For release on delivery
11:30 a.m. EST (8:30 a.m. PST)
November 29, 2011

# Aggregate Demand and the Global Economic Recovery

Remarks by

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at

"Asia's Role in the Post-Crisis Global Economy"

Asia Economic Policy Conference Sponsored by
the Federal Reserve Bank of San Francisco

San Francisco, California

November 29, 2011

Good morning. I'm delighted to return "home" to the Federal Reserve Bank of San Francisco and honored to kick off the Bank's second Asia Economic Policy Conference.

In my remarks this morning I will underscore the urgency of strengthened international policy cooperation to attain strong, sustainable and balanced growth in the global economy--a theme that received emphasis at the Group of Twenty (G-20) Leaders' Summit in Cannes earlier this month. The global economy is facing critical challenges. The recovery in the United States and other advanced economies has been proceeding too slowly to provide jobs for millions of unemployed people. There have also been clear signs of slowing growth in emerging market economies over the past year. In effect, we face a dearth of aggregate demand, not just among the advanced economies, but also for the global economy as a whole.[1]

In ordinary times, policymakers in the advanced countries would address such a demand shortfall with expansionary fiscal and monetary policies. But these are no ordinary times. Central banks in a number of advanced economies, including the United States, have brought short-term interest rates close to zero, so that further monetary accommodation can be provided only through unconventional tools, such as securities purchases and forward policy guidance. Meanwhile, the scope for fiscal stimulus is limited by concerns about sizable budget deficits and longer-term sustainability.

At the G-20 summit earlier this month in Cannes, the United States and other advanced economies--including France, Germany, Italy, Japan, Spain, and the United

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[1] I am indebted to Federal Reserve Board staff members Shaghil Ahmed, Eric Engen, William English, Joseph Gruber, Steven Kamin, Michael Leahy, Andrew Levin, Trevor Reeve, and David Wilcox for their assistance in preparing these remarks.

Kingdom--agreed to pursue fiscal consolidation plans to place public finances on a sustainable course over the medium term while sustaining the near-term recovery. Indeed, in the current environment of weak demand, near-term fiscal consolidation could threaten the economic recovery, which in turn may undermine the success of the fiscal strategy. In such circumstances, economies with the capacity to stimulate global growth--namely, countries with large current account surpluses and the potential to expand domestic demand--must take a leading role in adopting policies to rebalance and sustain the global economy. This commitment was made by all of the G-20 leaders, including those from China, Indonesia, South Korea, and other emerging markets.

In the remainder of my remarks, I will point out some key factors that have been restraining the pace of U.S. economic growth, and I will discuss the need for fiscal adjustments to place our federal budget on a sustainable path over the medium term without impairing the economic recovery. I will then turn to a consideration of the crucial role of the Asian economies in fostering a stronger global recovery. Of course, these remarks solely reflect my own views and not necessarily those of others in the Federal Reserve System.

**U.S. Economic Growth**

Since the middle of 2009, the U.S. economy has been recovering from the most severe recession and financial crisis to afflict our country since the Great Depression. However, the pace of the economic recovery has been less vigorous than desired or expected, and the unemployment rate has declined only about 1 percentage point over the past two years. Indeed, the number of jobs in the private sector remains more than 6 million below the peak level reached in early 2008--a distressing development made all the worse by the fact that new entrants have, of course, continued to come into the labor force in recent years. The fraction of those now jobless who have been without work for six months or more stands at a very high level. In addition to those officially unemployed, many individuals are involuntarily working part time or have dropped out of the labor force entirely.

The pace of economic growth in the second half of this year has been somewhat faster than in the first half, reflecting in part a reversal of the temporary factors that had weighed on growth earlier in the year. Nonetheless, a range of more-persistent factors also appear to be restraining the recovery. In recognition of these drags, the consensus of professional forecasters in the survey released earlier this month by the Federal Reserve Bank of Philadelphia was that unemployment would decline only slightly in the next few years, to an average rate of 8.4 percent in 2013. Moreover, financial market conditions have deteriorated, on net, in recent months, intensifying some of the headwinds facing the economy.

At the onset of the financial crisis, consumer spending contracted sharply and the personal saving rate began a steep ascent. Exhibit 1 shows that the saving rate rose from around 2-1/2 percent in 2006 to about 5 percent in the first half of this year. It now appears that consumer spending is advancing at a moderate pace. In the pre-crisis years, consumer spending grew rapidly, providing considerable impetus to the expansion. In contrast, over the next few years, consumer spending seems unlikely to serve as one of the main engines of growth. The ratio of household debt-to-income remains exceptionally high, even though over the past few years it has declined slightly from the post-World War II peak reached prior to the crisis. Although households appear to have made some progress in deleveraging, many still face elevated debt burdens and reduced access to credit. Moreover, high levels of unemployment and underemployment, slow gains in wages, and declines in the values of both homes and financial assets have weighed on household spending and diminished the ability of households to tap home equity in emergencies or for other purposes. Consumer sentiment dropped markedly over the summer and remains quite depressed, apparently reflecting households' concerns about the broader economy as well as their own financial situations.

