The Global Recovery and Monetary Policy

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I appreciate the opportunity to talk here tonight concerning the economic challenges facing the global economy. My opening remarks for this panel are intended to be broad-based, covering a wide range of issues. Still, I will not be able to cover all topics and so I hope that we can have a vigorous question and answer session later, in which I will have a chance to address additional concerns about the status of the global economic recovery generally and U.S. monetary policy in particular.

As usual, the remarks I make here tonight represent my own views and do not necessarily reflect the views of other FOMC participants.

My remarks are divided into three parts. First I will comment on the strength of the global economy. Asia has been a leader in the worldwide recovery following the very large global shock of late 2008, and I expect that leadership to continue during the remainder of 2010 and into 2011 and beyond. Next, I will turn to the U.S. economy, which is also growing, although not as strongly as some parts of Asia. My expectation is that growth in the U.S. is likely to continue at the current pace, or perhaps slightly faster, during the remainder of 2010 and into 2011. Finally, I will turn to the ongoing sovereign debt turmoil in Europe and try to assess a few of the implications for the global economy. My sense is that, while the sovereign debt crisis in Europe is indeed a serious matter, the global recovery at this point looks very strong and seems unlikely to be derailed.

Let me turn first to the strength of the global recovery.

THE STRENGTH OF THE GLOBAL RECOVERY

According to the April 2010 International Monetary Fund World Outlook, 2009 was a year in which global real GDP actually contracted. That is very rare indeed, something that did not occur in any year in the 1970s, the 1980s, the 1990s, or in the current decade before 2009.

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[1] I appreciate assistance and comments provided by my colleagues at the Federal Reserve Bank of St. Louis. Marcela M. Williams, Special Research Assistant to the President, provided assistance. I take full responsibility for errors. The views expressed are mine and do not necessarily reflect official positions of the Federal Reserve System. Similar remarks were given at the InterContinental Hotel, Tokyo Bay, Japan "An Evening Dialogue with Dr. James Bullard," organized by the Institute of Regulation and Risk North Asia

That is to say, despite all of the crises and upheavals of various types that occurred during the past four decades—the story has nevertheless been one of sustained growth globally up until 2009. This shows how severe the global financial panic of 2008 really was, and it also suggests that global integration is much stronger than it may have appeared several years ago. I was very concerned that we had encountered the first truly global recession in many years, and that we knew little about how the global economy might behave in such a circumstance.

As it has turned out, however, the global economy is now in the middle of a powerful recovery led by Asia. The IMF projects global growth will return in 2010 and continue into 2011. They forecast that world output will grow at a rate of 4.2 percent in 2010 and 4.3 percent in 2011. That growth is not evenly distributed, to be sure, but should it materialize it will be a great improvement over 2009.

With Asia as a leader in the global recovery, a risk is that the Asian economies might falter in some way, causing global growth to slow appreciably. Certainly, many Asian equity price indexes have declined substantially over the past two months, including those in China, possibly pointing to bleaker days ahead. But I would council caution in interpreting the volatile equity price data, as these markets are prone to overreaction and exaggeration. Still, one might worry that some type of "bubble" has formed in the Chinese economy in particular and that a disorderly unraveling of that situation might somehow derail the Asian-led global recovery.

While I am sympathetic to the possibility of "bubble" phenomena in macroeconomics generally speaking, I do not think that we should interpret China in this light at the current juncture. The more sensible interpretation of China is the one that has held sway for many years: It is a rapidly developing economy that is importing available production technology from the rest of the world, and creating its own as well, in a manner that leads to substantial gains in productivity, national income, and the national standard of living. Viewed this way, China has in the past year simply returned to its rapid growth path and is likely to remain on that path for a considerable period of time. Is every price in China exactly the one that would be associated with fundamentals in a country with perfectly functioning, perfectly free markets? Probably not. But still, the big picture is that rapid Chinese growth can easily be reconciled with the fundamentals, and so the risk of a sudden slowdown in China derailing the global recovery, while certainly not zero, seems limited.

Let me now turn to the U.S. economic outlook.

THE U.S. ECONOMY

The macroeconomic recovery in the U.S. remains on track and may be complete in the third quarter. U.S. real GDP peaked in the second quarter of 2008. As of the first quarter of 2010, real GDP stands just shy of the 2008 second quarter level, so that growth of about 1.25 percent would be sufficient to allow real GDP to surpass the previous peak. At that point, the U.S. economy would be fully "recovered" from the very sharp downturn of late 2008 and early 2009.

To be clear, the 1.25 percent is a quarterly number, and would be 5.0 percent at an annual rate. Although I think that 5.0 percent at an annual rate is too much to expect for current quarter real GDP growth, it seems like a reasonable possibility over the next two quarters *combined*. Given these conditions, I expect the U.S. recovery in GDP to be complete in the third quarter of this year.

Indeed, U.S. real personal consumption expenditure has already surpassed its previous peak, which occurred in the fourth quarter of 2007. Real investment has not fully recovered to its pre-recession peak, but has been improving.

