CENTRAL BANKING IN A GLOBAL ECONOMY

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to the Canada-U.S. Business Association
in Toronto, Canada
September 25, 1991

It is a great pleasure for me to be here in Toronto, and I am honored to have the opportunity to address the Canada-U.S. Business Association. I have chosen as my topic central banking in a global economy. In gathering my thoughts for today's presentation, it struck me how much things have changed since I first joined the Federal Reserve over 25 years ago. At that time, Federal Reserve officials traveled abroad far less frequently than today to discuss policy coordination or international banking, much less the "global economy." In fact, I do not believe that phrase had even entered common parlance. Although the Federal Reserve paid some attention to international affairs, we focused our attention almost exclusively on the domestic front. Even since 1983, when I became president of the Federal Reserve Bank of Atlanta, the political and economic changes in the world have been truly amazing.

Almost more quickly than we can comprehend, the world has crossed into a new frontier of interdependent economies. Perhaps because we are in the middle of so much dramatic change, we may not be fully aware of the progress we have made. The industrial economies have made enormous strides in advancing our individual national economic interests by looking outside of our own countries. Many less industrialized nations have achieved sufficient domestic economic development to become full-scale players in international trade. Financial institutions have forged ahead even more rapidly to create global money and capital markets.

Policymakers have facilitated this progress in many ways. Trade liberalization agreements have laid the groundwork for much more extensive economic ties among nations. Policymakers have also acted to coordinate exchange rates in order to facilitate international commerce and keep trade flows from being distorted or imbalanced. After the breakdown of the Bretton Woods agreement in 1972, for example, and an experiment with freely floating exchange rates for the next decade, the G-7 countries addressed the currency misalignment problems that had surfaced during the mid-1980s. In addition, industrialized economies recognized the need for more uniform regulatory treatment of financial intermediaries and jointly set higher capital standards for banks through the Basle Agreement.

Central banks played a key role in both of these agreements. They also play a less noticeable part, often on a day-to-day basis in other areas of international economic relations. Although the Federal Reserve is not involved at an operational level with the international payments system, the Fed, along with the central banks of other G-7 countries, is actively working to develop international payments-system risk policies. The Fed is also a key regulator of international banking, both in terms of supervising U.S. banks' overseas activities and overseeing foreign banks operating in the United States. Finally, through the foreign-exchange trading desk of the Federal Reserve Bank of New York, the Federal Reserve System counters disorderly conditions in currency markets, finances short-term credit arrangements with foreign governments, and, from time to time, carries out exchange stabilization on behalf of the U.S. Treasury.

Clearly, challenges remain on the horizon in many of these areas. In my remarks today, I would like to address the two specific aspects of central banking with which I deal on a regular basis--monetary and regulatory policy. Both of these public sector tools, which obviously have a considerable effect on the private sector, are now also entering a new era in order to keep pace with the demands of our greater economic involvement with the world around us. Along these lines, I would like to talk about some of the policy issues and obstacles on the road to enhanced international trade and financial flows.

On Progress with Free Trade--Where are We Today?

Let me begin with a quick review of where we stand today in our efforts to achieve a freer trading environment. As members of an organization set up to further business ties between the U.S. and Canada, you know that much of the progress we have seen in living standards around the world since 1945 has been founded on international agreements that support free trade. Because of the importance of free trade, I am frankly somewhat disheartened that the progress in furthering the General Agreement on Tariffs and Trade has stalled, although it is encouraging that more talks have been scheduled. Our ultimate goal must always be worldwide free trade and this goal can be achieved only through multilateral forums like the GATT.

