

## Rebalancing Toward Sustainable Growth

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The views expressed by the author are his own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

## **Introduction**

The U.S. economic recovery is under way, but it remains more uncertain and volatile than anyone would like. Some believe that the Federal Reserve can speed up the recovery by keeping the federal funds rate near zero, where it has been for nearly two-and-a-half years, and by promising to keep it there for an extended period. If I judged—or if evidence suggested—that a zero rate would solve our country’s unemployment problem or speed up the recovery without causing other adverse consequences, I would support it. However, monetary policy is not a tool that can solve every problem.

In today's remarks, I will outline my current views on the economy, and suggest what alternative options and policies our leaders might consider as we search for ways to build a stronger, more resilient economy.

## **U.S. economic conditions**

First, it is a testament to the U.S. economic system that even as this nation carries a heavy public and private debt burden, the economy is completing its second year in recovery. The level of activity, as measured by GDP, has now surpassed its pre-recession peak after growing at a nearly 3-percent pace last year. However, I am concerned that in working to offset the effects of this devastating crisis and to restore the economy to health, an extended zero-interest-rate policy is producing new sources of fragility that we need to be aware of and allow for in our future policy choices.

Governments, businesses and consumers have made financial choices and allocated resources with an understanding that a zero-interest-rate policy will remain in place indefinitely.

The longer we leave interest rates at zero, the more asset values will be defined by these low rates and the greater the negative impact will be once the inevitable move up in rates begins.

Complicating the fragility around monetary policy, fiscal policy as a pro-growth policy instrument also appears to be approaching its limit. The government's stimulus efforts to support the economy, along with lower tax revenues, have resulted in historically large fiscal deficits and a very large debt level. Without a dramatic change, the deficit and the debt will only become more daunting with the rising cost of entitlement programs and likely higher interest rates.

For well over a decade, the U.S. consumer has been a principal source of world demand and economic growth. As a result, the United States has incurred consistently large trade deficits, contributing to imbalances in the global economy. As we have painfully learned from the housing bust, growth built on imbalances is ultimately unsustainable.

Circumstances require, therefore, that we transition from an economy that relies too heavily on consumption and government spending for growth toward more sustainable sources of demand and economic prosperity. How we undertake this transition will define our economy and country's economic future.

To start, over the next several years, we must change our national savings, consumption and investment habits. Such shifts, though fundamental to long-term economic health, are admittedly difficult to accomplish. They require changes in behavior and expectations. They involve dramatic shifts in resource use, which are not painless as workers are temporarily displaced and industries are disrupted. The pain is immediate, and the payoff comes slowly. However, the gains also can be significant, as more sustainable long-run economic growth is well worth the effort and sacrifice.

In a recent visit to Singapore, I witnessed that nation's commitment to job creation. For example, during the recent crisis and recession, Singapore developed a program to retrain unemployed workers to ensure they would have the skills needed when its manufacturing sector recovered. As is well understood, workforce training matters. I spoke with individuals who described the drive to bring new factories on-line, with the goal of bringing a factory on-line with minimal delays and, by their description, without compromising safety.

### **Lessons from Germany**

Other countries have made similar changes out of necessity or during a time of economic distress such as we are experiencing today. Countries have made deliberate choices and not relied on chance to change economic incentives and behavior that served to improve economic performance. I'm not advocating that we pick winners and losers—in fact, that is my biggest argument against too-big-to-fail financial institutions. Rather, I have observed a number of countries that are building and expanding their manufacturing bases—such as Korea, Singapore and China—that have been able to experience strong GDP growth over long periods of time.

Germany offers another example of a country having made significant changes to accomplish real employment goals. In the mid-1990s, Germany's trade deficit was similar to that of the United States. Since then, Germany has moved away from trade deficits to surging surpluses, while the United States has continued to run large trade deficits. Complementing this shift, German levels of employment have made great strides, and its unemployment rate has touched its lowest point in nearly 20 years.

I am not suggesting that the United States attempt to be Germany or Singapore, two countries that differ from us in many ways. I am also not advocating that we suddenly strive to achieve a large U.S. trade surplus. This might only create other global imbalances and

distortions. However, adjustments in our economy are necessary, and other countries have shown it can be done.

Perhaps the most immediate, and obvious, observation is the simplest: We must change our national savings rate. To rebalance the U.S. trade position from deficit to balance requires that the sum of private and public savings match domestic investment. In other words, a country must not produce less than it consumes if it wishes to balance its trade position with the rest of the world.

During the 2000s, Germany's personal savings rate increased and is currently about double the U.S. rate. German households paid down debt and avoided heavily relying on debt, in contrast to the United States and so many other countries' households.

