

Globalization and Government Policy

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Most of you are probably familiar with the mock epitaph offered by W. C. Fields, a native of the City of Brotherly Love, who suggested his tombstone read, "On the whole, I'd rather be in Philadelphia." Well, I for one am delighted to be *both* alive and in Philadelphia today. I thank Tony Santomero and the Philadelphia Fed for inviting me to join so many distinguished scholars and analysts in contemplating the challenges posed by the federal government's budget deficits.

I wish George Shultz could be here. I'm sure many of you know him—or of him, at least. He is a distinguished economist and public servant, who inside and outside government has been an advocate for fiscal sanity for decades. Shultz is now at Stanford University's Hoover Institution. I spoke with him a few weeks ago and, sure enough, our conversation turned to one of his biggest concerns: our burgeoning structural fiscal deficits. He told me a story I want to share with you. When he was President Nixon's budget director, Shultz became increasingly worried about the inability of Congress to cut spending. Sitting in his office at 2 in the morning, he turned to his venerable aide, Sam Cohen, and asked, "Sam, is there really any difference between Republicans and Democrats when it comes to spending?" After giving it some thought, Cohen replied, "They both spend money. The only difference is that Democrats enjoy it more."

It is no longer clear who enjoys it more, but it is crystal clear we need to have a little less enjoyment and a lot more fiscal rectitude. Today's speakers have presented facts and figures showing what will happen if America does not change course. The economists who preceded me today gave a thorough accounting of our fiscal problems—all pretty grim. I have little to add to the message. I agree that the longer-term deficit projections are daunting, even if they do not present a clear and present danger to an expansion now entering its fifth year. I am, like many others here today, deeply concerned about the magnitude of deficits projected 20, 30 and 40 years into the future. Left unchecked, they *will* become a grave danger to our prosperity and run the risk of seriously undermining the progress we have made in taming inflation. That said, I believe the discussion of America's fiscal deficits is not complete unless we take into account the forces of globalization.

How globalization impacts the U.S. economy in general, and monetary policy in particular, has become our focus at the Dallas Fed. We believe that new technologies and market-opening policies are changing the economic environment—not only for the men and women who run America's businesses but for policymakers as well. We are not yet sure of globalization's precise impact on the economy's gearing, but we are fairly certain that the old econometric models, with their assumptions about output gaps, capacity restraints and money flows, are no longer the best guides for policy. At the Dallas Fed, we are trying to better understand how this country can succeed in a global economy.

Thus far, we have done a better job of raising questions than providing answers. I suspect I will do a bit of the same today. I also want to issue the standard disclaimer that I, like Tony Santomero and the other Reserve Bank presidents, speak only for myself and for no one else on the Federal Open Market Committee.

Economic Policy in a Global Economy

Globalization describes the economic reality of our times. In simplest terms, it means a nation's economic potential is no longer defined by political and geographical boundaries. Indispensable to the concept is factor mobility. The globalizing world we live in is one in which the goods, services, capital, labor and ideas that propel economic growth are increasingly free to migrate to where they are most valued and can work together most efficiently, flexibly and securely. These key factors of production avoid bureaucratic restrictions that lock them into outmoded methods and organizations and intrusive governments that limit their ability to adapt to a rapidly changing economic environment. They look for maximum profitability in returns on capital and the lowest tax burden on the sweat of the brow. In short, they constantly search for the environment with the fewest obstacles to success and—this is a point we must always remember—they are increasingly free to move to more welcoming environments.

Economic policies, of course, can have a big influence on decisions about where it is best to do business. A globalizing world means governments, national as well as regional and local jurisdictions, are forced to compete to attract and to hold these increasingly mobile factors of production.

U.S. business leaders have come to grips with the inevitability of global competition. Now, our policymakers must prove they can do the same.

I think monetary authorities around the world have gotten the message. They have achieved a new discipline, thanks in part to the competition created by globalization. Open financial markets allow investors to seek countries with stable money and shun those places where the value of their capital will be eroded. A clear result of globalization has been inflation rates converging at lower levels in North America, Asia and Europe. When it comes to accommodating inflation, central bankers everywhere have become, to quote my late, great father-in-law, Congressman Jim Collins, tighter than a new pair of shoes.

Has globalization brought a similar disciplining force to fiscal policy? It is hard for me to stand here today, among eminent scholars who delivered chapter and verse on America's fiscal profligacy, and tell you we are seeing better fiscal policies. Yet, I believe that globalization is having a beneficial impact on fiscal decisionmaking and that, while the United States is hardly virtuous on this front in an absolute sense, it is in better shape than most of its competitors.

Let me first turn to the discipline imposed on fiscal policy by global forces.

