Timothy F Geithner: A view from the Federal Reserve Bank of New York

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Business Council of Fairfield County's Economic Luncheon, New York, 19 January 2005.

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Thanks for giving me the opportunity to speak to you today.

I want to talk about the American economic agenda. And I want to start by looking back at the last decade or so, and the exceptional economic performance of the second half the 1990s in particular. What were the fundamental underpinnings of those achievements, and what are the principal challenges we face to sustaining those achievements?

Let me begin by reviewing quickly what distinguished that period of U.S. prosperity, relative to the past in the United States and relative to the other major economies. There are four things in particular worth highlighting:

- First, over this period of the past decade the U.S. sustained very solid growth in the range of 3.5 percent. This was not particularly exceptional relative to the preceding decade, but impressive relative to the other major economies, most of which saw a sustained slowdown in growth. Japan, for example, saw GDP growth slow from above 3.5 to just over one percent. Europe slowed from just under 3.0 percent to about two percent.
- Second, we achieved very moderate inflation. U.S. inflation by most measures fell in half to an average for the CPI of about 2.5 percent. This positive inflation performance was more generalized across the major economies, with Europe and most all major economies experiencing a similar slowdown, and Japan, more famously, slipping into sustained deflation.
- Third, U.S. economic performance during this period was characterized by lower overall volatility in growth and inflation. This moderation, economists call it the "great moderation," was reflected in a reduction in quarter to quarter volatility in output by about half. This more even pattern of growth was evident across most components of GDP. Some of the other major economies also saw some moderation in the variability of macroeconomic outcomes, but the trend is not as pronounced or well established.
- Fourth, productivity growth in the United States accelerated significantly with productivity growth in the non-farm business sector doubling from about 1.5 percent per year in the two decades up to the mid-nineties, to more than three percent on average over the decade since. This acceleration in productivity was not completely unique to the United States, but it has not yet been matched by the other major economies, though that may be in prospect.

What accounted for these achievements? This is important to try to understand, because it is important to assessing whether these trends are enduring or temporary, and what types of policies are likely to sustain them.

There is no definitive consensus on this question, and economists have an interesting debate underway about how much of this was luck and how much was skill. Most observers seem to attribute the record to the following mix of factors.

The first, of course, is technology. We experienced during this period the benefits of a powerful technology shock that made possible a revolution in the productivity of investment, in transportation and communication costs, in business methods, in computing power, etc. Given the speed with which technological advances are diffused, one might expect the benefits to have been more broadly spread among other economies, but that has not yet happened on a scale that is sufficient to narrow the growth gap.

The extent of technological progress and its impact on economic growth were magnified by the openness and flexibility of the U.S. economy. The United States became significantly more open over the past decade, with imports and exports as a share of GDP rising by about 50 percent. This happened in part because of the impact of trade agreements like NAFTA and the Uruguay Round that lowered U.S. trade barriers, and in part because we stayed out of the way of the impact of technology and globalization and did not, on the whole, try to insulate the U.S. economy from the pressures of competition.

We are by choice significantly more flexible than the other major economies. The major deregulations (telecom, transportation, finance, etc.) of the last two decades made us more so. We have relatively limited regulation of business activity, low barriers to entry by new firms, lower hiring and firing costs, and more worker mobility and turnover.

A third key factor involves the U.S. financial system. Our system has proven to be exceptionally good at matching capital to ideas, at rewarding innovation and penalizing failure, and relatively more resilient to shocks.

In comparison to the other major economies, banks are a smaller share of our financial system and the capital markets play a greater role. Securitization and other avenues for risk transfer advanced much more rapidly here. The venture capital, private equity and hedge fund parts of our financial system are much larger as a share of GDP than in the other major economies. These features of the U.S. financial system seem to have made us better at allocating U.S. savings, a more attractive place for the savings of other countries, and probably less vulnerable to shocks. They have also made macroeconomic policy more effective in responding to shocks.

And a final factor, by most accounts, involved good policy choices. This has been an exceptionally good period for U.S. monetary policy, with the formidable combination of Volcker and Greenspan achieving a dramatic and sustained moderation in inflation. Better monetary policy and inflation outcomes played a central role in laying the foundation for the increased investment that made the productivity surge possible and in bringing about the reduction in the depth and length of recessions that are a feature of the more even U.S. economic performance.

