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SPEECH

The Longer-Term Challenges Ahead

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Thank you for giving me the opportunity to speak here today. As always, my remarks reflect my own views and are not necessarily reflective of the views of the Federal Open Market Committee (FOMC) or the Federal Reserve System. As we emerge from a deep and protracted global recession and terrifying financial crisis, we should count our blessings—the outcome could have been far worse.

Extraordinary interventions helped to keep the financial system from collapsing and large doses of fiscal and monetary policy stimulus helped to put a floor under global demand, thereby preventing a full-blown depression.

However, now that we are on a bit of firmer ground, it is even more important that we take stock and evaluate the challenges that still face us. How we respond will determine whether the path forward will be relatively smooth or instead will be more tortuous.

I want to discuss three of these challenges today. The first challenge relates directly to the recent crisis: What needs to happen at the national and international levels to strengthen the financial system so that a crisis of this magnitude does not occur again.

The second challenge relates to the set of fiscal exit strategies that would put fiscal policies around the world on a sustainable path. In many countries, including the United States, budget deficits have widened sharply and the level of public debt is growing faster than gross domestic product (GDP). This trend is unsustainable.

The third challenge is how to rebalance global consumption and investment to support continued strong growth in the emerging world and a sustainable recovery elsewhere. In my view, sustainable global growth requires a shift toward a higher consumption share in the emerging world matched by a shift away from consumption in the United States.

These three challenges are interlinked. Without regulatory reform, we will not have the robust and resilient financial system that we need to match savers and borrowers around the world. Without fiscal consolidation, financial market participants will balk at providing the funds needed to close the gap between government revenue and spending. In addition, without rebalancing the composition of global demand, long-run economic growth will likely be weaker. Weaker long-run growth will lead to excessive unemployment and less government revenue, which, in turn, will make it more difficult to put fiscal policies on a sustainable course.

Turning to the first challenge of regulatory reform, the key issue is how to ensure that we take the right steps so that the type of financial crisis that occurred never happens again. From my perspective, I have several concerns about where the regulatory reform process is heading. First, the international consensus to harmonize standards globally appears fragile. If each country acts to strengthen its financial system in an uncoordinated way, we will be left with a balkanized system, riddled with gaps that encourage regulatory arbitrage. Second, I am concerned that the focus will be too bank-centric. Although it is clearly appropriate to strengthen the liquidity and capital standards for banks, regulatory reform needs to be comprehensive. Third, I worry that the Federal Reserve's role with respect to bank supervision will be unduly constrained. Let me discuss each of these concerns in more detail.

Turning first to the issue of harmonization, I think it is underappreciated how important harmonization is to ensure success of the global regulatory reform effort. Without harmonized standards, financial intermediation would inevitably move toward geographies and activities where the standards are more lax. This, in turn, would provoke complaints from those who cannot make such adjustments as easily. The political process, in turn, would be sensitive to such complaints, creating pressure for liberalization, which would cause the tougher standards to unravel over time. In the discussion between countries, the emphasis would subtly shift from how to structure the regulatory regime to ensure financial stability toward negotiating a regulatory regime that works best for the institutions headquartered in each particular country.

The harmonization process has some momentum due to the sponsorship of the G-20 leadership and the efforts of the Financial Stability Board (FSB) and other international standard setters. However, the process is fragile because there are pressures to shape

the standards in a way that puts the least burden on the domestic banks and financial infrastructures in one country relative to the institutions in other countries. There is understandable and genuine concern that the impact of moving to global standards will fall disproportionately on some types of firms. In my view, the way to mitigate these issues is to have a long phase-in period in the transition to the new standards rather than to soften or alter the standards to shelter those firms that happen—perhaps by historical accident—to be starting in a less advantageous position. The focus should be more on the side of all ending up in a similar place, rather than on the relative degree of difficulty in getting there.

The process is also fragile because some countries seem intent on strengthening their own set of standards before the international process has had a chance to reach consensus. Although it is understandable that countries would want to move quickly to strengthen their regulatory regimes, such actions should not be undertaken in a way that is immutable and unresponsive to the emerging international consensus.[1]

At the end of the day, to achieve harmonized standards, each sovereign nation is going to have to bend a little bit from what it believes is best for its financial system viewed in isolation. This is necessary, of course, because a series of regulatory regimes that appear best for each individual country would likely be distinctly second-best or even worse when considered collectively. The recent crisis underscores the fact that the regulatory regime needs to be harmonized and global in nature.

My second concern on the regulatory reform front is that reform may be too focused on the traditional banking sector and not enough on other financial intermediation activities. Of course, it is clear that we need to make the traditional banking system more resilient and robust.[2] But make no mistake, we also need to ensure that regulatory reform fully encompasses the full range of financial intermediation activity, including capital markets and insurance, over-the-counter (OTC) trading of securities and derivatives, wholesale collateralized funding markets, and payments and settlements.