In the meantime, many policymakers and economists suggest that in the not-too-distant future the global economy could be dominated by three major trading zones coalesced around the United States, the European Community, and Japan. As a foreshadowing of this division, they point to trade agreements along these geographic lines that are now being negotiated. For example, the U.S.-Canada Free Trade Agreement, along with the proposed pact with Mexico, would create a North American trade zone surpassing the EC as a marketplace. The EC itself is a trade bloc that currently has Germany as its key country. Smaller blocs, such as the Andean Pact in South America, are also creating trade opportunities in lieu of a broader multilateral agreement. It is my belief that these trade zones will afford each of the participating countries a chance to resolve the kinds of issues that are holding up an expanded GATT accord. In this way, they could serve as pilot projects for an eventual worldwide free trade zone. However, unless the will to perfect the GATT is rekindled among its signatories, the transition to global free trade could be stalled at a sub-optimal plateau of regional trading blocs.

The Role of Monetary Policy

While the Federal Reserve and the monetary authorities of other nations do not play a direct role in trade liberalization, our policies can help significantly in maintaining the momentum of trade liberalization. Aside from the activities I mentioned a moment ago, central banks, and the Fed in particular, can enhance international economic interchange through the influence of monetary policy on exchange rates. The Fed does not "target" the value of the dollar vis-a-vis other currencies as a policy goal. Nonetheless, as the U.S. economy has become more open, we certainly have become aware of the importance of international developments to the health of domestic economic sectors. Policy choices that lead to high interest rates or rapid inflation relative to those of our major trading partners can skew our currency, making it harder for domestic producers to sell their products abroad or to compete at home against imports. Conversely, by lowering inflation and keeping price pressures in check, monetary policy can not only minimize distortions to commerce and investment that inflation brings but also work toward making our currency more stable.

Are stable exchange rates so important? There are, to be sure, a variety of sophisticated financial instruments to help businesses conducting foreign trade hedge against the often volatile fluctuations in foreign-exchange rates. Nonetheless, I believe that a more stable dollar would be a great stimulus to international trade, particularly on the part of smaller U.S. companies. A number of smaller or less developed countries also seem to believe that more stable currencies are important. Beginning in the late 1980s, the central banks of many countries--from New Zealand to Mexico--adopted a more aggressive anti-inflationary stance in their monetary policies in order to prepare their domestic economies for full-scale participation in world markets. Some of these countries have also taken steps to bring their fiscal houses in order, reining in bloated public sectors that had encouraged inefficiency and waste. Such fiscal policy moves, of course, amplify the effectiveness of monetary policy's anti-inflationary stance.

The potential effects of these policy shifts are not limited to containing domestic price pressures and thus indirectly fostering more stable exchange rates. They also represent a greater unity of purpose in economic policy worldwide, thereby making it possible for a more effective degree of international policy coordination to emerge. There are those skeptics who question whether such coordination is possible or desirable. To that charge, I would emphasize that policy coordination does not mean that every nation must follow in lock-step with the same policies. Coordination does not mean sameness. It means harmony. When coordination is achieved through federation, as perhaps will occur in Europe, individual countries can pursue--at least temporarily--more inflationary policies than others. They can choose to bear the associated costs in terms of their exchange rates and their trade balances, if such a policy formula better suits domestic preferences. In the EC, the tension between the standard of fiscal and monetary restraint set by the already wealthy nations could remain at odds with the domestic interests of less industrialized countries like Portugal and Greece. Canadians, I dare say, do not have to be reminded of the difficulties associated with designing policies that satisfy a heterogeneous population.

Even in a complete economic union like the United States, we have seen that there is room for considerable variation at the local and regional level, at least in regard to fiscal policy. Some states like New York have met their residents' demands for extensive social programs, regulation, and other public sector involvement in the economy, but they have taxed themselves to pay for these outlays. In other areas like the Southeast, with which I am most familiar, states have tended to keep taxes low and the regulatory burden lighter. They see this as a way of fostering economic development and higher living standards for a working population whose incomes have traditionally lagged behind the rest of the nation. I am not endorsing either approach. In fact, both have problems. New York's higher social benefits have attracted people from other regions and its taxes have created cost disincentives for businesses, leading many to relocate outside the state. The South's low tax base has tended to cause underinvestment in important social programs, particularly education.