Take taxes. In a world where capital moves across borders more freely than ever, globalization heightens tax competition among nations, just as it does among states in this country. Indeed, we are seeing the average tax rate come down in the world's most open economies as nations compete for productive resources. Among OECD nations, the average top corporate tax rate fell from 38 percent in 1996 to 31 percent in 2002. Estonia has instituted a flat tax. Japan has learned through painful experience what it means to *raise* taxes. Poland and Germany are in the midst of tectonic political battles in which tax issues loom large. And China rarely, if ever, actually collects significant taxes from the corporate sector. In today's world, I doubt you can earn many brownie points, let alone raise more revenues, by increasing taxes on investors who are free to roam.

One would think that globalization would lead to similar discipline on the spending side. In theory, increasingly mobile companies and workers should not be fooled by a government that promises ever-growing spending not paid for by existing or new revenue streams. They should anticipate corrective measures down the road and adjust their behavior accordingly—at least if the theory of rational expectations has merit.

When people fully understand the economic environment in which policy is being made—that is, when they are rational—policymakers' power to manipulate the business cycle for short-term political gain is mitigated. In theory, fiscal authorities who face rational economic agents should find they can't use deficit spending to stimulate GDP because people will simply save more in response to today's increased public debt, anticipating tomorrow's higher tax bills.

But the deficit-reducing pressures anticipated by theory have yet to arrive in reality.

The United States continues to be a preferred destination for foreign capital, the most mobile of factors. These flows of international savings have made it easier—or at least less painful—to finance our deficits at low interest rates. Without capital from overseas, the growth of government spending might have crowded out the growth of household spending. Readily available foreign money has helped finance our surge in consumption spending and housing investment.

Why is this? I will offer one suggestion, drawing on my past experience as a market operator and putting on my old hat as an asset allocator: Other potential destinations for significant investment are actually doing worse than we are in terms of fiscal policy.

OECD data, which cover state and local governments as well as national budgets, show our public sector in the red at a projected 3.7 percent of GDP this year. In contrast, Japan is at 6.5 percent, Italy at 4.3 percent and Germany at 3.9 percent. France is only marginally better at 3.2 percent, according to the OECD. The assumptions behind these numbers may be a bit dodgy: For example, it is not clear whether the OECD data capture the impact strong U.S. growth is having this year on the federal deficit and on state and local revenues. A similar revenue swing is clearly not occurring in the budgets of the lander and central government in Germany, or in France. French Finance Minister Thierry Breton's straightforward revelations just a few days ago make it clear that his country's fiscal predicament is far worse than previously reported.

Here is the point: In terms of investors looking to allocate their capital, and the impact they have on the price of money, you cannot think of U.S. fiscal policies in strict isolation from what is happening in other countries.

Our long-term fiscal prospects may be daunting, but we do not suffer from the economic sclerosis that afflicts the Japanese and the major European powers. Looking longer term—to the structural problems of Social Security and health care programs—we also must recognize that we do not face the grim demographic challenge posed by

Japan's aging population. Or Germany's. In the title of the recent German best-seller *Das Methusalem-Komplott*, even the language-challenged will catch the reference to the Biblical Methuselah. Before the Latinization of Florida, some of us used to jokingly call the state God's antechamber, a reference to its aging population. Perhaps the title now better suits Japan or the European lineup of Germany, France and Italy.

Syndicated columnist Scott Burns and Boston University Professor Laurence Kotlikoff describe the demographic challenge in catchy terms in their thought-provoking book, *The Coming Generational Storm*. They divide the nations of the world into four quadrants defined by two dimensions—life expectancy and birthrate. One quadrant is occupied by the major European economies, Japan and China, all of which share the characteristic of a long life expectancy and low birthrate. This group they label the “Decrepit Quarter.” Another, defined by low birthrate and short life expectancy, is morosely labeled “Postmodern Malthusian Hell.” It is occupied almost exclusively by Russia and other former Soviet states. The United States inhabits the quadrant Burns and Kotlikoff call the “Panglossian Balance.” In their view, we teeter on “the tattered edge of Panglossian balance,” with a population replacement rate that is dangerously close to being insufficient but still better than Europe's, Japan's and China's and free of Russia's unique pathology.

From an investor's viewpoint, one might reasonably assume that Panglossian Balance trumps the Decrepit Quarter and Postmodern Malthusian Hell—to say nothing of the fourth quadrant, occupied by high-birthrate, low life-expectancy Africa and labeled “Traditional Malthusian Hell.” So does a more tolerant attitude toward immigration and a culture that encourages risk taking, enforces the rule of law and exhibits ever-evolving flexibility and adaptability to competition. We cannot, moreover, ignore the reinforcement investors derive from steady noninflationary growth. A few days ago, we received revised numbers for third-quarter GDP—an annualized gain of 4.3 percent. Take that 4.3 percent and apply it to an economy that produces \$11.7 trillion a year and you get a little more than \$500 billion in growth. Think about that: In a year, the U.S. economy grows in an increment only slightly less than Russia's total GDP, measured in dollar terms. Or 31 percent of China's total output, 25 percent of France's, 19 percent of Germany's, 11 percent of Japan's. In one year! So we do offer investors the attraction of significant growth, together with a less-threatening demographic profile.

