The Federal Reserve Board

Remarks by Vice Chairman Roger W. Ferguson, Jr.

2004 Distinguished Alumni Award, Sidwell Friends School, Washington, D.C.
May 22, 2004

Economics and Ethical Behaviors

I am pleased to be here today and honored to accept the Sidwell Friends School Distinguished Alumni Award for 2004. It is awe-inspiring to be included in the company of so many accomplished graduates, including Walter Gilbert, Hanna Holborn Gray, Antonio Casas, Helen Colson, and Bill Nye. All of you, as Sidwell Friends graduates and friends, clearly understand the value of a good education. Indeed, economists have long noted an "education premium" in compensation, with college-educated workers earning approximately fifty percent more than workers with no more than a high school education.[1]

However, you also know that a good education is more than just the classroom-based learning of facts, or even the skill of critical thinking. A truly outstanding education also encourages moral behaviors and appropriate decisions. Sidwell Friends, with its grounding in Quaker traditions, certainly values the moral and ethical development of its students. Fortunately, many schools teach the importance of choosing the "hard right over the easy wrong." That is where I will focus my brief remarks. From my perspective as a policymaker, I want to commend the emphasis on a complete education, with technical, critical thinking, and ethical components, and encourage you and other schools to, if anything, redouble your efforts to instill moral values and ethical behaviors. Obviously, we as Sidwell graduates hope to exemplify those values as much as possible in our personal and professional dealings. Similarly, I encourage the current generation of students to take advantage of the moral and ethical training available at these schools. Do not forsake a solid grounding in those topics that will help you to do "good" while you are learning the skills required to do "well."

Some of you may have noticed that I encouraged this focus on teaching and practicing ethical and cooperative behaviors as an economic policy maker. In that role, shouldn't I encourage you to be only a coolly self-centered, utility-maximizing, *homo economicus*? The answer is no. Economic outcomes are improved when market participants "play by the rules." This fact has a strong grounding in economic theory and empirical research. In fact, you may be surprised to know that the economics profession, even with its hard-headed assumption of rational actors pursuing their own self interest, has for the last few decades also focused on the role of moral and cooperative behaviors in leading to better economic outcomes.

As one major example, a recent Nobel Prize in economics was shared by George Akerloff, who in a classic paper in 1970 showed that a failure of markets arises when the seller does not share honest and complete information about the quality of a product, in his paper, used cars, with would-be buyers.[2] Akerloff went on to show that such asymmetry in information and opportunistic behavior will ultimately drive honest dealings out of the market unless it is overcome by new institutional structures. Some of those structures arise from the private sector. As a policymaker, I see many of those structures arise in the form of regulation. In

those markets in which there is a strong likelihood that self-policing behavior will not emerge, and opportunistic behavior is a real risk, the government must create regulation to protect the weaker or less-well-informed party from the stronger, better-informed one. These regulations are well intended and often have the desired outcome; however, in spite of the regulators' best efforts, they can be burdensome, and compliance with them may well consume resources that might go to providing more or better goods and services. This is not an argument against regulation; sound regulation is needed. It is an example of the cost imposed on society by the unscrupulous behaviors of a few.

Not only have economists identified theoretical failures that come from unethical and opportunistic behaviors, social scientists have also demonstrated real world benefits from cooperative behaviors. For example, a study of engineers found that individual workers who are more generous with their time with other workers, and in turn frequently benefit from the help of others, are more productive and have higher social standing.[3]

More recently of course, the entire economy, that is to say all of us, have experienced the costs of unethical behaviors in a matter of great macroeconomic consequence. The recent accounting and governance scandals were sufficiently numerous and serious to generate widespread concern among investors about the reliability of financial reporting in general. These scandals were a notable factor behind the U.S. stock market slide in the spring and summer of 2002, amidst the cascade of scandals culminating with WorldCom's revelations in June that year. And concerns about corporate governance probably contributed, at least in some measure, to the heightened business caution and sharp fall-off in business investment during this period. Thus, although other, more important factors were also working to restrain real activity during this period, it seems likely that the scandals exacerbated an already weak economic situation. Just as opportunistic behavior by individuals calls forth regulations as a counterweight, so too these corporate governance scandals have called forth new laws and regulations, which were probably the proper response and required to restore confidence, but which have almost surely added to the cost of doing business.

The negative effect from lapses in corporate governance at the macroeconomic level in the United States is a very visible example of the national costs of poor corporate governance. Social scientists have also found that at the level of the individual company poor corporate governance costs and good corporate governance pays, quite literally. Some researchers have found that investments in firms which engage in unethical behavior earn abnormally negative returns for prolonged periods (Long and Rao, 1995).[4] Others find that firms that have better corporate governance also have higher stock market valuations, higher profitability and faster sales, and there is evidence that buying shares of firms that score high in corporate governance and selling shares in firms that do not yields abnormally positive returns (Gompers, Ishii and Metrick, 2003).[5]

All of this is true not just in the United States, but globally as well. At the macroeconomic level, the World Bank has identified corruption as the single greatest obstacle to economic and social development. The Bank states that "corruption undermines development by distorting the rule of law and weakening the institutional foundation on which economic growth depends."[6] Fortunately, there is some evidence from studies of emerging markets that firm-level corporate governance matters more in countries with weak legal systems, and one can infer from this work that firms can partially compensate for ineffective legal systems by practicing ethical behavior.[7]

Let me close by saying that the economy of the United States depends greatly on an educated workforce. My own research demonstrates that our productivity boom of the last nine years requires a talented and flexible work force.[8] Education, however, must be broadly defined to include moral and ethical behaviors and good decisionmaking. There is plenty of evidence that such behaviors pay an ample reward to the individuals who make them and, unfortunately, the absence of such behaviors extracts a cost, potentially from all of us. I am pleased to have attended a school that continues to value such an education, encourage all schools to emphasize such training, and am truly honored to accept this award from my fellow alumni.

Footnotes

1. Card, David and John E. DiNardo, Skill Biased Technological Change and Rising Wage Inequality: Some Problems and Puzzles, *Journal of Labor Economics*, Vol. 20, No. 4, (2002), pp. 733-783. Return to text

2. Akerloff, George A., The Market for Lemons: Quality Uncertainty and the Market Mechanism, *The Quarterly Journal of Economics*, Vol. 84, No. 3 (Aug., 1970), pp. 488-500. Return to text

3. Flynn, Francis J., How Much Should I Give and How Often? The Effects of Generosity and Frequency of Favor Exchange on Social Status and Productivity, Academy of Management Journal, Vol. 48, No. 5 (2003), pp.539-553. Return to text

4. Long, D. Michael and Spuma Rao, The Wealth Effects of Unethical Business Behavior, *Journal of Economics and Finance*, Vol. 19, No. 2, (Summer 1995), pp. 65-73. Return to text

5. Gompers, Paul, Joy Ishii, Andrew Metrick, Corporate Governance and Equity Prices, *The Quarterly Journal of Economics*, Vol. 118, No. 1, (Feb., 2003), pp. 107-155. Return to text

6. The World Bank Group, The New Anticorruption Home Page. Return to text

7. Klapper, Leora F. and Inessa Love, Corporate Governance, Investor Protection and Performance in Emerging Markets, *Journal of Corporate Finance* (forthcoming). Return to text

8. Ferguson, Jr., Roger W. and William L. Wascher, Distinguished Lecture on Economics in Government: Lessons from Past Productivity Booms, *Journal of Economic Perspectives* (forthcoming) Return to text