A sharp downturn in housing was at the core of the previous recession, and this sector continues to weigh on the recovery. Robust increases in housing activity have helped spur recoveries from most U.S. recessions since World War II. This time, in contrast, residential construction remains depressed by a large inventory of foreclosed and distressed properties either currently available for purchase or probably soon to become so, tight credit conditions for construction loans and mortgages, and concerns about the possibility of further declines in home prices. As a result, new home construction currently is at only about one-third of its average pace in recent decades. In addition, homeowners with insufficient equity in their homes have found it difficult to take advantage of today's low interest rates by refinancing their mortgages. Recently announced changes to the federal government's Home Affordable Refinance Program, or HARP, are designed to improve the opportunity for homeowners to refinance and I'm hopeful this program will succeed in reducing household debt service burdens and the flow of foreclosures. More generally, I see a strong case for additional policies to foster more-rapid recovery in the housing sector. Indeed, to provide greater support for mortgage markets, the Federal Reserve recently adjusted its program for reinvesting its securities holdings.

The Federal Reserve continues to provide highly accommodative monetary conditions to foster a stronger economic recovery in a context of price stability. Moreover, the scope remains to provide additional accommodation through enhanced guidance on the path of the federal funds rate or through additional purchases of longer-term financial assets.

**Challenges for U.S. Fiscal Policy**

Turning now to U.S. fiscal policy, with the onset of the recent recession and financial crisis, the federal budget deficit widened significantly and has remained wide. Exhibit 2 shows that, as a result, federal debt held by the public has increased relative to our national income to a level not seen in the past half-century. These budget developments have reflected both the weak economy, which has depressed revenues and pushed up expenditures, and the fiscal stimulus that was implemented to help ease the recession and support the recovery. So long as the economy continues to recover, the deficit should narrow over the next several years as a growing economy boosts revenues and reduces expenditures and as the policies put in place to provide economic stimulus continue to wind down. Even so, the ratio of debt to gross domestic product (GDP) will continue to edge higher over the next decade unless the Congress and the Administration are able to agree on a program of deficit reduction that is more ambitious than the targets incorporated in last summer's Budget Control Act. Looking yet further out, it is apparent that, absent significant policy shifts, budget pressures resulting from the aging of the U.S. population and fast-rising health-care costs will continue to push the federal debt ratio higher in coming decades. The dashed line in exhibit 2 shows the Congressional Budget Office's long-term projection of the debt-to-GDP ratio through 2035 under current policy settings, including the effects of the Budget Control Act.

It is crucial that the federal budget be put on a sustainable long-run trajectory, and we should not postpone charting that course. A failure to put in place a credible plan to address our long-run budget imbalance would expose the United States to serious economic costs and risks in the long term and possibly sooner. Timely enactment of a plan to put the federal budget onto a sustainable trajectory will make it easier for individuals and businesses to prepare for these adjustments. In addition, the sooner our longer-term budget problems are addressed, the less wrenching the adjustment will have to be and the more control that policymakers--rather than market forces or international creditors--will have over the timing, size, and composition of the necessary adjustments.

At the same time, too much fiscal tightening in the near term could harm the economic recovery. Significant near-term reductions in federal spending or large increases in taxes would impose an additional drag on the economy at a time when aggregate demand is already weak. Indeed, under current law, federal fiscal policy is slated to impose considerable restraint on the growth of aggregate demand next year. We need, and I believe we have 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. I do not underestimate the difficulty of crafting a strategy that appropriately balances short-run needs with long-run considerations, but doing so would provide important benefits to the U.S. economy.

**The Key Role of the Emerging Asian Economies**

In light of the various factors weighing on aggregate demand in the United States and other advanced economies, I believe it is crucial for emerging market economies, particularly in Asia, to take further steps to boost domestic demand, providing support for their own growth and that of the global economy. Indeed, such policies are a core component of the G-20 nations' commitment to strong, sustainable, and balanced growth.

Of course, emerging Asia has already made an important contribution to bolstering the global economy in the wake of the financial crisis. The top panel of exhibit 3 shows that even though the emerging Asian economies were hit quite hard by the global downturn, they recovered much more quickly than did other parts of the world. The full extent of the Asian bounceback can perhaps best be appreciated by comparing the level of output in Asia, shown in the bottom panel of the exhibit, with those in advanced economies and other emerging market economies. Asia's output level--the solid line--has increased substantially from its barely perceptible trough. Output in other emerging market economies--the dashed line--has also increased significantly. In comparison, output in the advanced economies--the dotted line--has not yet attained its pre-crisis peak.

A key factor contributing to the relatively rapid recovery of the Asian emerging market economies was that, in contrast to many previous episodes of severe stress, these economies were well-positioned to permit the use of countercyclical fiscal and monetary policies. Cyclically-adjusted fiscal balances in emerging Asian economies fell noticeably in 2008 and 2009, reflecting a more expansionary fiscal stance; fiscal stimulus was particularly large in China, India, and Singapore. Monetary policy was also eased substantially throughout emerging Asia.

Partly as a result of those policy measures, the growth of the emerging Asian economies over the past several years appears to have relied less on external demand from the advanced economies. The top panel of exhibit 4 shows that the shares of exports in nominal GDP in the Asian economies have trended downwards since 2006 following a decade of solid increases. However, trade balances in the region (shown in the bottom panel of the exhibit) generally remain in surplus, notwithstanding some recent narrowing in several countries. These surpluses suggest that, on balance, the Asian economies continue to add more to global supply than to global demand.

Crucially, private consumption as a share of output still remains quite low in several emerging Asian economies. Exhibit 5 shows that China's consumption share--the solid line--which was already well below that of other major economies in 2000, has fallen steadily over the past decade to about one-third of its GDP.[2] Private consumption shares in other emerging Asian economies--the dashed line--are also significantly below those in the advanced economies--the dotted line--and have not moved up in the wake of the global financial crisis.

