance of the emerging market economies and the ever-deepening integration of these economies into the global economic system. A shift toward more market-based and outwardly oriented development on the part of the EMEs has enabled hundreds of millions of people across the emerging world to become integrated into the global economy for the first time. The outcome has been a rapid rise in living standards and a reduction in poverty on a scale that is without precedent in human history.

These changes have been most evident in China, with a historic transformation that began with the economic reforms of Deng Xiaoping and continues to this day. But the EME story is much broader than China. Over the past decade,[1] excluding China, the emerging world has grown at a 4.7 percent annual rate – its fastest rate on record.

The EME world is, of course, not monolithic. There are the dynamic large economies, EMEs that are broadly complementary to them, and some countries that are both less complementary and less competitive than their peers. Happily, for the most part, EME success is proving mutually reinforcing, as witnessed by growing intra-EME trade.

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[1] Based on the International Monetary Fund World Economic Outlook database, covering the period 2001 through 2011 (forecasted).

As EME output has grown rapidly, their share of the global economy has increased markedly. EMEs now account for 38 percent of global gross domestic product (GDP), up from 23 percent in 1990. And it is the EMEs, not the developed economies, that have been the engine of global growth in recent years. For example, during the 2000s, EME growth accounted for 59 percent of global growth, up from 33 percent and 25 percent, respectively, in the two preceding decades.

By other measures, the EMEs have been even more important. For example, EME growth has been very commodity intensive. Thus, while China is still only two-fifths the size of the United States in GDP terms, it dwarfs the United States in terms of its demand for some key commodities.

The growth momentum among the EMEs is the result of years of tough choices and sound decisionmaking across the emerging world. Policymakers learned from the mistakes of past crises and capitalized on globalization and technological change. However, while the rise of the EMEs is due mainly to the efforts of the EMEs themselves, the reaction of the developed countries in maintaining an open global trading system and resisting calls for protectionism has also been essential.

Even before the financial crisis, the sustained dynamism of the emerging economies was bringing about a profound shift in the role of the EMEs within the global economy. The traditional distinction between the industrialized "core" of the system and the emerging "periphery" was becoming harder to justify as an analytical construct – still less an organizing framework for policy – as the periphery took on more weight and became a much more important driver of global economic developments.

However, the crisis and its aftermath accelerated this transition. Although many emerging market economies contracted sharply following the peak of the financial crisis in late 2008, economic activity in the EMEs has since rebounded powerfully. In contrast, the recovery for the developed economies has been anemic. Economic output for the BRICs this year will be about 31 percent higher than it was in 2007; for the G7 just 1 percent higher.[2]

The rapid rebound of the EMEs occurred mainly because the locus of the financial crisis was elsewhere and that helped limit the damage to their financial system and balance sheets. But many EMEs also recovered quickly because they had the capacity and credibility to pursue countercyclical policies in response to large external shocks to aggregate demand for the first time.

On many fiscal metrics, some economies in the emerging world now look in better shape than many of those in the advanced world. This challenges the traditional distinction between developed country and emerging market sovereign creditworthiness. Where the developed world still stands apart is in the quality of its institutions, legal and policy frameworks, and the sophistication of its technologies and markets. But even here the gap is narrowing.

The story of the EMEs has generally been an extraordinarily positive one for the world as hundreds of millions of people have lifted themselves out of poverty.

Nevertheless, even before the crisis, it was evident that the relationship between developed and emerging economies was becoming strained and needed to be adjusted; the status quo would clearly be unsustainable. Consider, for example, the economic relationships between the United States and China that prevailed over the past decade or so.

Some experts have summarized the arrangements as follows. The United States bought Chinese exports at low prices, which bolstered U.S. living standards and held down U.S. inflation. The United States did not take extreme steps to try to force China to revalue the renminbi upward against the dollar, and China, in turn, invested its trade surplus and capital

[2] Figures are real GDP-weighted indexes for each group. BRICs include Brazil, Russia, India and China.

inflows into U.S. Treasuries in order to keep the renminbi from appreciating too rapidly. The U.S. terms of trade improved as the cost of imported goods dropped, and U.S. interest rates stayed relatively low as China recycled its trade surpluses back into U.S. financial assets. For China, the benefits included strong economic growth, technology transfer and the creation of many manufacturing jobs. These developments, in turn, helped foster rising living standards and political stability in China.