This is necessary for two reasons. First, too much focus on raising the requirements on banks runs the risk of just forcing activity into the non-banking sector. Second, many of the problems of the financial crisis originated outside of the banking sector. To a significant degree, the crisis was about regulatory gaps—be it gaps in terms of loosely regulated mortgage underwriting practices in the United States, the activities of bank-sponsored structured investment vehicles (SIVs) and conduits, the providers of insurance guarantees against structured finance products such as AIG Financial Products Group, or the structured finance models of the rating agencies and others that turned out to be defective. Thus, the experience of the recent crisis strongly suggests that confining regulatory reform to strengthening the banking sector would be insufficient to make the financial system as a whole resilient and robust.

A crucial case in point is the too-big-to-fail problem. Having some firms that are too big to fail creates moral hazard, which distorts incentives. These firms are able to obtain funding on more attractive terms because debt holders expect that the government will intervene rather than allow failure. This creates an incentive to get large to achieve such status, not because it facilitates greater efficiency, but instead because the implicit government backstop enables the too-big-to-fail firm to achieve lower funding costs.

Although the United States has an effective resolution mechanism for commercial banks, we do not yet have a good resolution scheme for large non-banking institutions or bank holding companies with large international operations. To address the too-big-to-fail problem, we need to develop a truly robust and credible resolution mechanism that allows for the orderly wind-down of any institution—regardless of its size—and that limits the contagion to the broader financial system. This will require not only domestic legislation, but also extensive work internationally to address a range of legal issues involved in winding down a major global firm.

I want to emphasize how important it is that the incentives we embed within the regulatory apparatus for financial intermediaries encourage the type of behavior we seek—behavior consistent with safety and soundness and financial stability. For example, consider the efforts underway to standardize OTC derivatives and move the clearing of such trades to central counterparties (CCPs). These are good and worthwhile efforts. However, I suspect that these efforts will not fully succeed without measures to develop marketplaces and infrastructures that promote greater transparency for all OTC derivatives activity, including more and higher-quality information on prices and transaction volumes.

OTC derivatives dealers have natural incentives to favor opaque, decentralized markets that preserve their information advantage relative to other participants. The greater profit margins that derive from this advantage create incentives to favor more bespoke OTC derivatives over more standardized OTC instruments. Making more and better pricing information available to a wider range of market participants will increase competition and lessen the profit incentives that stem primarily from the opacity of these instruments and markets. Improving transparency should make the benefits that stem from standardization such as increased liquidity, reduced transaction costs, and lower counterparty risks more dominant, helping push the evolution of the OTC derivatives market in the direction of greater standardization and homogeneity.

This doesn't mean that bespoke products will vanish. They will continue to exist. But they will exist primarily because they better serve the needs of the OTC derivatives customer, not because they create an informational asymmetry that allows rents to accrue to the securities dealer.

Greater transparency would also have other benefits. If regulators had ready access to current OTC derivatives transaction information in trade repositories, I suspect that this would serve as a brake on the use of OTC derivatives that are used for more questionable purposes. For example, this includes trades undertaken to evade accounting rules or to circumvent investment charter limitations. Such transparency would also allow regulators to monitor and identify concentrations and trading patterns that might be related to market manipulation.

In addition, if the public had more detailed information about the OTC derivatives positions of market participants, market discipline would be enhanced by providing market participants with information that would help assess risks during times of stress. Uncertainty about the valuations of complex derivatives due to the lack of price transparency was a factor that exacerbated the financial crisis. Large financial institutions became less willing to engage with one another because of an inability to assess the size of the exposures or to value the opaque positions held by their counterparties.

My third regulatory reform concern is that the Federal Reserve's role in regulatory oversight will be excessively constrained going forward. This threatens to throw the baby out with the bathwater.

The Federal Reserve made mistakes, as did others, in the run-up to the crisis. We are fully cognizant of that, which is why we are revamping how we oversee the financial system and supervise large, systemically important institutions. To cut back our bank supervisory role significantly would be a mistake because macroprudential supervision is important; the Federal Reserve is particularly well suited to this role; and because bank supervision helps inform the Fed in its lender-of-last-resort role and in the conduct of monetary policy.

Macroprudential supervision, which I characterize as the top-down assessment of risks throughout the financial system, is essential because it addresses the problem of gaps in the regulatory regime and the regulatory arbitrage that such gaps can encourage. In addition, macroprudential supervision is needed because the financial system is interconnected. As amply demonstrated during the crisis, siloed regulatory oversight is problematic. Supervisory practices must be revamped so that supervision is also horizontal—looking broadly across banks, nonbanks, capital markets, payment and settlement systems and geographies.