The personal savings rate in the United States has modestly increased since the start of the recession, which is an important positive trend. Unfortunately, this improvement has been more than offset by the dramatic deterioration in public saving reflected in the nation's fiscal deficits. Though a significant amount of the recent deterioration in public finances is related to the U.S. financial crisis, the fact remains that our national savings crisis has been under way for nearly three decades. Since the early 1980s, our nation has consistently chosen to spend rather than save, as witnessed by the long-term decline in our private savings rate and our tendency toward fiscal deficits. Most importantly, when we look across the more developed countries, we see that those with higher national savings rates tend to have smaller trade deficits and higher domestic production per person.

Germany has also benefitted from managing unit labor costs in a manner that keeps its labor force globally competitive. Over the last decade, the German economy experienced relatively modest wage increases and important productivity gains. Both of these factors

contributed to keeping unit labor costs in check. However, another important component of its success came in the form of labor policy reforms.

In the early 2000s, Germany, with labor and management input, passed a series of labor market enhancements called the “Hartz laws.” These laws modified some of the more generous employee benefits and reduced restrictions on temporary workers and the ability to lay off workers. Germany’s reforms also sought to incentivize unemployed workers to transition to employment by making changes to job training programs for the unemployed and creating targeted subsidies to support some manufacturing job creation.

Finally, Germany developed export markets by focusing on meeting the needs of parts of the world experiencing the fastest growth and demonstrating strong demand for capital goods that German manufacturers produce: emerging economies in Asia, Europe and Latin America.

The United States is well-positioned to match this kind of performance, if it chooses to do so. For example, since 2000, the share of our exports going to the BRIC countries—Brazil, Russia, India and China—has more than doubled. If we choose to increase our savings rate, if government, labor and management see the mutual advantage of investing in and building a competitive manufacturing environment, then job growth will follow.

As the U.S. economy shifts gears to shrink its trade imbalances, many parts of the country will have a role to play. I fully expect Iowa to be an integral participant in this shift. Iowa already possesses a strong manufacturing base that is a key driver of the state economy. By some estimates, about half of the manufacturing firms in the state are small- and medium-sized enterprises, which provide some parallels with Germany’s renowned export powerhouses, known as the *Mittelstand*.

## **Real solutions versus economic shortcuts**

Rebalancing our economy and improving our trade position is a necessary development, but unfortunately, it will take time. And as our immediate desire is to rush to improve our economy, I warn against the all-too-common impulse to take shortcuts and suffer their unintended consequences. Here in Iowa, for example, one area where I suspect this tradeoff might be playing out is in the recent rapid run-up in agricultural land prices.

Agricultural exports have played a significant role in the rapid rise of land prices. Since 2000, agricultural exports from Iowa have increased by a factor of six. A portion of this growth reflects surging commodity prices due to factors on the supply side—such as extreme weather in parts of the world—and on the demand side, including the well-documented, rapidly growing food demands of emerging economies.

In addition to anticipated strong future demand for agricultural commodities, there is another factor affecting these prices: exceptionally low interest rates. As a bank regulator in the 1980s, responsible for financial institutions in Nebraska, Kansas, Oklahoma, Missouri, Wyoming, Colorado and New Mexico, I witnessed the devastating effects of easy credit and leverage in agriculture, real estate and energy. We closed or assisted nearly 350 banks in our region alone.

With interest rates near zero and with additional massive liquidity poured into our economy, all interest rates are affected. Therefore, asset values of every kind are also being affected, including land values in Iowa. Loans for land are available at rates well below historical levels—in some instances, 400 basis points below historical averages. The effect on land assets, like any asset, is to artificially boost its value. And there is ample experience that tells us that if rates were to rise quickly, this would affect world demand for commodities and raise the cost of

capital on land almost instantly. When—not if—the adjustment occurs, we will see a dramatic drop in values. In the meantime, if operators and speculators have incurred large amounts of debt, then a new crisis will emerge.

Finally, we know that a crisis can affect more than one segment of the economy. It nearly always affects the broad economy and employment. Shortcuts don't work. We need to focus on the real economy. We need to focus on real reform.

## **Conclusion**

My point today is simply that as powerful as monetary policy is, it sometimes is not enough. It cannot ensure an economy that balances its savings and investing needs. It by itself cannot correct our current account deficit or enhance savings and investment. These will require important changes in our real economy. Providing the right environment in which government can play its role in supporting business and the consumer to save, invest, manufacture and service national and global needs in the end will create real income and wealth.

We need to focus on long-term, stable monetary policy and fiscal policy goals that support these broader goals. Having seen the effects of financial crisis after financial crisis as short-term policies beget short-term policies, we should know that an ever-present short-run focus, even if well intentioned, is the road to ruin.