Challenges Facing the U.S. Economy and Financial System

November 17, 2010
Posted November 19, 2010

Terrence J. Checki, Executive Vice President

Remarks at the Economic Club of New York, New York City

Good morning. Thank you, Andrew, for your kind introduction. It is a pleasure to be here this morning to offer some reflections on the challenges facing the United States—although I think you will understand if I say that it would have been more of a pleasure a few weeks ago, before the furor surrounding the Federal Open Market Committee's (FOMC) latest action. Let me underscore that my comments this morning are personal, not institutional, and do not reflect the views of the Federal Reserve System or the Federal Reserve Bank of New York.

As you know, the United States is now about a year and half into recovery from the longest and deepest recession of the post war period. Growth has resumed, and our financial system, pushed to the brink two years ago, has stabilized.

We are recovering, but we are far from recovered. The rebound to date has been much less vigorous than has been the norm for U.S. recoveries. The economy has been adding jobs—some 875,000 since the start of the year—but unemployment remains stubbornly high. Growth has slowed, averaging just under 2 percent over the last two quarters, as support from the fiscal stimulus and the turn in the inventory cycle is fading. Bank lending standards are no longer being tightened, but bank credit continues to contract. The backlog of inventory in housing appears likely to weigh on activity in that sector for some time to come. And the large amount of slack created by the recession continues to put downward pressure on prices and wages. All in all, a fragile picture.

This sluggishness is a reflection of the fact that what came before was not a garden variety recession. Put simply, our current circumstances are not *just* the result of the crisis. Our growth was too reliant on spending and borrowing, as opposed to saving and investing and competing in the increasingly globalized marketplace. Too much of what occurred in the run-up to the crisis was framed against a backdrop of monetary, supervisory and fiscal policy focused too much on the quantity of growth, and not enough on the quality.

Experience with balance sheet recessions and debt overhangs is relatively limited in the advanced economies, at least in the post war period. But these types of problems are far less rare in the emerging world. And the record there suggests that recovery takes time and requires painful adjustments, as households and creditors work through the overhang of excessive borrowing and lending, and the associated decline in asset prices and employment opportunities; and as financial institutions work to strengthen their balance sheets to meet more robust standards for capital and liquidity. I see little to suggest that a similar dynamic isn't likely to hold true for us as well.

Adding to the challenges confronting us at the moment is the large amount of uncertainty in the wind. In addition to the headwinds for the macro outlook, there are questions about the long-term sustainability of U.S. fiscal policy; six weeks from the start of a new year, households and businesses still don't know what the tax regime will be in the coming year, let alone for the medium term; they face questions regarding the new health regime and its costs; on the financial side, there are hundreds of new regulations to be written during the next year or so in the context of Dodd Frank and Basel III, and those carry with them concerns about the availability and cost of credit, as well as the durability of certain business models. And the state of our domestic political discourse hasn't exactly been confidence-inspiring—or investment-friendly.

All of this clearly affects confidence, the prospects for growth and employment, and the hand-off from a fading turn in the inventory cycle to a sustained upturn in business fixed investment and, over time, consumption. As we know, jobs depend on growth; growth depends on investment; and investment capital flows where it is welcome, where the rules of the game are perceived to fair and predictable, and where it can expect a reasonable return.

In this context, there are numerous questions about what role monetary policy can and should play. And as we've seen in the past few weeks, there is no shortage of views on answers. So let me share my bias:

Monetary policy can create favorable conditions for growth, by helping to foster an environment in which job creation can take place. And monetary policy can provide a supportive environment for households and firms as they work through difficult balance sheet adjustments, by lifting asset prices and net worth, lowering debt and equity costs, and ensuring that disinflation or deflation do not derail the adjustment process. Finally, monetary policy can contribute to reduced uncertainty about the outlook for growth, and help guard against the risk that a new negative shock could threaten what is still a fragile recovery.

But monetary policy has limits. It cannot, by itself, create growth or jobs. Nor can monetary policy, by itself, provide the answers to all of the uncertainties that are weighing on consumption, investment and job creation, or eliminate the need for balance sheet adjustments.

It is understandable that the decision to undertake Large Scale Asset Purchases has been greeted with some degree of anxiety and skepticism. On the other hand, I am not persuaded by much of the reaction.

Monetary policy works by influencing the level and shape of the domestic yield curve. In normal times, the Fed does this by buying and selling Treasury securities at the short end of the curve, thereby influencing short-term rates. The Fed's purchase of Treasury bonds (under quantitative easing "QE" or LSAP) simply extends classic open market operations to longer duration securities, to produce similar results: a shift in the yield curve consistent with desired financial conditions.

While I have some sympathy for those who question the degree to which this will ultimately be successful in producing the desired real economy effects, I am not sure what to make of the fact that a change in operating procedure *per se* could have generated such an uproar about the Fed's fundamental commitment to price stability, to preserving the central role of the dollar as the world's reserve currency—and to executing on the responsibilities that brings with it. Based on our record on that score over the past thirty years or so, I find it particularly curious.

Regarding the external implications of the policy, several points are worth keeping in mind. One is that the goal of policy is to stimulate demand *in the United States* by encouraging lower real yields. To be sure, the dollar has weakened of late, but as a side effect of policy, not as a goal, and not by more than might be expected in light of our recent slowing and recent changes in interest rates and inflation expectations. And as growth strengthens, the value of the dollar should adjust accordingly.

Policy-induced shifts in financial conditions—lower expected real yields, tighter spreads, higher asset prices—should provide some support for growth in the quarters ahead, notwithstanding that aspects of the credit channel remain impaired.