These outcomes were by no means all the result of a deliberate grand strategy. But I think this is a reasonable, albeit overly simplistic, description of what happened.

Although the pre-crisis arrangements worked reasonably well for a while, the flaws became increasingly evident over time. Looked at from the lens of the developed world, the combination of rapid gains in production capacity and relatively repressed consumption in the EME world helped foster a global deficiency of demand relative to supply. In these circumstances, the United States and many other industrialized economies had to sustain domestic demand at elevated levels in order to achieve "full employment" and prevent deflation.

For the United States, the consequence was elevated consumption facilitated by asset price inflation, easy underwriting standards for credit and structural budget deficits. Of course, this particular outcome was not preordained or caused by the EMEs. There were multiple combinations of domestic demand consistent with full employment in the United States during the pre-crisis period. For example, if the United States had adopted different policies, it might have shifted the composition of growth toward more business investment and less consumption and housing. But in a disinflationary global environment amid chronic EME trade surpluses, the United States could not achieve a high level of employment with a high level of national saving.

Looked at from the lens of the emerging world, sustained consumption demand in developed nations induced the EMEs to continue to emphasize investment and exports. This meant that still poor populations did not reap the full benefit of their labors in the form of increases in real income and consumption commensurate with the gains achieved in productivity and output.

Also, this system led, in many cases, to poor returns to EME savers. This resulted, in part, from the cost of sterilizing reserves accumulated in the process of managing exchange rates and the use of the banking system as a tool of industrial policy.

While it is tempting to draw a line of causation from actions in one part of the global system to the other, this is overly simplistic. Rather, we have to think of the global economy as a single system, with outcomes based simultaneously on all the choices and preferences throughout the system. What is new is that the so-called periphery is now weighty enough to have a large impact on the pattern of economic activity in the core, as well as vice versa.

Although the outcomes were not caused by currency arrangements per se, it is hard to avoid the conclusion that regimes with limited exchange rate flexibility linked to the dollar at undervalued exchange rates frustrated one channel through which relative prices might otherwise have adjusted in a way to induce more balanced global growth.

It is clear that the pre-crisis formula for global growth was not sustainable. This is obvious in the case of industrialized nations where private consumption and fiscal deficits reached unsustainable levels and needed to be cut back.

Less obviously, this is also the case for EMEs, as growth strategies that rely on excessive consumption elsewhere in the system are no longer viable. Put simply, we now have a problem of arithmetic – particularly for China as the largest and most dynamic EME.

As China becomes increasingly weighty in the global economy, it will not be able to sustain export growth in the high teens annually[3] in a world that is growing (ex China) at less than 4 percent a year on average. For China, the business fixed investment side of the ledger also appears unsustainably high as a share of GDP. In this context, China's ongoing rapid accumulation of foreign exchange reserves, which carries real economic costs, seems less a sign of strength than an indication of how difficult it is to shift to a different growth path.

The financial crisis did not cause the old growth patterns to become unsustainable. They already were. But its aftermath forces us to confront the need for adjustment with greater urgency, due to the added imposition of extreme cyclical pressures on what were already unsustainable structural relationships.

There are now two additional dimensions to the problem: (1) the stress created by exchange rate regimes that link the monetary conditions of economies at very different stages in the business cycle, and (2) the need for far-reaching fiscal adjustment in the crisis-hit economies of the developed world in the coming years.

Again, to simplify, take the case of the United States and China. The Chinese economy is experiencing the pressures of rapid economic growth that threaten to lead to overheating. Chinese wages – especially in the coastal regions are rising rapidly and consumer prices, on a year-over-year basis, are rising at about a 5 percent annual rate. In contrast, U.S. inflation is considerably lower, growth is subdued, and the United States is still 7 million jobs short of the peak reached in 2007.

An extreme cyclical imbalance exists between the EME world and the United States. The monetary policy appropriate for the United States is increasingly inappropriate for the vast majority of EMEs and vice versa. This creates for EME authorities a dilemma that cannot be resolved entirely via macro-prudential regulatory policies, regardless of their merit.