The near-recovery in U.S. output has so far not been matched by a similar recovery in U.S. employment. Measures of labor input to production remain far below their peak levels. Significant job gains have occurred during the past several months, but generally speaking the increased level of production in the past year has come through productivity gains, not through employment gains. While productivity gains are welcome, firms will most likely have to hire workers during the remainder of 2010 to keep up with increasing demand.

Like Asia, the U.S. has experienced an increase in financial market stress during the past two months, mostly in response to events in Europe. U.S. equity prices have declined substantially. The VIX index, a measure of volatility, is well above its average value over the past two decades. The St. Louis Federal Reserve Bank financial stress index, which had declined more or less continuously since early 2009, has now turned around and moved sharply higher. At this point, I think these movements reflect more worry than reality about the prospects for a slowdown in global growth. Still, the European sovereign debt situation is serious and there are many unanswered questions about how events will unfold.

The crisis has produced at least two advantages for the U.S. in the near term. Much as it did during the Asian currency crisis of the late 1990s, the U.S. is benefitting from a flight to safety effect in world financial markets, which has driven down U.S. Treasury yields. From a peak yield of about 4.0 percent in early April for 10-year Treasury securities, the market has moved below a 3.2 percent yield on some recent trading days. To the extent this type of movement is sustained, it affects all trading in U.S. financial markets and acts like an aggressive and successful monetary policy action. If the situation in Europe continues to spark market volatility, the flight to quality will sustain lower yields in the U.S. than would otherwise be the case. The turmoil has also sent commodity prices lower, which, overall, tends to help the U.S. economy.

The U.S. dollar has of course strengthened against the Euro during the crisis. On a TWEX basis, however, the dollar is about where it was one year ago.

THE EUROPEAN DEBT CRISIS

The key concern in world financial markets has been the extent to which the sovereign debt crisis in Europe portends a global shock, possibly strong enough to upset the picture of global recovery I have been sketching.

There is no question that, in part as a response to the events of 2008 and 2009, many governments in Europe and elsewhere elected to increase deficit spending and thus to increase their debt as a percentage of GDP. For some countries, starting from weak economic conditions, the increase in borrowing was so large as to call into question their ability and willingness to repay in international financial markets. Confidence lost in such markets is difficult to regain, and for this reason I think we can expect market concerns to remain for months, possibly years, rather than just days or weeks. Governments must take aggressive action to earn credibility, and then sustain that effort over a long period of time. I think that a well-run fiscal consolidation can be a net plus for economic growth, as it was in the U.S. during the 1990s.

To be sure, sovereign debt crises are not at all unusual in the history of the global economy. Nations often have incentives to borrow internationally and are not always willing to repay. While sovereign debt restructuring or outright default is often associated with substantial market volatility—understandably, since some parties are not getting repaid—the events are not normally global recession triggers. A relatively recent and prominent example was the Russian default of 1998.

The agreement in Europe to provide funding if necessary through an SPV backed by government guarantees and through the IMF has provided time for the affected countries to enact fiscal retrenchment programs. Those programs have a good chance of success because the incentive for countries to keep unfettered access to international financial markets is substantial. Even if a fiscal consolidation program does not go well in a particular country, so that a restructuring of debt has to be attempted at some point in the future, restructuring is not unusual in global financial markets and can be accomplished without significant disruptions.

One of the persistent worries during this crisis has been that some of the largest financial institutions in the U.S. and Europe might be exposed to additional losses and that a type of financial contagion could occur should conditions worsen. I think this is a misreading of the events of the past two years. U.S. and European policymakers have essentially guaranteed the largest financial institutions. This has been the essence of the very controversial "too big to fail" policy. The policy has clear problems, including its inherent unfairness and the fact that economic incentives for institutions that are guaranteed can be badly distorted. But to argue that governments would now give up these guarantees in the face of a new shock that could threaten the global economy seems to me to be far-fetched.

One important lesson from the European sovereign debt crisis, well-known in emerging markets, is that borrowing on international markets is a delicate matter. There can be benefits of such borrowing in some circumstances, but too much can erode credibility and lead to a crisis in the borrowing country. In short, countries cannot expect to borrow internationally and use the proceeds to spend their way to prosperity.

The U.S. fiscal situation is difficult as well, with high deficits and a growing debt-to-GDP ratio. The U.S. has exemplary credibility in international financial markets, built up over many years. Now that the U.S. economy is about to achieve recovery in GDP terms, it is time for fiscal consolidation in the U.S. Irresponsibly high deficit and debt levels are not helping the U.S. economy and could damage future prospects through a loss of credibility internationally. A substantial and credible fiscal adjustment could set up the U.S. for a sustained period of growth, as it did in the 1990s.

CONCLUSION

In conclusion, I hope I have provided enough background in these remarks to set up an interesting discussion. I will be happy to comment not only on the content here, but also on many other issues that I was not able to address in these brief remarks. Thank you very much.

REFERENCES

International Monetary Fund. World Economic Outlook (WEO). *Rebalancing Growth*. April 2010.