

THE ROLE OF SMALL COUNTRIES IN INTERNATIONAL FINANCIAL MARKETS
Remarks by Robert P. Forrestal, President
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and The American Icelandic Chamber of Commerce
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It is a pleasure for me to be here in Reykjavik on my first trip to Iceland. It is also an honor to have the opportunity to address the Icelandic and American Chambers of Commerce. I vividly remember the impact Reykjavik had on the world in 1986 during the summit between former President Ronald Reagan and then General Secretary Mikhail Gorbachev. Little did we know at that time how much the world would change politically in just five years. Similarly, the creation of the "1992" program will soon launch a much greater degree of economic integration in Europe. We are also in the vanguard of tremendous changes in the financial markets, which are forging ahead at a rapid pace to become truly worldwide in their linkage. These changes have profound and positive implications for all countries, both large and small.

The role of small countries is, in fact, my topic today, and I will be focusing on Iceland. This afternoon I would like to talk about how your country has done a good job in preparing itself to become a stronger participant in today's increasingly global commercial markets and, in my judgment, what more it can do. Along these lines, I will be giving special emphasis to your role in financial markets, particularly in terms of access to sources of financing and investment. First, though, I would like to set the stage by addressing the larger issue of what globalization means, especially in financial markets.

The Global Marketplace

While I admit that the term "globalization" may have become a bit overused, it is, nonetheless, clear that the world's industrialized economies have made enormous strides in advancing their national economic interests by looking outside of their own countries. Many less industrialized nations are also achieving a degree of economic development to become full-scale players in international trade. Financial institutions have progressed even more rapidly to create truly global money and capital markets. Today capital moves across national borders primarily as investment flows and secondarily as international trade financing. In dollar terms, global financial transactions today stand at a historically high multiple of world trade volume. Growing interconnections among financial markets have been made easier thanks to advances in communications and computer technology.

In order to keep pace with the increased volume and scope of financial transactions, the financial industry has turned to automated trading systems. These are transforming the traditional way securities are traded. In the past, traders concluded a trade face-to-face or over the telephone. Now, however, what used to be done exclusively on the trading floor in a physical marketplace is gradually being replaced by networks of computer terminals. These systems not only serve to open markets geographically; they also are laying the groundwork for 24-hour trading in order to satisfy customers around the world.

To my mind, the most valuable effect of these integrated global markets, which are tied together by phone lines and computers, is that every country in the world can play a role. Not

too many years ago, a country like Iceland located near the Arctic Circle in the North Atlantic did not have as much access to capital markets as the big economic powers of the world. Often their best hope of overcoming this isolation was through close ties with a particular country. Now, however, the globalization of financial markets, together with their automation, is giving far wider access to credit to all would-be borrowers.

Currency Coordination

At the same time that the world is becoming a more prosperous and open place, thanks to the increasingly global scope of trade and finance, we are also seeing the emergence of trading blocs. Some observers predict 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. They point to the trade agreements adhering to these geographic lines that are now being negotiated as a foreshadowing of this division. For example, the U.S.-Canada Free Trade Agreement, along with the proposed pact with Mexico, would create a North American trade zone with more consumers than the EC. Through the Europe 1992 agenda, the EC itself is taking steps that will further open up trade and financial flows among member countries. Japan has strengthened its ties with several Asian economies, and a number of South American countries are liberalizing trade relations among themselves.

Such trade zones can afford each of the participating countries a chance to resolve the kinds of issues that are holding up an expanded GATT accord. Thus, they could serve as pilot projects for an eventual worldwide free trade zone. However, I would not want to see trade

liberalization permanently limited to the regional level, which is clearly less beneficial than free trade on a worldwide basis.

In my view, much of the progress we have seen in living standards around the world since 1945 is founded on multilateral agreements that support free trade. Because of the importance of free trade, I am frankly somewhat disheartened that progress through 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 ultimately be achieved only through multilateral forums like the GATT.

