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Financial Market Integration in a Global Economy: A Central Bank Perspective

remarks of

Wayne D. Angell
Member, Board of Governors of the Federal Reserve System

at the

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Good morning ladies and gentlemen. I am pleased to join you at the international finance symposium to discuss the importance of financial integration to our global economy. I want to begin by thanking the Chicago Mercantile Exchange and the Chicago Board of Trade for this opportunity. As I will note later, the futures exchanges have made valuable contributions to financial market efficiency. And, they are now in the vanguard of increasing efficiency in the financial markets by offering new products that lower further the barriers to international financial trading posed by geography and time zone differences.

This year's symposium is being held at a time of great promise, yet great challenge, for the world economic order. There are a number of developments that offer much promise for improved economic welfare throughout the world. There is, for example, the continued unfolding of political and economic reforms in Eastern Europe and movement toward economic integration in the European Community. In addition, there is new momentum for the economic integration of North America by the Mexican-U.S. proposal. Getting the Uruguay Round back on track, including agriculture, would, in a meaningful way, provide significant opportunities to lower barriers to trade in goods and services. But, there is still a significant danger that pressures for governmental intervention in the markets through subsidies to economic sectors or cartel-like groups could cut short the efficiencies from trade and give further impetus to the forces of protectionism.

I strongly support and earnestly hope for the renewed efforts that will result in further lowering of trade barriers, including barriers to trade in financial services, the spread of market economics, and enhanced competition in markets around the world. I would also note that there is an important monetary and financial aspect to improved economic efficiency. In particular, maintaining a sound and efficient international financial system is of the utmost importance to efficient world markets.

As a central banker, my day-to-day concerns are with monetary conditions. Accordingly, I have a keen interest in the roles of money both as a store of value and as a medium of exchange. It goes without saying that these roles, as played by reserve country currencies, are as important to international trade as they are to domestic economic activity.

In order for money to function efficiently as a medium of exchange, it must be dependable as a store of value. Central banks gain credibility by making certain that the value of their currency is not eroded by inflation nor enhanced by deflation. Moreover, qualified store of value currencies may not serve efficiently as a medium of exchange in domestic and international markets unless there is in place an efficient and reliable clearing and settlement process, which minimizes the cost and risk of discharging financial obligations. Efficient and reliable clearing and settlement is complicated by greater international integration and by the explosive growth in the number and value of cross-border transactions.

My prepared remarks today are brief -- they are designed to set the stage for what I hope will be an interesting discussion among us of international financial issues. There are two basic themes that I will emphasize. First, I will highlight the essential role played by central banks in promoting real economic growth and establishing the foundation for effective financial integration. Second, I will share with you my perspective on an important component of the international financial mechanism that transfers monetary value and that helps determine the usefulness of money as a medium of exchange, namely, the international payment system. In the process, I will update you on private and public initiatives aimed at increasing the efficiency and safety of cross-border payment mechanisms, including mechanisms which involve clearing and settlement in multiple currencies. Efficiency and reliability are especially important features of the international payment process in a world that is characterized by a multiplicity of monetary and payment arrangements rooted in national practices.

My first main point is that by acting as responsible monetary authorities, central banks can make their greatest contribution to long-run real growth in both their domestic and international economies. Above all, central banks should direct their efforts toward providing a stable monetary environment in which economic actors are able to make rational market decisions. And, by a stable environment, let me make clear that I mean one of long-run price level stability.

For me, price level stability means just what it says -- a target of zero inflation plus a commitment to offsetting cumulative errors in one direction. In this way, the purchasing power of a currency will remain constant long into the future. I do not buy the notion that a central bank can be satisfied by pursuing a target inflation rate of, say, 4 percent or 2 percent as a reasonable alternative goal of monetary policy. Any inflation, even at low levels, entails costs that reduce efficiency and retard long-run economic growth. There are a number of reasons that inflation of any amount distorts markets, including both financial and real markets, and interferes with the process through which wealth is created. I have dealt with this theme elsewhere in considerable depth and will not dwell on the topic here. It is enough for now to say that inflation obscures price signals that guide economic decision making, contributes to higher real interest rates as investors demand additional risk premiums on their investments, and thereby distorts income incentives and provides less than an optimal allocation of capital.

While inflation can act to misallocate resources and capital flows in domestic markets, it is even more burdensome in international markets. Because exchange rate interdependencies in the international financial markets depend on perceptions about the future buying power of national currencies, the uncertainty and distortion that result from inflation uncertainties contribute to volatile foreign exchange markets. The world has suffered a significant loss in welfare from foreign exchange rate volatility associated with the soaring inflation of the 1970s as well as by the forceful efforts needed to wring inflation out of the system in the 1980s. I hope you appreciate that I am not advocating a return to a fixed exchange rate regime. It is true, however, that price level targeting will provide a more stable anchor for international exchange rates.

In addition to a stable monetary environment, the international financial system depends on a safe and effective payment system. Because of the large number of national currencies involved in international transactions, the payment system can be complex, involving a number of intermediate steps between trading and settlement. The world payment system has been radically altered by the increase in world economic activity and by the development of electronic mechanisms for completing international payments. The world payment system has become increasingly more efficient and reliable, but opportunities remain to make the system for transferring and settling large payments even more efficient and safe.