Measures to boost private consumption would appear to benefit not only the global economy, but also the emerging Asian economies themselves. China and other emerging market economies have already taken some steps to promote household consumption, but the progress on this front has been slow and further measures are warranted. Indeed, at the G-20 Cannes summit, China pledged to rebalance its demand

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[2] Output per capita has been growing very rapidly in China, so per capita consumption has also been rising.

toward domestic spending through policies to bolster household income and strengthen social safety nets, and Indonesia and Korea each made similar commitments to facilitate the process of global rebalancing.

What are some specific policy measures that could be helpful? First, increased public spending on social services, such as education, health care, and retirement benefits, could spur consumption by reducing the need for precautionary household saving. In China, some redistribution of the profits of state-owned enterprises to the central government through larger dividend payments could provide revenue to support such spending. Second, government support could be shifted away from manufacturing toward encouraging service-sector development, which has typically lagged behind in these economies. Services tend to have a higher non-traded component, so faster growth of this sector would help rebalance growth toward domestic demand. Third, additional development spending could be directed toward these countries' poorest regions; for example, China has recently strengthened its efforts in this area.

The case for boosting investment rates in Asian emerging economies to support global demand is less clear-cut. At about 45 percent of GDP, Chinese investment rates are now so high that the return on new investment may already be quite low in some sectors. In a number of other countries, however, investment rates are only at about the average of those in the advanced economies. It seems plausible that, with their lower capital-to-labor ratios, investment rates should be higher in some emerging Asian economies. Indeed, some have argued that infrastructure needs remain extremely pronounced in many emerging market economies, and that a wave of investment may be in the offing for the world's developing economies.[3] With low interest rates throughout the world, this would certainly seem to be a propitious time for countries to pursue productive capital investment.

Finally, exchange rate adjustments will play a crucial role in boosting emerging Asia's contribution to global demand. Indeed, the G-20 leaders welcomed China's determination to increase exchange rate flexibility and to carry out its plans to increase convertibility of the renminbi capital account. Such flexibility is crucial if Asian domestic demand is to be expanded without exacerbating inflationary pressures. Exchange rate appreciation channels demand toward foreign products, thereby creating the scope for policies to expand domestic demand without exacerbating inflationary pressures. More generally, exchange rate flexibility makes it easier for monetary policy to respond to domestic considerations and to achieve price stability. Perhaps most important, since the ultimate goal of economic growth is to improve standards of living, allowing the currency to appreciate can help ensure that a greater proportion of output is devoted to household consumption, enabling social welfare to improve at a faster pace.

**Conclusion**

To sum up, growth in advanced nations, including the United States, faces serious headwinds. Households are still deleveraging, corporations are reluctant to invest, and fiscal consolidation is needed over time to place public finances on a sustainable course. Despite some pickup in growth in the United States during the second half of the year, the outlook is for unemployment to diminish only slowly, remaining painfully high for

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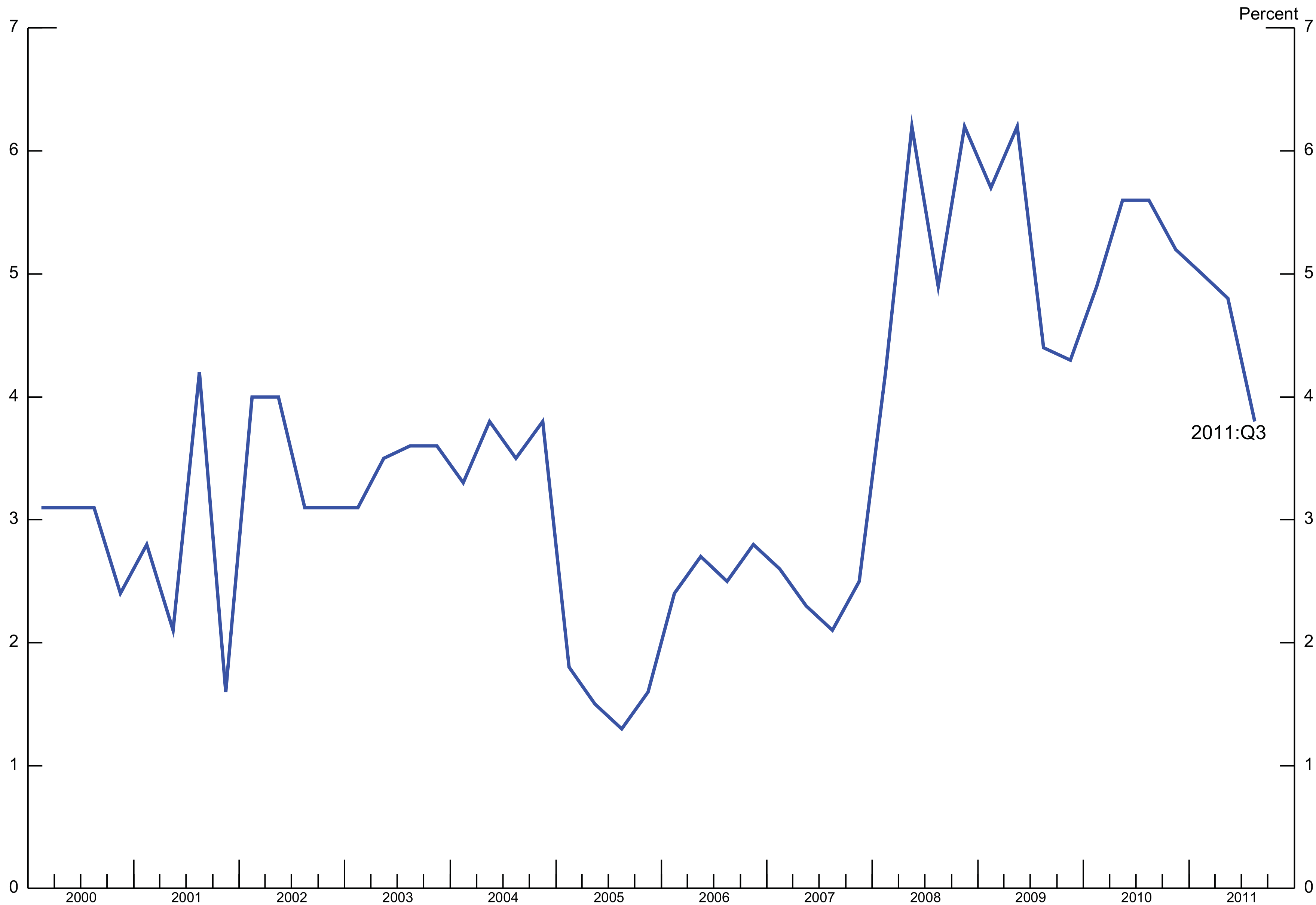
[3] See, for example, McKinsey Global Institute (2010). *Farewell to Cheap Capital? The Implications of Long-Term Shifts in Global Investment and Saving.* McKinsey and Company, December, available at www.mckinsey.com/mgi/publications/farewell_cheap_capital/index.asp.