An EME faces the choice: let its currency appreciate more rapidly and risk losing competitiveness in international markets, or restrain the rise in its currency through intervention and risk inflation. The steps required to mitigate the inflation risk through sterilization can involve big fiscal costs.[4] Neither option is attractive, though the former strategy of currency appreciation is much less problematic if other EMEs are acting in a similar manner.

Meanwhile, we all have to bear in mind that current circumstances put stress on the support for open global markets in the developed world.

On the U.S. side, the recovery remains distinctly subpar in spite of aggressive monetary and fiscal stimulus. On the monetary policy front, short-term rates remain near zero and the Federal Reserve is just about to complete its $600 billion Treasury purchase program. On the fiscal policy front, the U.S. government has engaged in large stimulus program. This supported demand and employment while the private sector shifted its saving balance into surplus in an effort to repair balance sheets.

However, the large size of the fiscal deficit and the rapid increase in the country's federal debt-to-GDP ratio means that this is not sustainable for much longer.

Ultimately, the composition of economic activity in the United States needs to be rebalanced. There are two issues here. First, the consumption share of GDP may still be too high.

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[3] In nominal dollar terms Chinese exports rose 20 percent annually from 2000 to 2010. The Federal Reserve Bank of New York estimates volume growth of about 18 percent.

[4] EMEs typically issue sterilization bonds to offset the increase in the money supply caused by foreign exchange intervention. These generally carry a higher yield than the assets purchased in the course of the intervention, typically low-yielding U.S. Treasuries. The difference in yields results in a net fiscal cost.

Second, the need for U.S. fiscal consolidation implies that there will have to be offsetting increases in investment and the U.S. trade balance as the recovery proceeds.

To illustrate this second point consider the following accounting identity: The public sector balance + the private sector balance = the current account balance

Right now the identity holds as roughly: –10 percent of GDP public sector balance + 7 percent of GDP private sector balance = –3 percent of GDP current account balance.[5]

If the public sector balance must over time move from around –10 percent to around –3 percent to stabilize the federal debt-to-GDP ratio at tolerable levels, then the private sector balance and the current account balance must move by roughly 7 percentage points of GDP to take up the slack.

Assuming that the consumption share of GDP still needs to fall over the medium term, the adjustment in the U.S. private balance will have to occur primarily in terms of rising residential or business fixed investment.

There does seem to be room for business investment to expand significantly when firms become more confident in the economic outlook, provided that the United States remains a competitive location for investment. But residential investment is unlikely to climb very much for some time given the chronic overhang of unsold homes.

If these two sectors cannot take up all the slack created by necessary fiscal retrenchment in the years ahead – as seems likely – then the U.S. trade balance will need to improve as well. This implies that EMEs will no longer be able to rely on expanding U.S. demand as a key driver of their own economic growth.

Of course, this is not just an issue of U.S. and EME adjustment. Adjustments will be required in other industrialized countries, too – and not just the deficit countries. There has to be recognition on all sides that global rebalancing in terms of the composition of activity and growth and in terms of global capital flows is necessary.

Fortunately, this is not a zero-sum game: it is in the interests of all sides. However, it is still very difficult to accomplish because it is not in the short-term interests of some interest groups in many nations. This means that there are likely to be considerable political obstacles to adjustment in many parts of the global economy.

In this process, the United States needs to show leadership in contributing to a smooth adjustment. In this regard, I think there are a number of actions that the United States can take – unilaterally and in its own interest – that will make this rebalancing process easier and less prone to disruption.

As discussed earlier, no issue is more important than a credible commitment for getting our fiscal house in order, but at a pace that does not forestall a sustained economic recovery. What is needed here is fiscal consolidation that begins slowly, builds over time to substantial magnitude, and is difficult to dismantle – i.e., it requires the commitment of both political parties. The decision of how big the U.S. government should be and what functions it should perform is a political decision that I leave to the voters and our legislators. However, as a nation we need to acknowledge that we must be willing to pay for whatever government services and transfers we want to have. We should not assume that an excess of global savings will always be available to easily finance our public deficits.

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[5] To be more precise, as of the first quarter of 2011 with statistical discrepancy of 1.2 percentage points attributed to private balance, the figures are as follows: government balance –9.5 percent + 6.3 percent private sector balance equals current account balance of –3.3 percent.

The choice of fiscal sustainability is not a political one, it is an economic one and if we do not act voluntarily and preemptively, the market will inevitably force the outcome later – most likely in a much more difficult and messy fashion.