In the United States, the Federal Reserve is well suited to play a major role in such oversight because it alone has the expertise in three major aspects of the financial system—banking, capital markets, and payments and settlement systems. It also currently has oversight responsibility for most of the firms that one would view as systemically important.

In evaluating what the Federal Reserve should do, it is important to recognize that the Federal Reserve's three primary roles—monetary policy, the lender of last resort function, and supervision—are closely interlinked. Each one of these activities helps the Federal Reserve perform the others. For example, the information we collect as part of the supervisory process gives us a frontline, real-time view of the state of the financial industry and broader economy. Monetary policy is more informed as a result. Only with this knowledge can a central bank understand how the monetary policy impulse will be propagated through the financial system and affect the real economy.

Similarly, involvement in the supervisory process gives us critical information in fulfilling our lender-of-last-resort responsibilities. Information sharing with other agencies is simply not as good as the intimate knowledge and understanding of markets and institutions that is gathered on a first-hand basis. Indeed, many institutions at the center of the crisis and arguably the most troubled—Bear Stearns, Lehman Brothers, Merrill Lynch, AIG and the government-sponsored enterprises—were not supervised by the Federal Reserve. Consequently, when those institutions came under stress, the Federal Reserve had poorer quality and far less timely information about the condition of these institutions than would have been the case if we had had the benefit of direct supervisory oversight.

Let me now shift gears and turn to the two macroeconomic policy issues: fiscal sustainability and balanced global economic activity. The deep downturn in economic activity has led to a sharp deterioration in the fiscal condition of many countries—the United States is no exception. The problem is not so much that the economic downturn has caused large budget deficits to open up—this always happens when a decline in economic activity leads to a sharp drop in revenue and increased spending on the safety net—but instead is more due to the fact that these deficits generally have a very large structural component. By structural, I mean that the deficits are projected to be persistent—absent changes in tax and spending policies—even after the individual economies have recovered and the unemployment rates in these countries have fallen as low as is possible, consistent with price stability.

Fiscal stimulus measures undertaken to support demand have been responsible for much of the recent deterioration in the structural budget deficits. For example, in the United States, the Congressional Budget Office estimates that the structural federal budget deficit rose by nearly $1 trillion between fiscal 2007 and fiscal 2009, to $1.1 trillion or 7.3 percent of potential GDP.

Obviously, different people have different views as to how much stimulus was needed and the form of that stimulus. But to me it is clear that an accommodative fiscal stance was the appropriate policy response given the circumstances. In the case of the United States, without substantial fiscal stimulus, the economy would have been even weaker and the unemployment rate considerably higher. Given the fact that the federal funds rate could not be pushed any lower, fiscal stimulus was indeed important in stabilizing the economy.

Going forward, however, market participants are worried that many countries are now on unsustainable fiscal paths. By unsustainable, I mean a scenario in which persistently high deficits cause the amount of outstanding debt to rise relative to GDP indefinitely, even if the economy performs well in the future. The concern is that at some point, investors worried about the potential for default would balk, and this would lead to sharply higher interest rates and a fiscal crisis.

Just as there needs to be a credible exit strategy for monetary policy to anchor inflation expectations, there also needs to be a credible exit strategy from fiscal policy stimulus to anchor expectations about the risks of sovereign debt default. This is not going to be easy for several reasons. Even abstracting from considerations involving political will—it is never easy to vote for higher taxes or lower spending—there is also the important issue of timing. The economic recovery is still very fragile. This means that premature fiscal retrenchment could jeopardize the recovery and push a convalescent economy into a double-dip recession.

Given this risk, why not just wait and see how things go? After all, in the United States, market participants appear to be quite tolerant of the current large fiscal imbalance. In fact, long-dated Treasury yields have stayed low despite signs that the economy is indeed recovering.

I think this is a risky strategy because it fully exposes the economy to the vagaries of market sentiment and because shifts in such sentiment can have important consequences for both the deficit path and the economy. Furthermore, the dynamics provoked by a sentiment shift can be self-reinforcing. Risk premia rise, driving up interest rates and debt service costs. In addition, the rise in longer-term rates constrains economic activity—making it even more difficult to sustain an economic recovery.

Moreover, once confidence begins to erode, it can do so very quickly. Even if a country were willing to pay higher interest rates, this path is not viewed as credible given the implications such rates have for future debt service costs and deficits. Put simply, to wait and see ultimately is likely to necessitate an even bigger fiscal adjustment.

In addition, waiting for the market to say “no more” may mean losing discretion as to the timing and magnitude of fiscal tightening. It is very unlikely that the time when market sentiment turns most adverse would also be the most attractive time to have to tighten fiscal policy. Thus, there is a balancing act between solving the longer-term problem of needed fiscal consolidation and, at the same time, not tightening fiscal policy too soon or too abruptly so as to derail the nascent expansion.