Better fiscal policy in the 1990s helped too, by reducing long-term interest rates and improving confidence in future U.S. economic performance. More of the savings the United States borrowed from the world went to finance private investment rather than government consumption.

This list of factors - technology, openness and flexibility, the more innovative U.S. financial system, and good monetary and fiscal policy - is not a comprehensive list. It’s hard to know how important each element was to the overall record and whether we would have seen as much improvement without all four of these elements.

We were fortunate in the sense that the size of the shocks we experienced were smaller than in the past. The strategic environment of the 1990s seemed at the time more peaceful and secure, and so our security needs claimed a smaller share of resources than is true now and may be true for some time.

But it wasn’t just luck. Much of what was exceptional in the U.S. was the result of conscious choices by policy makers. This is encouraging in the sense that it suggests that with good policy choices we have the capacity to sustain quite strong rates of income growth in the future.

We face a number of major challenges to sustaining this record. I want to focus on just a few of these - those where the risks are highest and the return to sensible policies is likely to be highest.

The first of these challenges is the combination of our fiscal and external imbalances. Both are unsustainable. Each magnifies the risk in the other. Fiscal deficits of the magnitude projected are large enough to damage future growth prospects of the U.S. economy, which in turn magnifies our vulnerability to a decline in the willingness of other countries to lend us their savings, which could lead to higher risk premia on U.S. financial assets, also damaging long-term growth prospects.

It is important that the United States work to build more confidence that it will act on the fiscal front to achieve a better balance between our commitments and our resources, both with respect to the medium term and the longer term. Building a stronger fiscal cushion and strengthening confidence in our fiscal sustainability is critical to reducing the risk in the size of our external imbalance.

A second important challenge involves sustaining a commitment to openness and market-oriented economic policies. The pressures that have accompanied the process of technological change and more rapid global economic integration have eroded the strength of the center of the U.S. political spectrum that has been the source of our commitment to an open trade policy. The cost of this political shift is more evident so far in new trade expanding opportunities forgone, more than in a broad and major increase in the level of protection or barriers against imports of foreign goods and services.

This is a difficult political challenge. Success depends in part on how creative we are in equipping our citizens with the skills that offer higher returns in the future. It depends in part on what you might call our commitment to the quality of equality of opportunity in America, for people are likely to be more accepting of change if they are confident of the opportunity for mobility and advancement. And it depends in part on confidence people have in the transitional safety net that is available to bridge the transition to future employment.

The last challenge I want to emphasize involves education. The education imperative has always been compelling. It is more so today for several reasons.

First, we are seeing a significant erosion in the traditional premium accorded higher education in the United States and in some dimensions of the relative level of educational achievement in America. This cannot be good for the cause of improving the odds of sustaining this productivity surge.

Second, U.S. citizens now face the prospect of bearing a much larger share of the risk of paying for health care and preparing for retirement. Making good decisions in the face of these changes requires a higher level of financial and economic literacy than our schools typically equip people with.

Third, in a world where the returns to quality education have gone up substantially (and the penalty for inadequate skills also) we have not done as well as we could in ensuring that Americans have the opportunity to take advantage of the best education this country offers, opportunity that is based on talent, not on the economic fortune of one's parents.

And finally, the prospect for building a political base for confronting our fiscal challenges requires that Americans expect more from their politicians, and raising the overall quality of education is probably an important part of getting better policy results in a democracy.

Let me end by noting that by many measures the immediate economic landscape looks reasonably favorable.

The U.S. expansion has proven quite resilient. We enter the new year with what appears to be a pretty solid underlying pace of growth. Core inflation is moderate, and various measures of inflation expectations suggest confidence in the outlook for price stability. Estimates of structural productivity growth remains high, although there has been some moderation recently.

The pace of global growth has moderated a bit, but most forecasts anticipate a quite strong and broad-based expansion. The IMF's projection is just over four percent for real global GDP growth.

In the financial markets, this broadly positive outlook has been accompanied by a dramatic reduction in risk premia, leaving the price of insurance unusually low against a less favorable or more volatile environment.

Whether this confidence is justified and whether the U.S. economy does as well in the future as it did over the past decade or so, will depend critically on how successful we are in meeting these challenges in the areas of fiscal sustainability, and over the longer terms in trade policy and education.