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SPEECH

Developments in the Global Economy and Implications for the United States

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It is a pleasure to be here at the Council on Foreign Relations, and to be here with Jerry Corrigan.

A few brief remarks about the global economy, both the real and financial dimensions, to provide a basis for our discussion.

2006 marked the fourth successive year of a global expansion that has been remarkable for its strength, for its breadth, and for its stability in the face of economic shocks and uncertainty in the geopolitical realm.

This period of broad-based growth in income has been supported by a number of important fundamental forces.

Rapid technological innovation and greater economic integration have brought stronger growth and higher levels of productivity. The acceleration in productivity growth that occurred in the United States in the second half of the last decade seems likely to remain intact. And productivity growth is accelerating outside the United States, most strikingly in some of the large emerging economies.

Financial innovation and greater integration of national financial systems has contributed to the strength of real economic activity by improving the allocation of resources within and among economies. Improvements to risk management and to capital cushions are likely to have made the financial system more stable and more resilient.

And macroeconomic policy has improved around the world. The increase in monetary policy credibility in a broad range of countries has produced lower rates of inflation and more stability in inflation expectations. Greater public confidence in monetary policy was critical to laying the foundation for the improvements in real economic performance, by providing a stable foundation for long-term investment decisions.

In emerging markets, better monetary policy has been accompanied by more disciplined and conservative fiscal policy and a range of other policies that have reduced, though not eliminated, vulnerability to changes in confidence, capital flows and exchange rate movements.

These factors are each fundamentally important, and they are, of course, interrelated. The policies that delivered better inflation outcomes, more openness and competition and stronger financial systems were critical to fostering an environment in which improvements in productivity and growth could occur.

This expansion has also been notable for the financial conditions that have prevailed over the past several years.

Long-term interest rates have remained relatively low in nominal and real terms. Equity and other asset prices have moved higher. Credit spreads have declined to quite low levels. Market participants report exceptionally high levels of liquidity. And volatility, both realized and expected, has remained low across many different types of financial assets, market and economies.

This general constellation of market conditions and asset prices is unusual, at least in comparison to what we have seen over the past several decades. This has been a distinguishing feature of the present expansion, but it is not something we fully understand, and we cannot be confident in judgments about how durable it will prove to be.

To a significant extent, these financial developments reflect a high degree of confidence in future macroeconomic and financial stability, reinforced by the improvements in inflation performance, growth outcomes and financial resilience of the past several years.

Better monetary policy has lowered expectations of future inflation and inflation volatility and has contributed to lower risk premiums in general. Changes in the cyclical behavior of financial intermediation and credit provision, coupled with the increased stability of the real economy, seem likely to have reinforced the improvements on the monetary policy front.

And rapid growth in the major emerging market economies, together with the substantial earnings of energy-producing and commodity-exporting countries, have produced a substantial increase in wealth and savings relative to perceived investment opportunities. In a world where capital can now flow much more freely across national borders, a significant portion of these savings has moved across national borders.

These are powerful and fundamental forces, and they certainly help explain the broad reduction in risk premiums and the substantial demand for credit risk and financial assets.

There are other factors at work as well, however, that have less favorable implications. Part of this recent dynamic in financial markets is a consequence of the present state of the international monetary system, in which a substantial part of the world economy runs exchange rate regimes tied in some way to the dollar. This has entailed a sustained period of very substantial official accumulation of dollar reserves, putting downward pressure on U.S. interest rates and upward pressure on U.S. asset prices.

These forces are surely transitory, but their impact on capital flows, interest rates and asset prices are important, not just in terms of their short-term impact on growth. If they are large enough, they have the potential to alter or distort current decisions about investment and consumption in a way that could be detrimental to our longer-run growth prospects. And they are important because they work to mask or dampen the effects on risk premiums in financial markets that we might otherwise expect to be associated with the expected trajectory of the fiscal and external imbalances in the United States.

Given this broad context, I want to touch briefly on some of the policy issues that are likely to be important to the prospects for economic performance, here and around the world. Despite the relatively favorable performance of the global economy, we face a range of daunting longer-term economic policy challenges. The improvements in the conduct of monetary policy were critical to the improvements in productivity and growth that we are now seeing on a global scale. And monetary policy will, of course, continue to be critical, but monetary policy alone cannot provide the elements of the framework necessary to provide an environment for innovation and long-term decisions that will be so vital for future growth. Economic policy, in general, needs to be more forward looking in providing a longer-term framework for stability.