The foreign exchange markets have experienced explosive growth with the rapid economic integration of market oriented economies among the countries of the world. At the time of its last survey in April 1989, the Bank for International Settlements estimated the size of the foreign exchange market at about $640 billion a day. London, New York, and Tokyo are primary centers for foreign exchange trading, and final settlement in the different currencies that are traded ultimately occur in the country of issue. The U.S. dollar figures in about 90 percent of all currency trades and about half of the nearly $1 trillion in payments that are made and settled over the CHIPS system in New York each day are related to foreign exchange transactions. The dependence of the international financial markets on a variety of currencies, and the consequent explosive growth in and importance of the foreign exchange markets, pose special challenges for the safe and efficient functioning of cross-border clearing and settlement.

In addition to their role as monetary authorities, central banks have a role to ensure that there is a safe and efficient system to settle transactions involving their currencies, including foreign exchange transactions. The central bank role is especially important when the monetary system is public and the economy relies upon fiat money as opposed to "full bodied money," as under a gold standard. Under a public monetary system the central bank has an advantage in providing final and irrevocable settlement because it cannot fail. However, central bank involvement can introduce an element of moral hazard into the clearing and settlement process unless steps are taken to increase the role of the private sector in assuming responsibility for the market integrity of this process. Indeed, in my view the development and operation of safe and efficient clearing and settlement arrangements needs to be primarily a private banking function, not only with respect to domestic arrangements but arrangements involving cross-border settlements, possibly involving multiple currencies, as well. Central banks have the unique capability either to guarantee final and irrevocable settlement or to make a special contribution to the settlement process by providing private banking exposure to risk. By motivating private banks to reduce risk, central banks can help ensure both the micro stability of the financial institutions, and the macro system used to settle domestic and international financial obligations including multiple currencies.

Clearing payment instructions followed by settlement of payments through transfers of deposit claims on banks is a core banking function. Banks have provided clearing and settlement services to their customers at least since the Middle Ages. Recently, increased size and complexity of payment flows have caused bankers to find ways to better manage their credit and liquidity risks in providing settlement services.

One of the primary innovations for controlling interbank settlement risk is netting, which may take the form of bilateral or multilateral netting. Properly done, netting can not only increase the efficiency of the settlement process by reducing the number and value of payments, it can also make a substantial contribution to risk reduction. Risk reduction derives in part from the adoption of minimum financial standards that must be met by those participating in the netting, including methods to control counterparty risk and financial commitments to ensure settlement, should a participant not be able to meet its obligation. Bilateral netting is currently employed in the foreign exchange market. Now, two different groups of banks, one in Europe and one in North America, are busy developing multilateral netting systems for foreign exchange.

These prospective new systems for netting foreign exchange transactions would achieve multilateral netting through the creation of a central counterparty, or clearing house. Indeed, the legal structure may be something like that of existing clearing houses in the futures, options, and securities industries, although the financial structure may differ significantly. The clearing house, as central counterparty, would maintain running, legally binding net positions vis-a-vis each participant for each currency and delivery date. For a given set of contracts, this process would leave each participant with net amounts due to or from the central counterparty that equated its multilateral net positions vis-a-vis the other participants in the arrangement as a group. I understand that there is already talk of extending the concept of multilateral netting beyond foreign exchange to other types of over-the-counter interbank financial markets.

In November 1990, the Governors of the G-10 central banks, through the Bank for International Settlements, published the Report to the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries. The report acknowledges the responsibility of central banks for cooperative oversight of cross-border and multi-currency netting systems. It also sets out the minimum standards that multilateral netting arrangements should meet if they are to operate on a sound basis. These standards are being used now to evaluate existing netting arrangements and as a guide to the design of prospective new netting arrangements, such as the multilateral systems for foreign exchange.

I am very pleased to see the private sector using netting and further investigating its use as a means to control better the risks inherent in the settlement of foreign exchange transactions. These are privately contracted risks that must be shouldered by the private sector in a responsible manner. Similarly, I appreciate the additional work that is being done to develop innovative new banking services to allow market participants to settle financial positions in multiple currencies more efficiently and safely.

To facilitate private initiatives, central banks should determine what types of support they might provide to complement private initiatives aimed at enhancing the settlement process for financial obligations involving cross-border payments in multiple currencies. Along these lines, the G-10 Committee on Payment and Settlement Systems is following with interest the private initiatives aimed at establishing foreign exchange clearing houses that might ultimately seek payment services from a number of central banks. The logical possibilities appear to include a coordinated expansion in the hours of operation of central bank settlement facilities. This would enable large-value payment systems operated by central banks, such as Fedwire, to provide temporal overlap among the major interbank payment systems. It is also possible to envision a coordinated provisioning of central bank services to the developing foreign exchange clearing houses or other cross-border and multi-currency netting arrangements. What services might be offered depends on the requirements for the safe and efficient operation of these clearing houses.

An important point is that continued improvement in the mechanisms for settling cross-border payment obligations, which may be denominated in a number of currencies, will probably be best accomplished by the private and public sectors working toward the common goals of an efficient and safe international payment system. As I mentioned, central banks have laid out the minimum standards netting schemes should meet if they are to pass the test for integrity. And, those designing systems for foreign exchange appear to be working diligently to attempt to meet these standards.

In summary, the world markets are being challenged to support major new demands for efficient trade and finance and to do their part in creating the conditions that will permit a general improvement in world economic welfare. Central banks can best contribute to economic progress, not only domestically but also internationally, by controlling inflation and thereby permitting underlying market forces to determine the value of goods, currencies, and financial instruments. There is a need for cross-border and multi-currency clearing and settlement arrangements that provide both efficient and safe means for transferring value. Commercial banks and central banks have dual roles to play in developing efficient and safe clearing and settlement. We are, I believe, heading in the right direction with respect to new arrangements that will help strengthen the foundation of our international financial system.

Thank you.

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