many years to come. These developments have also affected emerging market economies, where there are now clear signs of slowing growth. In addition, downside risks to global growth have increased significantly because of rising financial market pressures, reflecting an intensification of stress in European banking and sovereign debt markets as well as broader concerns about the outlook.

These circumstances call for concerted domestic policy actions to boost growth and create jobs. Indeed, as I already noted, we at the Federal Reserve are moving vigorously to promote a stronger economic recovery. However, monetary policy is not a panacea, and it is essential for other policymakers to also do their part. In particular, there is a strong case for additional measures to address the dysfunctional housing market. Stronger housing demand has the potential to boost recovery. The Congress and the Administration also can support the recovery in the near term while simultaneously putting fiscal policy on a sustainable trajectory in the long term.

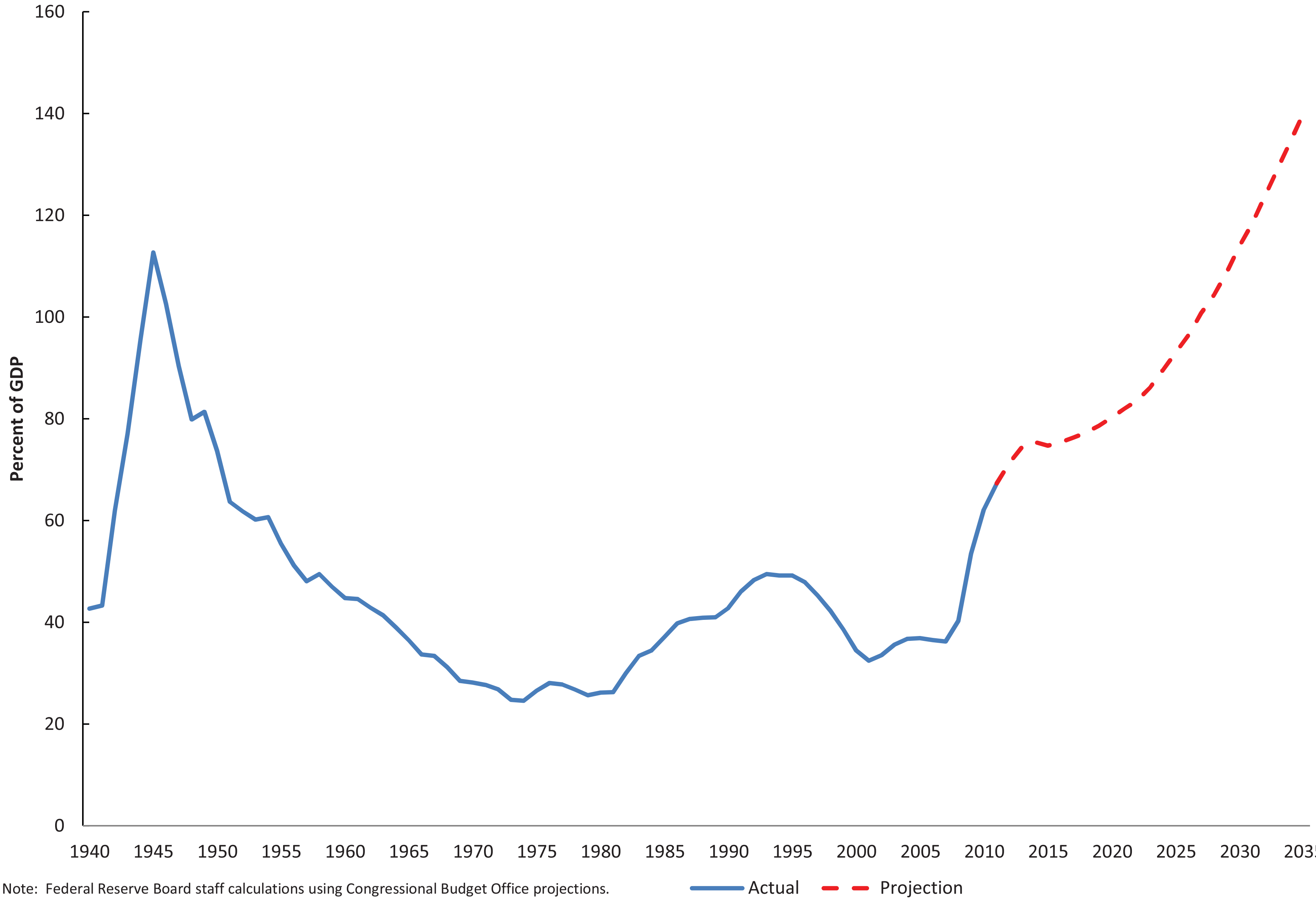
As I have emphasized in this talk, there is also an urgent need for policy action from a number of countries. In Europe, forceful action is essential to address the region's fiscal and financial stresses, which pose a threat not only to growth but also to global financial stability. In addition, many emerging market economies, particularly in Asia, have the scope to bolster domestic demand. Such policies would support stronger, more balanced, and more sustainable global economic growth; they would enhance social welfare at home as well. The most profound effect of the Asian miracle of the past several decades has been to lift hundreds of millions of people out of poverty. Further actions to boost aggregate demand in Asia will ensure that this miracle is sustained.