I mention these two contrasting types of state policies merely to support my thesis, while over time we are moving toward greater uniformity in policy, significant diversity can persist, even in a fully integrated economic union. The main point, however, is not that coordination is difficult to achieve or limited in its effectiveness but rather that it can be quite helpful in reaching the ultimate goal of every country's domestic economic policy--raising living standards. Thus, monetary policy can play an important role in this process by setting the stage for formal international coordination. Even when such concerted international actions are not needed, monetary policy, as I have tried to show, can help domestic businesses engage in commercial or financial transactions with other countries. Central banks do so by fostering appropriate monetary and economic growth and by containing inflationary biases that distort exchange rates as well as many other aspects of business activity.

U.S. Performance

Let me turn now from the more or less theoretical role of monetary policy in regard to international trade to the specific performance of the United States. In looking back over the past several years, I am proud of the record of the Federal Reserve. In the late 1980s, the Fed began a sustained effort to renew the fight against inflation. We had waged an intense and successful campaign earlier in the decade, bringing price pressures down from double-digit levels. Then, after several years when the core inflation rate seemed "stuck," so to speak, at around 4 1/2 percent, we discerned signs of renewed acceleration in prices. While we have not yet been able to achieve our stated goal of price stability, price pressures have abated considerably in response to the restrictive monetary policy pursued by the Fed beginning in the late 1980s. This progress allowed us the leeway to be more accommodative toward the demand for credit in order to help bring the economy out of recession.

Whatever success we have had with regard to inflation is all the more significant in view of the fact that fiscal policy has not undergone the kind of shift toward restraint that had been widely expected with the passage of the Gramm-Rudman Act in 1985. That legislative effort to reduce the U.S. government's massive budget deficits ultimately proved ineffective. A new budget reform law promises to be more workable over time. In the meanwhile, fiscal policy has remained excessively stimulative, and the resulting fiscal-monetary policy mix is not ideal. The Fed's efforts to fight inflation might have been more effective if there were not such an inflationary bias in our economy associated with large federal deficits.

Looking ahead, I remain concerned about this bias despite the new Congressional commitment to fiscal restraint. That concern is grounded in the enormous array of unfunded contingent liabilities to which the U.S. government has committed itself and the U.S. taxpayer. The onset of the savings and loan crisis and the ever-growing deposit insurance costs associated with the thrift industry debacle have made us realize how these can become real and massive liabilities. Unfortunately, we have even more promises to pay--in case of default--by a number of government-backed agencies.

At the same time, we need to invest more in our human capital through improved educational and health care systems, and in our physical capital--roads, bridges, and other infrastructure. Yet, because of our low savings rate, we have been a borrower from the rest of the world. These issues, together with the inflationary bias that our large federal budget deficits add to our economy, could make the United States more a source of strains and tensions in international economic relations than a dynamic force fostering cooperation.

What this means is that the United States has yet to come to terms with its own social preferences. We are unwilling to tax ourselves for the social programs we have put into place, yet we are equally unwilling to live with fewer of these programs. In the long run, the dynamics of the global economy will force us to address this issue. Certainly, the lesson was driven home by our huge trade deficits of the 1980s, which exerted a devastating impact on manufacturing. This imbalance forced us to begin the process of fiscal reform as the basis for the Plaza and Louvre accords on currency coordination. I can only hope that it does not take another such crisis to keep us on the road to greater fiscal responsibility.

The Role of Regulatory Policy

I do not want to leave you with a completely pessimistic impression. It is true that the failure of fiscal policy to complement monetary policy makes it harder for the Fed to promote sustainable economic growth--nationally or internationally. Still, we at the central bank are working to promote freer trade flows through oversight of financial markets, which are, after all, the lifeblood of commerce in goods and services. I believe there is cause for optimism in regard to financial regulation. As I mentioned, international accords have been fashioned for several areas of financial regulation ranging from capital standards to money laundering. There is more work to be done, I admit, as the BCCI affair has vividly shown us, in regard to coordinated regulation of international banking institutions.