Compared with other nations, we look fairly handsome, or at least less ugly. That said, being better than the worst is cold comfort. Pursuing least-bad policies carries tremendous risk. We can never be sure our advantages will last, particularly if deficit spending erodes economic performance or our politicians embrace protectionism or other policies that might cause mobile factors to flee.

It always comes back to globalization. A world of porous borders, for example, increases the ability of younger citizens to escape the taxes foisted upon them by the elderly. The young aren't handcuffed to the old—at wage-earner-to-pensioner ratios of 10 to 1, 3 to 1, or whatever the demographic profile might be. Why should the productive, mobile youth of the 21st century, cyberpowered from birth and at home in an interconnected world, stay and subject themselves to high Social Security taxes when they can move somewhere else and keep much more of their pay?

Globalization makes it harder to sustain a Social Security system based upon intergenerational transfers. It exposes much more rapidly and acutely the inherent limits of such policies. If our fiscal authorities were to take this and other real world verities into account, it might just encourage better policies. And putting our fiscal house in order *before our competitors do* would further enhance our edge as an investment destination, securing the future of successive generations of Americans.

The Monetary Temptation

At face value, fiscal policy may not seem a concern for the Federal Reserve. Taxing and spending, after all, are not the Fed's business. Congress holds the power of the purse. But the Fed cannot be an indifferent bystander to the overall thrust of fiscal policy. The reason is straightforward: Bad fiscal policy creates pressure for bad monetary policy.

When fiscal policy gets out of whack, monetary authorities face pressures to monetize the debt, a cardinal sin in my mind. I do not believe the Fed or any other responsible central bank has total leeway to monetize deficits in a globalized world anyway.

In the foreign capital flows that support our consumption, we have recently seen the bright side of what globalization means for monetary policy. We learned in Economics 101 that deficits exert an upward push on real interest rates by crowding the market for available funds. This theoretical pressure, however, has been mitigated in today's globalized economy, where we have had little trouble tapping foreign savings to meet our domestic needs. Capital has been “crowding in” to our growing, noninflationary and stable economy. The crowding-out issue might reassert itself over

the next few years, however, as resurgent business investment begins to compete with spending by households and government. The prospect looms larger if other economies provide more attractive environments for investment capital.

In a closed economy, the Federal Reserve might face political pressure to keep interest rates from rising, with an eye toward accommodating fiscal stimulus. Or if fiscal imbalances were to balloon—to, say, the dimensions forecast by many of this conference’s participants—there could be pressure to deliberately trigger inflation and thereby reduce the real value of the public debt. Doing so would fuel inflation. In an open economy, however, the situation is different. When capital is free to move at the click of a computer mouse or the close of an inventory cycle, we cannot accommodate political pressures even if we were so disposed—which we are not—because of the added risk of capital flight to destinations where the purchasing power of capital is better preserved.

It is the duty of the Fed to refrain from the slightest temptation to monetize deficits or embrace any other inflationary policy. In the Volcker and Greenspan eras, the Fed has done quite well in this regard, and it can be expected to continue countering inflationary pressures should they arise.

Some of you may recall that we gave in to the temptation to monetize fiscal imprudence in the 1970s. The cure imposed by the FOMC under Paul Volcker’s leadership was bitter and painful for the nation. Since then, monetary policy has been resolute. It is important to bear in mind that the world is also a different place than it was in the 1970s. We have seen the adoption of the euro, the rise of China and India, advances in technology that fuel factor mobility and dramatic changes in economic opportunities in what was then the Third World. All these forces give us less leeway to operate in isolation. In today’s world, we have no option but to extend the Volcker–Greenspan legacy of sound monetary policy.

I think a city ordinance requires that all speakers taking a podium in Philadelphia quote Benjamin Franklin. This is easy for me because I always carry a few words from Franklin as a reminder of my obligation as an inflation fighter. In 1748, when we were a society of farmers and the crown was the colonies’ currency, Franklin said, “He that kills a breeding sow destroys all her offspring to the thousandth generation. He that murders a crown”—a dollar—“destroys all that it might have produced.”

This was true in the agrarian world of Ben Franklin, and it holds as well in the cyber, nano, bio interconnected world of Ben Bernanke—though I, of course, speak for neither of them. Coddling inflation by monetizing deficits is not an option in a globalized world. It would erode our currency’s value and undermine our economy’s potential to grow and create jobs. The solution to the problems laid out by the participants in today’s conference rests squarely in the hands of our politicians, not with the central bank.