# Exhibit 1:  U.S. Household Saving Rate




Source: Bureau of Economic Analysis.

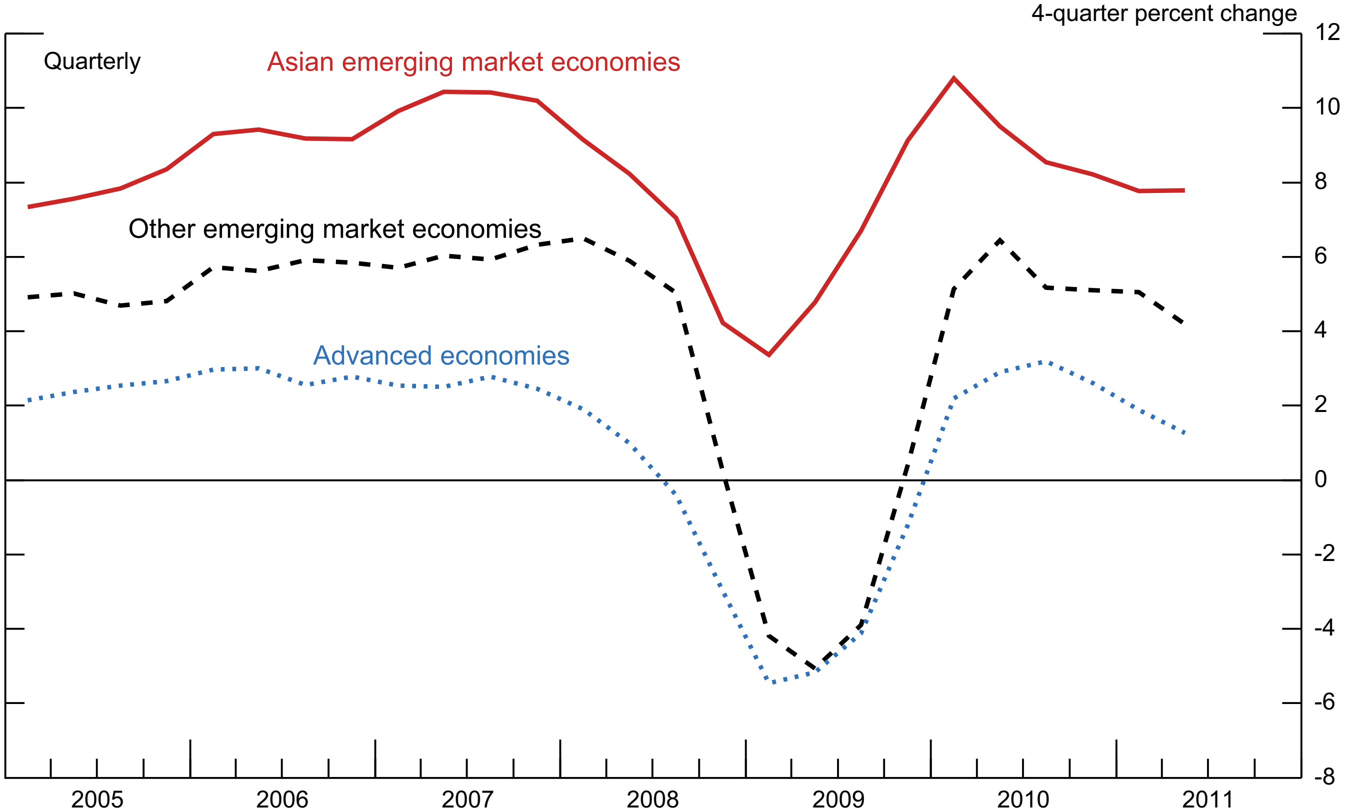
## Exhibit 2: U.S. Federal Debt Held by the Public



