The Federal Reserve Board

Remarks by Governor Roger W. Ferguson, Jr.

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Global Financial Integration: Historical Perspective and Policy Implications

Thank you very much for inviting me to speak to this distinguished group of business economists and analysts. As we have discovered over the last eighteen months or so, we live in a rapidly changing global economic and financial environment. Today, given the theme of your conference, I would like to put the events of the last few years into a broader historical context, and ask what are the most appropriate policy solutions.

Yesterday and Today
Let me turn to a previous period of close global linkage in economic and financial markets: the forty years or so prior to World War I. Here I will draw on a recent NBER working paper by Michael Bordo, Barry Eichengreen, and Jongwoo Kim.[1] During this time, capital flowed essentially without restriction, chiefly from developed Western Europe to overseas regions in the then rapidly developing countries of the Americas and to Australia. Just to put this in perspective, these three economists report that at its peak, the outflow from Britain reached 9 percent of GNP and was almost as high in France, Germany, and the Netherlands. Much of this capital was invested in bonds that financed railroads and other infrastructure investments and in long-term government debt instruments, but there was also significant direct foreign investment.

Bordo, Eichengreen and Kim find that one element of the pre-1914 episode of global financial integration is the size and persistence of the current account deficits of capital importing countries, mainly Australia, Canada, Argentina and the Scandinavian countries. Similarly, the current account surpluses of some capital exporters, particularly the United Kingdom, showed considerable persistence. These economic historians indicate that it was not unusual for these countries to experience current account imbalances, deficits for the capital importers or surpluses for the capital exporters, of between 5 percent and 10 percent of GDP lasting for several years.

The size and persistence of these capital account imbalances in the pre-1914 period appear to compare roughly with the size of current account imbalances that have existed in the most recent period of global financial integration. Economic historians indicate that during the period from 1971 to 1997, emerging market countries have been running, on average, current account deficits of about 4 percent of their GDPs. However, according to these historians, capital flows to the emerging market countries of today have been somewhat more variable--as measured by the standard deviation of the current account to GDP ratio--than those provided to the "emerging market economies" of the late 1800s and early 1900s.

While the pre-1914 period can be characterized as more stable in some respects, economists have identified other important differences between that period of global capital flows and our own. First, gross flows are far greater today. A second difference is in the composition of the investment. While data are not complete, it does appear that the bulk--possibly as much as 85 percent according to estimates reported by Bordo, Eichengreen and Kim--of pre-1914 investments were in government and municipal securities, railways, resource-extraction companies and public utilities. Today, it is safe to estimate that a larger proportion of investments is in commercial, industrial and financial concerns, whose assets are more intangible and whose operations are less transparent. Third, prior to 1914, the vast majority of portfolio capital flows took the form of bonds. More recently, portfolio flows have been more evenly split between bonds and stocks.

Lessons for Policymakers

Policymakers need to understand this earlier stage of global capital flows and should attempt to adapt any lessons to today's world of absolutely large, very liquid, and fundamentally less transparent cross border capital flows.

The core question, obviously, is what factors allowed for the apparent persistence and relative stability of the pre-1914 era of capital flows? One theory advanced by academics is that capital exports and investments went largely to countries linked through shared language, culture, legal systems and accounting regimes. Another hypothesis may be that, in the period leading up to World War I, the commitment of policymakers to stable monetary and fiscal policies was highly credible to market participants, perhaps reflecting a shared belief in and commitment to the gold standard.

The policymaker's challenge today is to build strong institutional structures, policy credibility, and private sector discipline that are at least as strong as might have existed earlier. However, we must do so against a background of modern, technologically driven, global finance. It is clear that we must make the adjustments required because, with the absolute scale of global financial markets increasing, the size of bailout packages needed to fill financing gaps during international crises will get progressively larger and become less feasible to assemble. In addition, policymakers must always be concerned about the moral hazard of appearing to stand ready to help private sector debtors and creditors escape from problems of their making. Finally, I believe that we must achieve these goals without attempting to step back to policy regimes of prior periods that are clearly unworkable now or that undermine the advantages that we know come with a free flow of capital.

So what are the policy solutions that meet these criteria? In overview, I would say that there probably are very few grandiose new solutions that need to be implemented as a policy response to today's global financial turmoil. Rather, I see an emphasis on basic, sound practices.