We recognize that success in easing financial conditions comes with risks: financial excesses may reemerge—this is something we will be especially watchful for. But this is not just a consideration for monetary policy, and is not unique to LSAPs. All of us—public and private sectors alike—need to be attentive to undue acceleration in financial activity, to slippages in risk management practices or underwriting standards, and to developments in an environment where many of the familiar reference points are changing rapidly.

So, to reiterate: monetary policy can potentially ease the headwinds we currently face and help reduce some of the downside risks, but it is not a cure-all for the challenges facing our country. These need to be addressed directly by the appropriate parties. Progress in areas beyond the purview of monetary policy is important if we are to achieve strong and sustainable growth, and durably shore up confidence in our economy, our currency and our credit.

Clearly, putting our public finances back on track represents one of our most important challenges. Fiscal support played a valuable stabilizing role in heading off economic and financial disaster, both in the United Sates and across the globe. But with the U.S. public debt rising at its fastest pace since the Second World War and set to soon reach its highest level in relation to national income in over 50 years, we would be kidding ourselves if we believed that today's very large and growing structural fiscal deficits are consistent with a continuing strong global leadership role.

We need a strategic approach, one that provides answers—growth friendly answers—about how spending and tax burdens are likely to evolve.

This does not mean we need to solve all of our problems at once. We have some scope for gradualism and even to provide further support for growth—but this needs to be embedded in a credible framework that gives greater predictability to the path back to a sustainable fiscal stance.

Fundamental financial reform also needs to be a priority, and important progress has been made both domestically and internationally in forums such as (Basel and the Financial Stability Board) on higher and better quality capital and liquidity buffers, more robust institutional arrangements, and resolution regimes for large interconnected financial institutions.

But these are complicated undertakings, with many details still to be worked out, (as evidenced by the more than 200 new rules scheduled to be written under Dodd-Frank in the months ahead). Details matter here—bank regulation rivals the tax code in its complexity but also in its impact on incentives—and a great number of moving parts will need to fit together efficiently and effectively. Once in place, regulations can also be difficult to change. So it is important that we get this right.

There is a tension between moving quickly to resolve regulatory uncertainties, however, and introducing greater scope for unintended consequences. Transparency, consultation, and international coordination should help on this score.

We also need to keep in mind that our ultimate success in enhancing financial stability will depend on aspects that cannot be addressed by legislation and static rules. As I noted earlier, all of us have role to play in guarding against potential side effects of the accommodative environment that prevails in much of the globe at present.

Let me conclude with a brief word about the role of the emerging world in all of this.

The emerging markets, so often a source of instability in the past, have been an important source of resilience and stability in recent years. Indeed, after spending much of my career helping countries in the emerging world work through difficult patches, I now find myself on the other side, spending a fair bit of time discussing, with visitors from the emerging world, how we plan to get ourselves back on track.

Growth prospects and policy performance in much of the emerging world remain relatively strong, notwithstanding prospects for subdued growth in the advanced economies. These positive trends, even more than the push of low yields in the advanced economies, have been encouraging capital to flow once again to the emerging world. On balance this is a positive development, as it can facilitate more rapid increases in the standard of living in these countries, as well as a needed rebalancing of global demand. But it also poses its fair share of challenges.

I think it is well understood that the emerging world will need to expand its role further, and become more of an engine of growth and global demand, if the global economy is to successfully navigate the difficult straits it faces. But experience has taught the emerging market economies to be cautious. They know better than anyone that they are not decoupled from the risks that the advanced economies are facing. And they also know the risks of market exuberance and complacency. In this context, it is no surprise that self insurance through reserve accumulation has again been on the rise.

Unfortunately, with jobs scarce in the advanced economies, and authorities in the emerging world understandably concerned about being overwhelmed by excessive capital inflows, the scope for fractious and defensive policies is growing. I cannot recall a time in my career when protectionist sentiment was bubbling so close to the surface.

We need a framework for dealing with these issues, which go well beyond exchange rates and include a host of policies that influence savings, investment and growth trajectories. But there are no easy answers, because while there are important common interests, many others are not clearly aligned.

Achieving the needed global adjustment will require cooperation, consultation and leadership—real leadership that identifies common principles, that frames policy against principles that can be mutually shared, that inspires confidence by delivering on commitments, and that makes possible concessions that facilitate broader interests.

Success will hinge in part on the willingness of the emerging economies, particularly the larger ones, to meet this challenge.

But I have a hard time seeing how we can get to a better place without strong leadership from the Unites States as well. In this respect, we have our work cut out for us. It is not enough for us to have good ideas about what others can do, we need to show that we are holding up our end, and delivering on the reforms that we need.

I think we all recognize that the crisis damaged our global leadership role. The size and vitality of our economy, respect and confidence in our policy framework, and the liquidity and robustness of our financial system—have all been important sources of soft power for the United States, and have allowed us to exert influence in support of an open global trade and financial system, not just to our benefit, but to the benefit of greater global prosperity.

These strengths are still there, but the rest of the world expected better of us in terms of management of our economy and our financial system—just as I think we expected much better of ourselves.

Addressing our challenges is vital if we are to continue to play an effective leadership role going forward. Let me be clear. This is not about the demise of Unites States or Western leadership. It is about the reality of change, the need to adapt to it, and the need to engage with it. The rest of the world is getting better; if we are to help the world get to a better place, and thereby help guarantee our own interests and prosperity, we have to as well. Thank you.