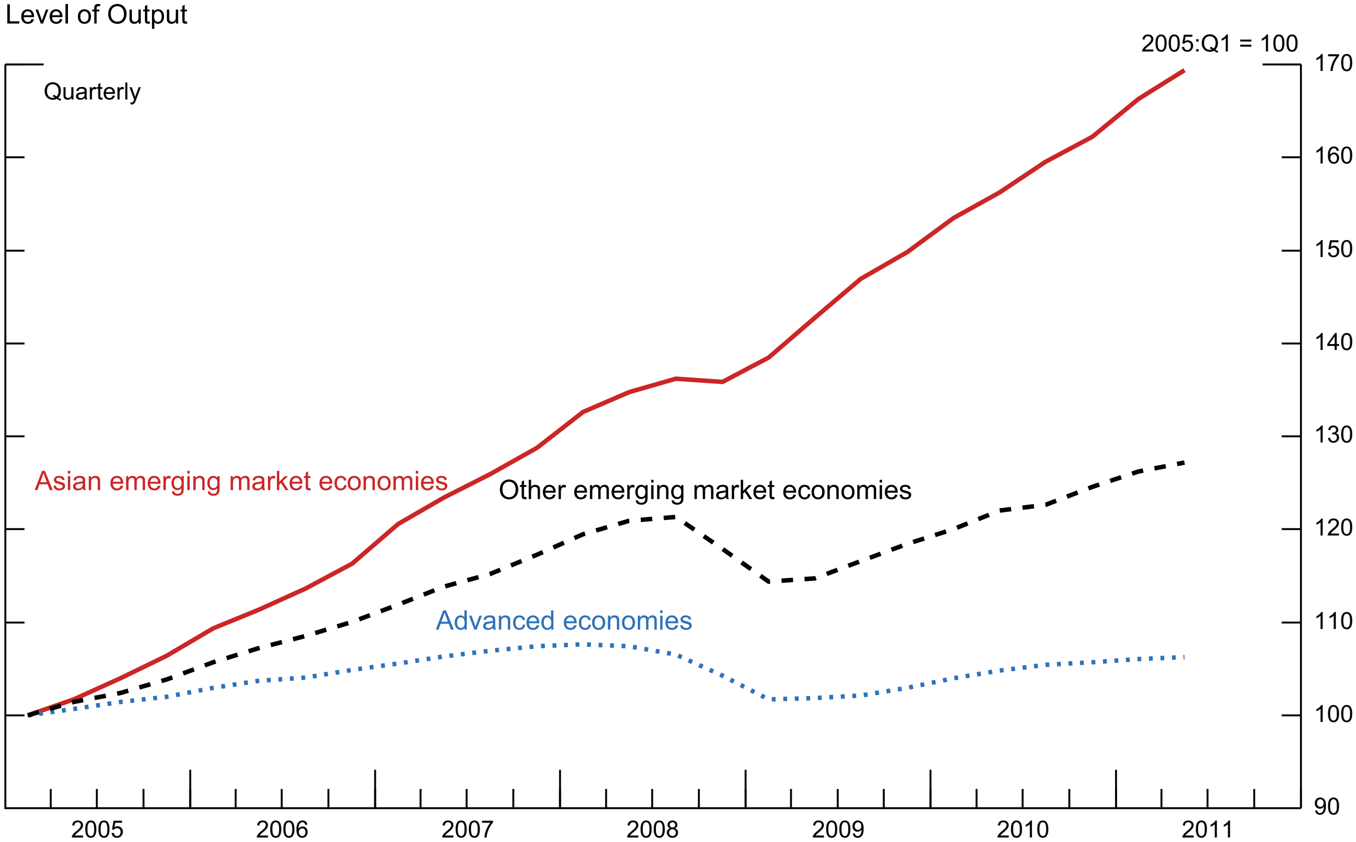

Note: Federal Reserve Board staff calculations using Congressional Budget Office projections.