The Need for Sound Institutional Underpinnings

One lesson suggested by the pre-1914 period of relative stability in capital flows is the importance of broadly understood and accepted institutional arrangements. Countries that wish to participate in the modern global financial market need to modernize their institutional underpinnings. Several actions come to mind. First, the basic underpinnings of private property protection need to be in place. The legal system needs to define and support the enforceability of contracts. For example, while international bankruptcy procedures do not seem feasible, the adoption or improvement of national bankruptcy systems is essential and should have a high priority. Debtors and creditors alike need to have an understanding of the rules under which private sector defaults are to be resolved and confidence that these rules will be consistently applied. I put the highest priority on bankruptcy procedures because they provide the self-adjusting mechanisms that allow the private sector to continue to function even in a world in which financial crises are likely to occur. Various plans to improve international financial rules will emerge, but they must all, in my judgement, include a focus on national bankruptcy codes.

Similarly, accounting standards and private sector disclosure are important areas for improvement. Accounting standards provide the foundation for credible financial statements and other disclosures that are key means for communicating a company's operating results and its overall health, as well as for making more transparent various operating activities. Disclosure of reliable information facilitates market discipline, strengthens confidence, improves decision making and reduces the chance that rumors and misleading information could cause instability in national and global markets. Also, by facilitating market discipline, public disclosure helps reinforce supervisory efforts to encourage banks and other companies to maintain sound risk management practices and internal controls. For these reasons, the Federal Reserve and the Basle Committee on Banking Supervision have strongly supported initiatives to improve the quality of national and international accounting standards and disclosure practices.

Finally, bank supervision and regulation must be upgraded. Banks are an important mechanism for transmitting funds both domestically and internationally. However, in societies in which banks are afforded certain benefits and safety nets because banking problems have the potential to disrupt financial markets, banks can perform their intermediary role best if they are properly supervised. This supervision, in turn, should start with oversight by depositors and participants in private debt and equity markets and be reinforced by appropriate supervisory practices and safeguards.

Assessing the soundness of banking institutions is difficult, simply because of the nature of the banking business. Extending credit inherently involves subjective judgments, and standards of adequate risk measurement and disclosure must continually evolve along with the nature and complexity of banking products and the ability of institutions to assimilate information. Both authorities and market participants must request and receive sufficiently accurate, timely, and relevant information on which to base their decisions. They must also have sufficient insight and expertise to evaluate it properly.

No discussion of institutional arrangements in the global economic and financial system will be complete without a discussion of the IMF, the international financial institution central to resolving balance of payments crises. If the IMF did not exist we would probably need to create something like it. In a world of global finance, it is useful to have a multilateral organization that has some responsibility for providing liquidity assistance to countries when they do not have access to capital markets and also encouraging countries to undertake prudent fiscal and monetary policies.

The IMF has come under some criticism for elements of its policy prescriptions. I am sure that economists and policymakers will have opportunities to review and evaluate the performance of the IMF during this period. It might be appropriate to define more clearly the functional roles played by the IMF and other international financial institutions in order to improve the efficient use of scarce international resources. At the present time, however, the IMF is a critical participant in maintaining international financial stability.

The Need for Credible Economic and Financial Policies

A second lesson of history and recent experience is that policymakers must follow sound and credible macroeconomic, microeconomic and financial policies. In particular, a necessary condition is fiscal and monetary policies that are, and are perceived to be, responsible. As we have seen in some of the crises that have hit in global financial markets, particularly those that have a public sector origin, heavy short-term borrowing by governments, when coupled with fiscal imbalances, can be a recipe for financial market crisis. Credibility comes from monetary policies aimed at achieving price stability, avoiding either general increases or decreases in price levels, and fiscal policies that avoid imbalances and unsustainable public sector debts or deficits. In short, in the absence of an external control on fiscal and monetary policy, policymakers and politicians must act with a great deal of discipline.

However, we also know, particularly from Asia, that fiscal and monetary rectitude is not sufficient. Many of those countries had strong fiscal positions and sound monetary policy, but still suffered from international financial uncertainties. Microeconomic and financial policies must also be credible. The policies that are most responsible are those that allow free markets to work without undue intervention from governmental authorities. We have learned that governmental influence in private sector borrowing and investing decisions is to be avoided. This is all the more true because, as the research has shown, a larger portion of cross-border investment in the modern era appears to be in sectors in which financial performance and the valuation of assets is harder to gauge. In those circumstances any hint of governmental support is certainly to be avoided.

