



KEYNOTE ADDRESS

**PRESENTED BY TIMOTHY F. GEITHNER,
PRESIDENT AND CEO, FEDERAL RESERVE BANK OF NEW YORK**

Japan's Economic Future: Policy, Politics, and Producers
Center on Japanese Economy and Business 20th-Anniversary Conference
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On October 2, 2006, Columbia Business School's Center on Japanese Economy and Business (CJEB) hosted its 20th-anniversary conference, "Japan's Economic Future: Policy, Politics, and Producers." Timothy F. Geithner, president and CEO of the Federal Reserve Bank of New York, delivered the keynote address. He was introduced by Lee C. Bollinger, president of Columbia University.

In his introduction, President Lee Bollinger noted that Timothy Geithner is "steeped in professional knowledge as much as anyone" and has "the feel of the world." Mr. Geithner has studied Japanese and Chinese and has lived in East Africa, India, Thailand, China, and Japan. President Bollinger described those twin characteristics as essential to Mr. Geithner's role at the Fed because one can no longer "understand banking without understanding the world, in every sense."

Echoing the theme of President Bollinger's introduction, Mr. Geithner's address focused on both the global impacts of broad financial integration and the policy implications of that integration. Particularly challenging, noted Mr. Geithner, is the fact that despite the rapid pace of integration the world remains "some distance from a fully integrated global financial system." As a consequence, our theories and models, which are best equipped to deal with a fully integrated system that responds freely to market forces and incentives, need to be adjusted to account for the distortions that exist in the current market environment. They need to be adjusted to "the reality of a world in which markets aren't allowed to adjust freely."

As a notable example of one such distortion, Mr. Geithner pointed to barriers to fluid changes in exchange rates resulting from the "implicit or explicit mandate" that some policymakers have "to limit the variability of the nominal exchange rate against that of their trading partners." He argued that these and other policies that restrict trade or capital flows,

“distort the incentives of businesses and investors” and that as a result “understanding the policy implications of globalization you need to understand not just what integration does but the impact of these constraints and distortions on economic activity.”

Mr. Geithner turned to an issue close to the heart of the Federal Reserve and other central banks. Citing the work of economist Ken Rogoff, he posited an overall increase in central bank credibility as a result of greater financial integration. Competition, by increasing the flexibility of prices, reduces the “inflationary bias”—a tendency to increase unanticipated inflation in return for short-run gains to output—that a central bank might have. Mr. Geithner pointed to other ways in which globalization could lead to a reduction in short-run inflation, including increases in productivity that result in higher potential growth.

But just as those tendencies have made the job of a central bank a little easier, globalization has complicated the practice of gauging underlying inflation—something of critical importance to central bankers. “As the share of goods and services that are . . . affected by trade increases, the challenge of extracting some measure of underlying trend inflation gets more interesting,” Mr. Geithner said. “External factors can have bigger effects on the movements of some prices.” These comments were particularly relevant in light of both the Federal Reserve’s decision, only one day prior, to hold rates constant and of the bank’s more general efforts to reconsider the way it communicates around monetary policy.

Returning to the issue of exchange-rate policy, Mr. Geithner again highlighted the presence of a number of emerging economies that have sustained or implemented fixed exchange rates. And significantly, he stated that these policies, resulting not just from the interest in amassing and sustaining prudent reserves but also from an “aversion” to letting rates adjust to market forces, have led to increases in national reserves.

“That some of the forces governing capital flows and asset values are driven not by market-determined expected return but by policy measures,” Mr. Geithner said, summing up the implications of distortions such as fixed exchange rates, “means that at least some of what we observe in global capital markets may be attributed to these distortions.” These factors further complicate the policymaker’s task of discerning the overall forces affecting the national and world economy.

Despite the ways in which financial integration impacts national economies and can blur the measurement of inflation and other key underlying dynamics, Mr. Geithner closed with a strong statement that these issues do not excuse central bankers from their responsibilities. The fact that global integration impacts national economies does not

diminish the important role of central bankers and other financial policymakers. “Integration does not . . . limit our ability to achieve our objectives,” he said. “Rather, it forces us to think harder about how our economies are evolving and how developments in the rest of the world affect our markets.”

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