# Exhibit 3: Real GDP

Output Growth



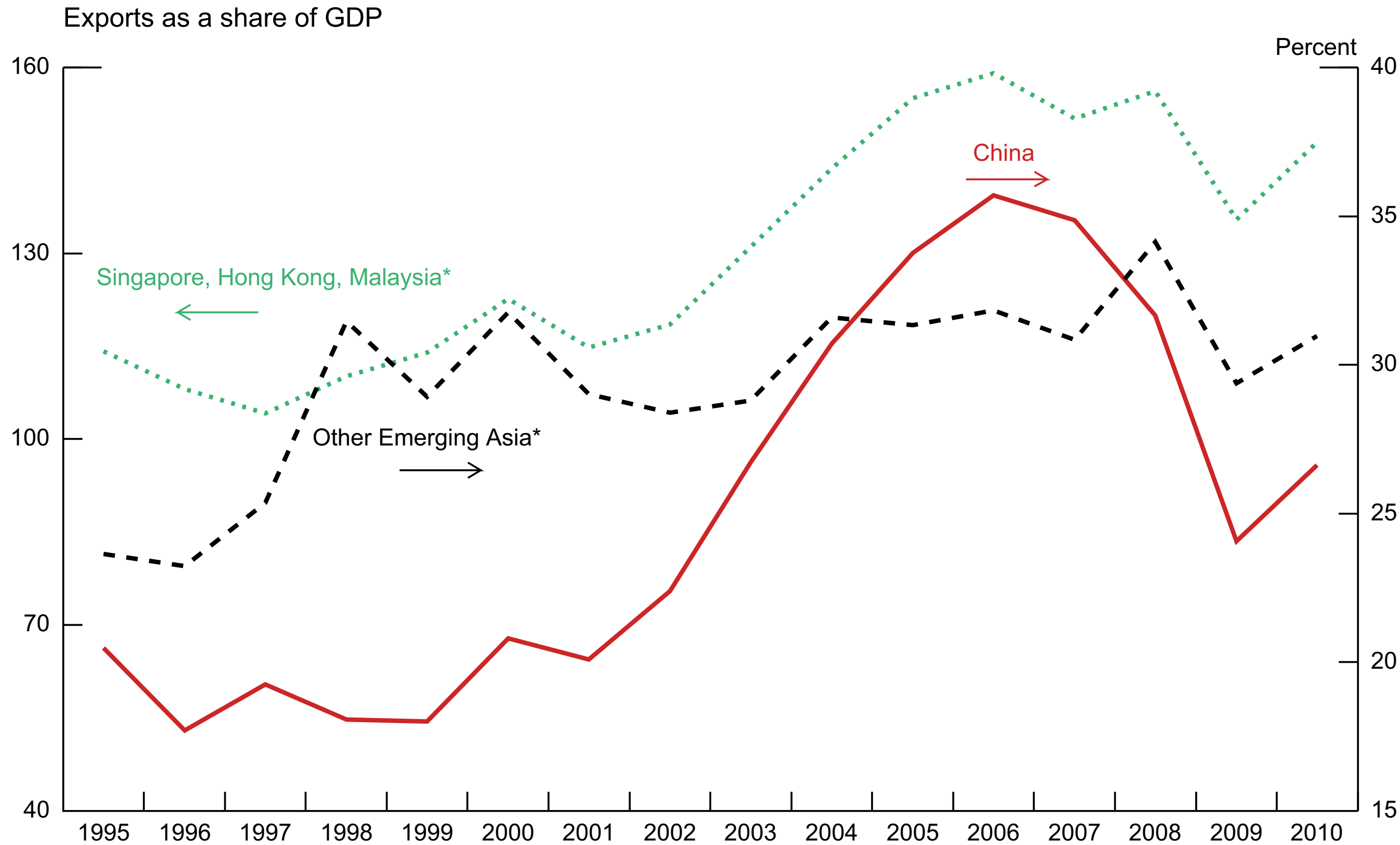

Level of Output




Note: GDP weighted aggregate. Advanced economies consist of Australia, Canada, the euro area, Japan, Sweden, Switzerland, the United Kingdom, and the United States. Asian emerging market economies consist of China, Hong Kong, India, Indonesia, the Philippines, Malaysia, Singapore, South Korea, Taiwan, and Thailand. Other emerging market economies consist of Argentina, Brazil, Chile, Colombia, Israel, Mexico, Russia, Saudi Arabia, and Venezuela.

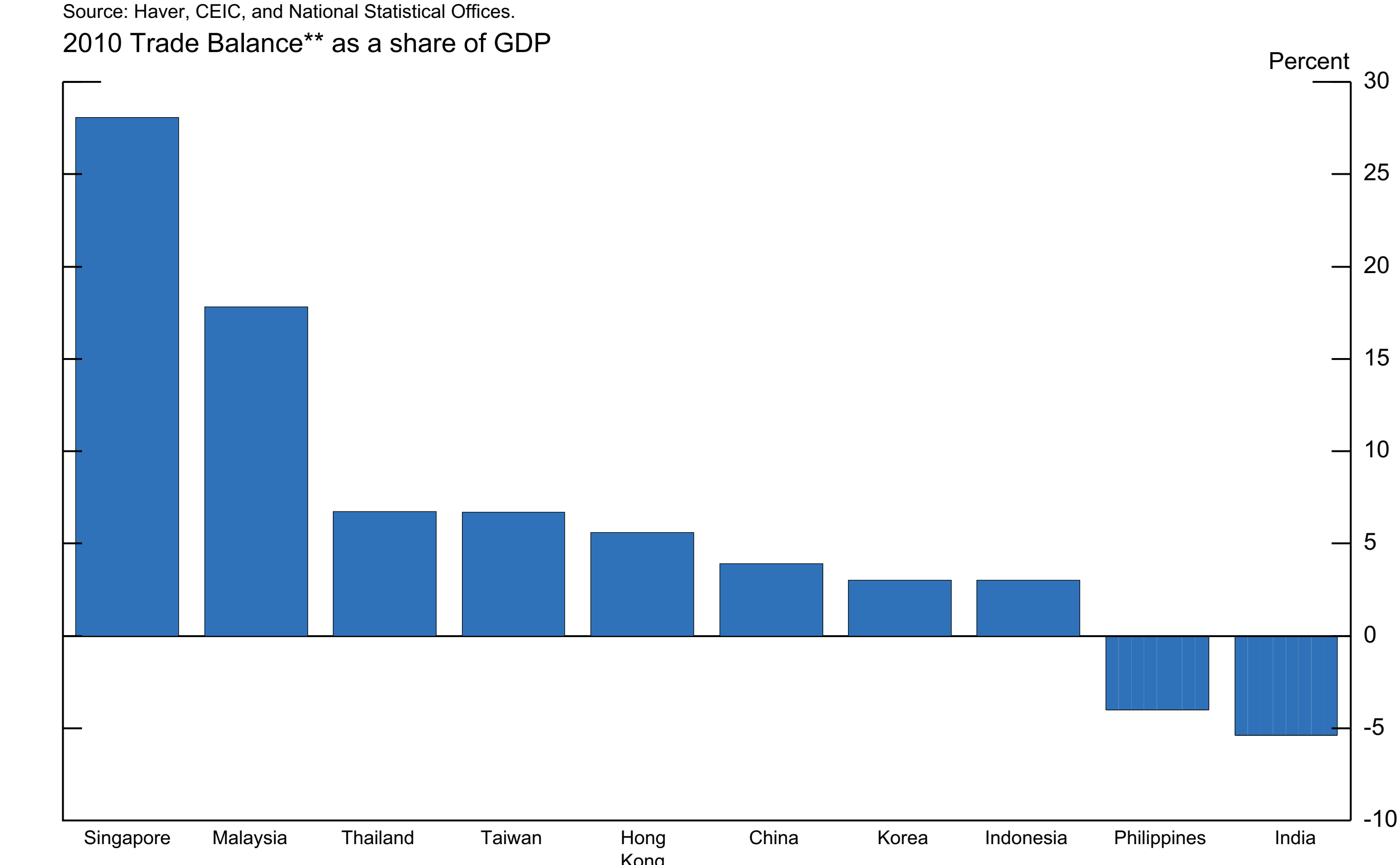
Source: Country sources via Haver; International Monetary Fund; Federal Reserve Board staff calculations.