So what should be done? I believe that moving ahead earlier with a credible plan is preferable to waiting. I am not going to enter a political debate about whether the restraint should be more in the form of higher taxes or lower spending. However, I do believe, like most other economists, that fiscal consolidation that has the least negative impact on investment in physical and human capital is bound to be most effective. That is because fiscal capacity depends on economic capacity. The bigger the economy grows over time, the more fiscal resources can be made available. Thus, taking steps that do not hurt long-term productivity growth would seem preferable to steps that reduce the amount of invested capital—both physical and human—and/or its quality. I also would be inclined to measures that indicate a credible commitment to long-term budget consolidation, but with a contractionary impulse that phases in only slowly and builds over time.

The last challenge I wish to discuss is how to move from a cyclical recovery to a more balanced and sustainable pattern of growth globally.

Just as there are substantial fiscal imbalances in several countries that threaten to become unsustainable in the absence of consolidation, so there are large-scale imbalances in the world economy as a whole that raise issues of long-term sustainability. In particular, there continues to be a need to reduce consumption and increase saving relative to investment in the United States, and a parallel need to increase consumption relative to investment in parts of the emerging world. The recent crisis has reduced but not eliminated current account imbalances worldwide. In many cases, the imbalances remain sizable, and they could begin to grow again and ultimately become destabilizing.

The case for global rebalancing is compelling when we consider the structural backdrop. If we in the United States and other

deficit countries are to move to a more healthy balance of private and public spending in relation to income, other countries cannot be as reliant on us as in the past to be their growth engine. The recent configuration of global demand, after all, has involved persistent trade surpluses in many emerging markets and this represents foregone consumption and investment that has mostly been recycled into large scale accumulation of foreign exchange reserves.

To be sure, the crisis demonstrated the value of an ample reserve cushion to protect against sharp shifts in capital flows. However, a number of countries have surely reached a point at which further reserve accumulation comes with more costs than benefits. The expected return on foreign exchange reserves is likely to be quite low in relation to potential domestic uses. In fact, there is the prospect that reserves could earn a significantly negative return in local currency terms, especially when the acquisition of such reserves is undertaken to resist local currency appreciation that must eventually occur anyway. Finally, delay in adjustment of demand patterns and currencies raises the risk that these adjustments will ultimately occur in a more compressed and wrenching manner. How many times have we seen bottled-up pressures ultimately give way to disruptive overshooting?

Moreover, lack of progress on rebalancing demand would put at risk the open trading regime that has been so important to global prosperity and growth. To date, protectionist pressures have been largely contained. But if surplus countries are perceived as resisting global adjustment, the political consensus in favor of an open global trading regime could begin to erode. Protectionism is a lose-lose proposition—for surplus and deficit countries alike—which would ultimately prove very harmful to global growth.

Sustainably rebalancing global growth won't be an easy task—and it will take time. A larger share of consumer spending (and lower saving) in the emerging economies requires the development of a stronger and more comprehensive safety net for households. Only with institutional support for health care and retirement are families likely to become more comfortable saving less of their income. It also requires the further development of financial systems so that households can more easily obtain credit and shift expenditures forward in time—for example, to finance spending on education or to purchase housing. The fact that progress will be gradual simply bolsters the case for getting started as soon as possible.

Action on rebalancing would also bring short-term benefits. As I've noted, the positive fiscal impulse that has supported global growth over the past 18 months is set to unwind. Indeed, in some countries, the stance of fiscal policy will soon turn contractionary. This means that such fiscal consolidation could conceivably put the global recovery at risk. This suggests that moves to rebalance growth toward domestic demand in trade surplus countries would provide a useful offset. Such actions would generate stronger external demand for countries undergoing fiscal consolidation. Even if stronger exports were to provide only a partial offset to the restraint from fiscal consolidation, the increase in demand generated by rebalancing would reduce the risk that the nascent recoveries might falter. This, in turn, would also reduce the risk of a protectionist backlash.

To conclude, the structural case for rebalancing is compelling. The current cyclical circumstances reinforce this case.

Thank you very much for your kind attention. I would be happy to take a few questions.

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[1] In this regard, I am considerably more worried about countries that implement standards that are more lax than the norm, rather than more tough than the norm. However, if many countries individually were to opt for tougher standards, this could raise questions about whether the international norm is too lax.

[2] Work underway by the Basel Committee on Banking Supervision and others all are designed to make the traditional banking sector more robust. This includes requiring more and higher quality capital, better capturing of risk in the application of capital standards, imposing a capital leverage limit on banks, raising liquidity buffer requirements, and requiring compensation regimes to be consistent with financial stability.