On the fiscal policy front, demographic changes confront governments around the world with exceptionally difficult choices. For the United States, these challenges are less acute than for many of the major economies, but they are still formidable in their scale and complexity. Even for the near term—for the period before the increase in number of retirees starts to have a major impact on Social Security and Medicare expenditures—we are running an unsustainably large fiscal deficit. Despite the recent improvements in revenues, the expected trajectory for the fiscal deficit will mean that federal government debt will continue to rise as a share of GDP. The restoration of fiscal rules—such as those that require new tax cuts or expenditure programs to be funded with offsetting policy measures—will help reduce the risk of further deterioration. However, they need to be complemented by a consensus on policy changes that will produce smaller future deficits.

Restoring confidence in U.S. fiscal management would be important and necessary independent of the broader context of the global economy today, but it is more important given the size of our external imbalance, now running at the unprecedented level of 7 percent of GDP a year. The trade balance in real terms has been broadly stable over the past two years, but our net income payments have shifted to deficit, and the size of that component of the current account deficit seems likely to continue to expand. These large global imbalances, our current account deficit and the surpluses that are the counterpart to our deficit, will have to come down over time. How that process unfolds will depend on a complex mix of factors around the world. Confidence that the U.S. political system will act to generate a sustainable fiscal trajectory is important to raising the probability that this process of adjustment unfolds with less risk.

A successful conclusion of the Doha round of trade negotiations would provide some insurance against the risk that the process of economic integration will be interrupted or reversed. Despite the relatively favorable average income gains of the past few years, a common feature of the political context in economies around the world is the fragility or weakness of public support for openness and economic integration.

The political challenge of sustaining support for the process of integration may be the most important economic challenge of our time. To paraphrase Lawrence Summers, it is not enough to explain that globalization is inevitable and that policies that look politically attractive as a response to economic anxiety will only hurt the economy as a whole. Nor is it a politically effective strategy to state simply that economic integration is a necessary and powerful force in raising average incomes, or that technological change may be more important than trade or immigration as an explanation for slower growth in real wages for many Americans.

Raising the quality of education and exploring ways to improve the safety net are a necessary part of the solution to this challenge. But these reforms will have a long fuse and they may not yield the hoped-for increase in support. Trade does not appear to be more popular in countries with more generous safety nets, universal health care and highly subsidized higher education than it is today in the United States.

The political challenges of sustaining support for global economic integration and fiscal sustainability will be more difficult in the United States because of what has happened to the distribution of income and economic insecurity. Several broad economic forces substantially complicate an already difficult set of political challenges: the long-term increase in income inequality, the slow pace of growth in real wages for the middle quintiles of the population, the increase in the volatility of income that is a reflection of the greater flexibility of the U.S. economy, and the greater exposure of households to the risk in financing retirement and the burden of paying for health care.

More generally, the global financial system and the monetary arrangements that underpin it are in the process of a delicate and consequential transition as the major emerging market economies—particularly in Asia—move toward more mature monetary policy frameworks, more flexible exchange rate regimes and more open capital markets. This transition will require careful management, and the economic dimensions of getting it right would be complicated even without the political pressures those governments face.

One final note on the financial system. The global financial system is in the process of very dramatic change. The changes of even just the last five years are extraordinary, in terms of the size, and strength, and scope of the major global firms, the role of private leveraged funds, the extent of risk transfer and the increase in the size of the derivatives market, the change in the structure of the credit market, the increase in and changes in the pattern of cross border financial flows.

These changes, and others, seem likely to have made the financial system both more effective in moving capital to its most productive use and more stable and resilient over time. But they do not, of course, mean the end of systemic risk in financial markets. They could in some circumstances work to magnify rather than mitigate stress. Central banks, supervisors and those running the major private financial institutions need to continue to work to ensure that what Jerry Corrigan calls the "shock absorbers" in the financial system—capital and liquidity and the operational infrastructure—are sufficiently strong and robust to withstand economic and financial conditions more adverse than we have seen in the recent past.

Thank you.