# Exhibit 4:  Exports and Trade Balance




* GDP weighted average.

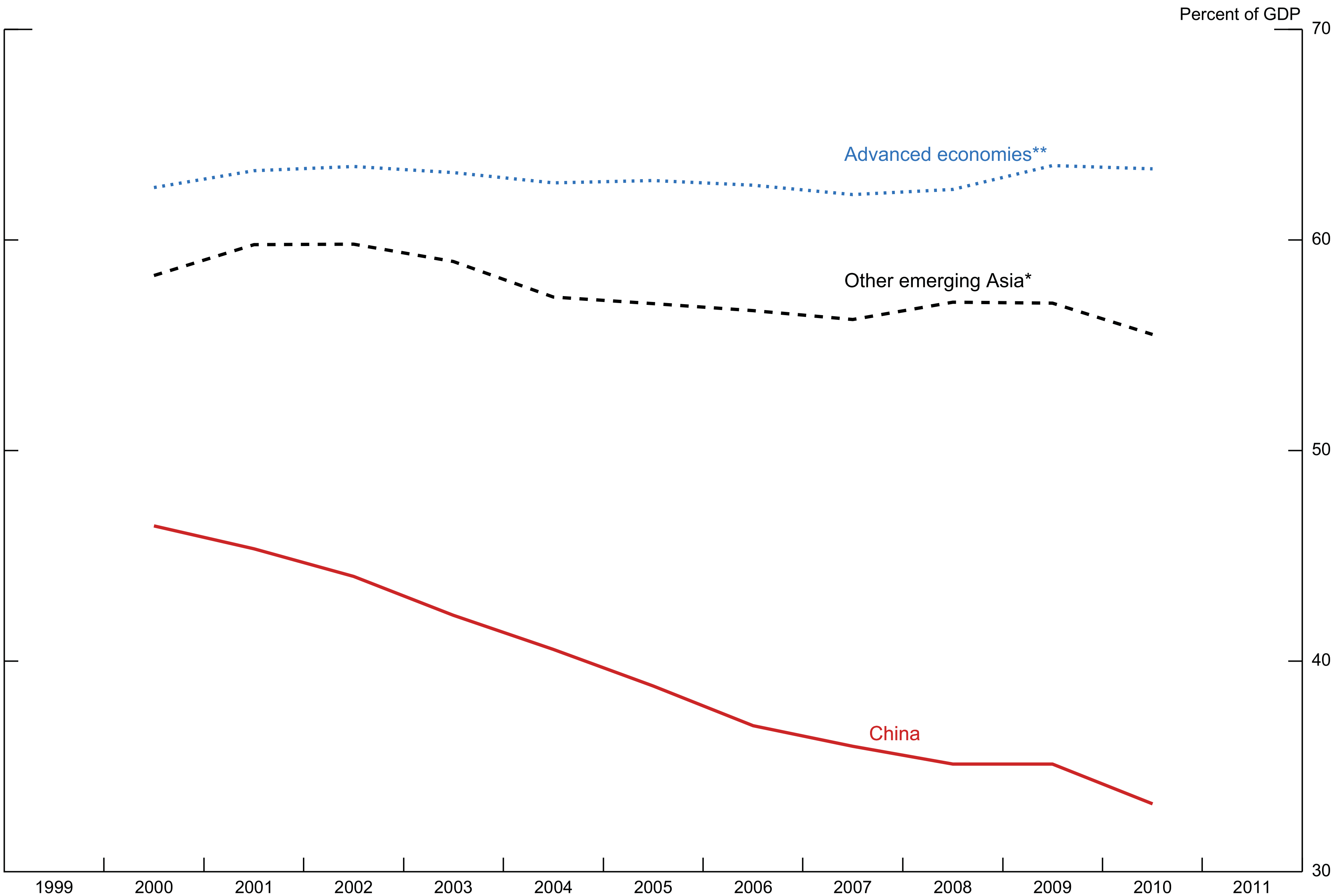
Source: Haver, CEIC, and National Statistical Offices.




** Goods and services.

Source: Haver.

## Exhibit 5: Private Consumption as a Share of GDP




* GDP weighted average of Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand.
** GDP weighted average of Canada, the euro area, Japan, the United Kingdom, and the United States.

Source: Haver, CEIC, and National Statistical Offices.