Of course, as on the monetary policy side, regulatory coordination cannot take place in a vacuum. Rather, domestic policies need to be appropriate to support coordination. In the case of the United States, we need some fundamental banking reforms in four critical areas--deposit insurance, capital standards, prompt resolution, and further geographic and product deregulation. The most basic reform, in my view, ought to be directed toward deposit insurance. Although deposit insurance has helped to shield the banking industry from systemic bank runs and has provided security for small depositors, it has also contributed to what is perhaps the U.S. banking system's most critical problem, namely, overcapacity. Deposit insurance has served as an implicit subsidy, making it attractive to open a bank in an already crowded banking system. As a result, we now have too many banking institutions vying for too few sound loan prospects, reducing profitability to unsustainably low levels. Ultimately, this situation poses a risk to taxpayers.

To some extent, the marketplace has begun to solve the problem of overcapacity through consolidation. Indeed, recently, some of the larger banks in the nation have begun to merge. However, the public sector must also play a role in the solution to overcapacity, because it has inadvertently contributed to the problem--both through regulation that created protected markets and by deposit insurance. While I believe it is socially desirable to keep deposit insurance, it is equally important, in my opinion, to reduce the deposit insurance subsidy. Over time this goal should be accomplished in large part through increased capital levels, perhaps even higher than those agreed to among international regulators. The reason to increase capital levels for all banks is to put them in a position of having more to lose from excessively risky behavior; in turn, they will ultimately be less likely to draw on our insurance fund, in part because of the greater cushion each institution would have. Of course, I do not expect market discipline to carry the entire responsibility for financial system safety and soundness. When banks begin to get into trouble, prompt resolution is essential, and that, in my view, must be the third plank of any effective reform platform. More specifically, regulators must be authorized to require institutions to take immediate steps when capital ratios fall below established thresholds. Regulators need to be able to act quickly, when needed, while paying appropriate attention to due process.

After bolstering banks' capital and reducing the deposit insurance subsidy, I believe Congress should allow a general expansion of bank powers. In particular, sound banking institutions should be allowed to get into the securities, mutual funds, and insurance businesses. Such expanded powers together with nationwide interstate banking is the fourth element of reform, as I see it. In a sense, we have interstate banking now, but the patchwork of regional agreements among the 50 states has added to the expense of crossing state lines and branching. The holding company structure of the United States' banking system requires redundant layers of management as well as boards of directors for institutions seeking to operate in a national context. Ideally, banking institutions could simply convert their subsidiaries into branches and then move to consolidate their corporate and operational structures. This approach would be a relatively quick way to reduce some of the overcapacity that plagues the industry, increase efficiency, and thereby enhance banking profitability.

While these proposals point to the need for some fundamental reforms in U.S. banking, I would like to point out that in some respects our experience with these weaknesses will be a strength when it comes time to venture farther out into the global economy. Canada's Big 6 and the banks of most European countries have virtual monopoly franchises. They have not really been tested by much competition. Could it be that these institutions are not quite at "fighting weight"? In a global economy, such banks could go head-to-head against many other institutions, both smaller and larger, putting the implicit safety net of these countries to the kind of test we in the United States have already been enduring. Therefore, while the U.S. banking system may appear to be weak now, it may also turn out that our experience with adversity has helped to toughen our banks and to educate our policymakers. If that experience leads us to the basic reforms I have outlined, U.S. banks should be better able to compete in an integrated world economy and to meet international companies' financing requirements.

Conclusion

In conclusion, the task that confronts policymakers today as we enter a global economy is daunting but attainable. Central bankers are positioned to play a key role in this process through their behind-the-scenes activities in banking regulation and the payments system as well as in their better known role of formulating sound monetary policy. In the United States, the Fed's job could be greatly enhanced by Congressional commitment to control federal spending and legislative action to modernize our banking system. Though progress on this side has been slower than I would have liked, I remain hopeful that U.S. legislators will enact the kind of banking and budgetary reforms I have outlined today. In doing so, the United States will be able to make its fullest potential contribution toward achieving a truly global economy.