Moreover, we must recognize that the rest of the world is closely monitoring our ability as a nation to come to grips with our long-term fiscal challenges, and to pay our debts when they come due. This is an important litmus test of our credibility and ability to exercise global economic leadership.

But the challenges extend far beyond fiscal policy. We, as a nation, have to take steps that facilitate the needed structural adjustment of U.S. economic activity that will position us to thrive in the next chapter of global economic transformation. We need to make sure the next business cycle will be more sustainable than the last, which was built on an unstable foundation of asset price gains, easy credit and outsized financial-sector profits.

This will require a shift in orientation from consumption to export and investment-led growth. As EMEs have shown us, comparative advantage and global competitiveness are not inevitable consequences of factor endowments – they are the result of the choices we make as nations.

There are no easy answers or quick-fix solutions. But in this regard, ensuring broad access to educational opportunity and improving opportunities for people to retool their skills mid-career so they can compete in a rapidly evolving global economy are important.

So too is ensuring that regulation is calibrated such that it achieves public policy goals in the most efficient manner possible, with the least compliance costs and unnecessary delays. A continued commitment to open markets and free trade is essential. Enlightened immigration policies can play a role – making sure that U.S. companies doing business here in the United States can augment the skill sets of workers here with those attracted from abroad.

Tax reform, energy policy, and housing policy also have crucial roles to play – as does financial reform, a subject to which I will return later in the speech.

Leveraging the comparative advantage that the United States has in higher education also makes sense. This should include encouraging foreign students to come here to study. Also, closer partnerships between universities and business could leverage the technological discoveries and advances that occur in university research so that the benefits accrue to a greater degree to U.S. firms and workers.

These are fundamentally structural issues – not cyclical issues. They cannot be tackled primarily through monetary policy. Instead, monetary policy is mainly a tool for stabilizing the macroeconomy and keeping inflation expectations well-anchored.

Nevertheless, monetary policy has an important role in supporting the transitions that need to take place, consistent with our dual mandate of full employment and price stability. As we do so, we must take international developments fully into account.

The integration of the EMEs into the global economy has been associated with some major shifts in relative prices. For a number of years, the United States and other industrialized nations benefited from disinflation in manufactured goods produced in EMEs. This shift in relative prices – a positive terms of trade gain – helped contain inflation.

More recently, the disinflationary tailwind in traded manufactured goods imported from China may have come to an end, at least for a period, as more of the increase in productivity there is captured in wage gains.

Meanwhile, growing prosperity and urbanization in highly populous countries such as China and India has been the principal driver of a major, multiyear upward shift in the relative price of commodities. This move – a negative terms of trade hit for the United States – has pushed up the overall rate of inflation, at least temporarily.

There are good reasons to believe that commodity prices will not continue to increase at the explosive rate of recent months. Households and businesses will adjust their activities in response to higher prices, and there will be a supply response to higher prices that will gradually build over time.

In any event, a shift in relative prices, even if spread out over a number of years, should not to be confused with the onset of an ongoing inflation problem. But the uncertain future path of commodity prices does make the task of the central banker harder.

It is the job of central bankers to ensure that changes in relative prices do not infect the general trend in prices. In the United States – unlike in many EMEs that are appropriately tightening policy – a large amount of slack and low unit labor cost increases provide a disinflationary counterbalance to commodity price gains. Of course, as I noted in a speech earlier this year, we will have to monitor inflation expectations closely to ensure that they do not become unanchored.

We also need to keep a close eye on the degree to which unit labor cost increases in EMEs and real exchange rate appreciation abroad are passed through into U.S. import prices and consumer inflation. Although the historic evidence is that pass-through has been limited in the United States, we cannot be complacent about this.

Meanwhile, we have to recognize that monetary policy works somewhat differently in a world in which a large share of global GDP is part of a *de facto* dollar block. In particular, we must take into account the feedback loops this creates – how U.S. monetary policy influences financial conditions elsewhere and, how these changes, in turn, influence activity and prices in the United States.

At the same time, other nations should recognize that we cannot and do not seek to make monetary policy for the world. Responsibility for ensuring that financial conditions in other nations are appropriate for their own circumstances appropriately lies with their national authorities, and they have a wide range of fiscal, monetary, exchange rate and other policy tools available for this purpose.