Recently some have proposed the creation of "target zones" for major currencies, presumably in order to create, in part, greater stability in global financial markets. I think that these proposals are unlikely to work. We have seen on several occasions that the scale of resources required for the authorities to move exchange rates in directions not supported by the fundamentals, or by market perceptions of those fundamentals, can be enormous and effects in terms of exchange rate movements relatively small and transitory. If monetary policy is used to maintain the exchange rate within a target range, authorities at times may have to choose between maintaining domestic price stability and a currency target. Most monetary policy authorities recognize the value of maintaining price stability as one of the requirements for creating sound macroeconomic conditions for sustainable domestic growth. For the major countries, the benefits of an explicit focus on exchange rate stability, rather than price stability and sustainable growth, are not clear.

I believe that policymakers should support greater transparency in the reporting of their own operations, as well as in private sector activities that I discussed above. Better and more timely information promotes better allocation of resources, including the global allocation of capital. The financial crises of the last several years indicate that greater transparency is needed on levels of external debt, including short-term foreign currency debt of the central government, and on levels of international reserves, including financial derivative positions. For transparency standards to be most effective, they require as broad a participation by authorities as possible. Further, they must balance the need for comprehensive and timely disclosure with the need for accurate data. Improvements in financial data from the private sector, which I have discussed, is crucial, but public sector disclosure must not await improvements in private sector disclosure.

The IMF can contribute to public sector transparency with respect to critical economic variables through implementation of the Special Data Dissemination Standards, or SDDS. Voluntary compliance with SDDS by all countries will provide some assurance that economic transactions are not being based on misleading or incomplete information.

The Need for Capital Mobility

A third lesson suggested by the historical analysis is that the ability to attract foreign exchange is a critical element of a stable global financial system. In the modern context, I believe that this finding has two corollaries. First, we must avoid blocking capital flows, particularly of long-term funds. There have been policymakers who have advocated capital controls. I do not need to give a group of business economists a lesson in basic economics, but there are those outside of this room who need to be reminded of the benefits of free capital flows. Even though current international financial troubles indicate that there are risks from the free flow of capital, the benefits are substantial and contribute importantly to rising standards of living. As you know, an individual country's pool of savings does not always equal its pool of investment opportunities. If borders were closed to the flow of capital, interest rates would adjust to equilibrate domestic saving and investment, but some investment opportunities, which might be attractive by international standards, might go unfunded while less attractive domestic opportunities would be funded. With the free flow of capital, countries that have a greater pool of highly productive investment opportunities will benefit from the inflow of capital and those that export capital can put their savings to better, more rewarding use. This presumes the institutional underpinnings outlined above.

Protectionist impulses for measures that impede the flow of goods, services and managerial know-how must also be avoided. While participation in such free exchange across borders creates industries and individuals that are made better off and some that do not fare so well, we know that, on balance, all societies are better off from allowing the free flows of international competition. Given the fact that there are scarce resources globally, it is important that all resources be employed to their comparative advantage, thereby increasing the stock of goods and services available to us all.

Conclusion

Let me conclude by saying that while the current era of globalization is quite distinct from the period prior to World War I, there are important lessons that can be learned from that earlier era. Some historians have argued that the pre-1914 era was notable for the size and relative stability of capital flows. Thus far our era has been notable for the size of international capital flows, but recently not for the stability. I do not doubt that there is room for improvement in the regimes that determine capital flows. However, I think that most of the solutions to the challenges that the world has faced require building institutional mechanisms and policy expertise that allow reliance on the strengths of the free market system. Improvements in policy discipline, information sharing, and institutional structure should all be evaluated by the litmus test of whether they enhance the flow of information to, and reduce bureaucratic interference with, markets and thus provide a safer and more stable global financial and economic environment.

Footnotes

1 Bordo, Eichengreen, and Kim, *Was There Really an Earlier Period of International Financial Integration Comparable to Today?* National Bureau of Economic Research Working Paper 6738, September 1998.

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