I do not see any fundamental conflict between U.S. domestic economic objectives and the interests of the global system as a whole. But the existing system of global currency and monetary arrangements does render effective pursuit of these objectives more difficult.

I believe that we would all be better off if the system evolved toward more flexible exchange rates and greater monetary independence in the EME world.

Notwithstanding this, we can and do pursue our monetary policy objectives in the United States ever mindful of how our policy choices affect other parts of the global economic system, recognizing that these impacts will, in turn, influence U.S. economic outcomes.

For the Federal Reserve, pursuing the dual mandate of full employment and price stability allows us to make an important contribution to global stability and growth. Ensuring low and stable inflation preserves the purchasing power of the dollar and sustains its attractiveness as a medium of exchange. Supporting maximum sustainable employment means that we have an important growth mandate.

This remains the case even when we are at the so-called zero bound with respect to short-term rates. In this context, I believe that our large-scale asset purchase programs were fully consistent with our global responsibilities. For example, our recent program to purchase $600 billion of Treasury securities sought to prevent a relapse into recession and to lessen the risk of deflation – outcomes that would have been very damaging to global economy.

I do not mean to dismiss lightly the concerns raised by some EMEs about the program. By removing long-duration Treasury assets from private investors' hands, we encouraged those investors to purchase other assets, including foreign assets. This eased U.S. financial conditions and, thus, boosted U.S. demand for both domestically and foreign-produced goods. The portfolio rebalancing also may have encouraged greater gross capital outflows. It

is at least possible that this amplified the fundamentally driven rise in EME asset prices and put some upward pressure on some EME currencies.

But, in my opinion, it would have been irresponsible for us to allow the risk of a deflationary outcome in the United States to persist without decisive policy action. If the United States had slipped back into recession, the global economy and financial system would have been destabilized in unpredictable ways, and capital flight to the EMEs and upward pressure on EME currencies would have likely increased rather than diminished.

The Federal Reserve is fully committed to keeping inflation in check and maintaining the purchasing power of the dollar. This is important for U.S. economic stability and growth. It is also critical if the United States is to retain foreign investor confidence, which, as an importer of capital, we should never take for granted.

In fact, we recognize that the United States, as the issuer of the global reserve currency, has singular responsibilities within the global system. The central role of the dollar and dollar assets rests on several pillars:

- confidence in the credibility and coherence of U.S. monetary policy, which preserves the long-run purchasing power of the dollar;
- the unimpeachable credit quality of the public debt that anchors our system;
- the resilience and vibrancy of our financial system; and
- the efficiency and security of our payments system.

These are strengths that we must constantly maintain.

Ensuring financial stability is essential to advancing the common interests of the global economic system. We have much work still to do in the developed world. But the EMEs also need to be active participants in this conversation, given their rising weight in the world economy, already large contribution to global savings and growing importance in the creation of financial assets. Everyone benefits if the EMEs can liberalize and deepen their financial systems in ways that avoid some of the mistakes that we in the United States and others have made.

To sum up, the rapid ascendancy of the EMEs in the world economy and the widespread improvement in living conditions associated with globalization are to be applauded. But aspects of this process have occurred in a manner that has led to strains on both a cyclical and secular basis. The current relationships in terms of capital flows and composition of growth are not likely to prove sustainable on a long-term basis.

The issue of global rebalancing has received plenty of attention elsewhere. My goal today is not to play the blame game. We all share responsibility for addressing our current set of challenges. Rather, it is to lay out the reasons why it is imperative that the United States and the EMEs collectively move toward arrangements that put us on a mutually sustainable path. I hope I have been convincing.

The United States must provide leadership in this global process. This is in our own national interest. The policy response we need combines fiscal and structural adjustments that would enable the United States to prosper in the next phase of global economic transformation. These issues cannot be addressed primarily thorough monetary policy. However, monetary policy has a role to play in supporting the necessary transitions, and it too needs to be conducted mindful of its global context.

As we step up to our responsibilities, we should look to the leading nations of the EME world to provide leadership too, commensurate with their growing importance in the global system, in rebalancing demand and increasing currency flexibility. If we lead together, with mutually supportive actions, we can achieve better outcomes than any of us can achieve on our own.

Thank you for your kind attention.