Although financial markets are setting the pace and standard for worldwide interchange, there are certain counterparts to regional trading blocs, namely, direct and indirect systems of linking currencies of countries. The EC is an example of direct exchange rate coordination, in which foreign exchange rates are fixed relative to one another within a trading range. When one country's currency moves persistently outside this band, its value vis-a-vis the others must be renegotiated. While not part of the Europe 1992 program, Europeans are already discussing the merits of moving to one currency and a single Central Bank for the whole EC. Governments can also decide to peg their currency to another country's currency in the form of an indirect currency bloc as, I believe, you have done with the Icelandic krona. By linking it to a marketbasket of 17 currencies, Iceland has positioned itself to have closer ties with the EC.

There are both costs and benefits to either form of foreign-exchange coordination. The main advantage is that pegged currencies can make accounting easier among trading partners. 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, a stable currency makes trade easier by removing uncertainty. Another potential advantage to formal currency coordination is that countries involved must pursue a more disciplined course in fiscal and monetary policy choices. Taking Italy as an example, we have seen how that country has had to change some of its ways in order to gain the maximum benefit of EC membership. In recent years Italy has worked to bring inflation under control in order to stabilize the lira, after an extended period during which policy was inflationary. This discipline is also the main disadvantage. A country loses some of the autonomy to pursue independent macroeconomic policies. That means the government may have to look to other sources, such as taxes, for deficit financing. This can be particularly problematic when a country cannot, at present, afford the taxes to finance the large public spending favored by certain segments of a heterogenous population.

My point is not that central banks should necessarily "target" the foreign-exchange value of their currency as a policy goal. Nor am I advocating the abandonment of the floating exchange-rate system that replaced Bretton Woods. Nonetheless, as foreign trade takes on greater importance to domestic producers, retailers, and consumers, policymakers will have to give greater consideration to the international sector. Countries will continue to have the choice of joining a currency union, pegging exchange rates, or standing alone. Over time, though, most

countries will need the kind of domestic economic policies that support a stable exchange rate. This principle even applies to large economies like the United States, which has become much more open. Certainly, the lesson was driven home by our huge trade deficits of the 1980s, which exerted a devastating impact on U.S. manufacturing. This imbalance forced us to begin the process of fiscal reform as the basis for the Plaza and Louvre agreements on currency coordination in the mid-1980s.

Strategy for a Small Country: What Iceland Has Done and Needs to Do

Let me turn now to the relationship of these major developments--particularly globalization of financial markets, automation of financial transactions, and greater coordination of exchange rates--to Iceland. Clearly, Iceland's leaders have decided that it is important to be seen as a full participant in world markets. The Atlantaf aluminum smelter project represents a way to begin diversifying your economy, so that it is not heavily dependent on the fishing industry. In terms of financial markets, Iceland's effort to bring inflation under control is commendable and will serve to stabilize the krona and to allow a freer flow of international financial transactions. These are important steps toward a stronger economy. Interestingly, they have been adopted by a number of smaller economies as well as lesser developed countries, ranging from New Zealand to Mexico. Such a shift in domestic policies--from those associated with high inflation and large public sectors to those that lay the groundwork for more international trade and finance flows--has become something of a trend. This fact means that countries which fail to make such adjustments will be left even more isolated and on the periphery of the global economy.

Now that Iceland has taken these basic steps, I am sure that you are looking to expand your circle of trading partners. Common wisdom would have you becoming part of the EC over time. As I understand the situation, however, protection of your fishing industry looms as a stumbling block. It seems quite possible that Iceland may want to pursue a strategy, helped by its geographic position, of not tying into one trade bloc, but playing to both sides of the Atlantic. As the westernmost European country, Iceland sits in an enviable position. Although in some senses Iceland is historically linked to Europe, it is geographically rather close to the United States and Canada. In fact, the United States is one of Iceland's two major trading partners. In order to broaden its horizons in this way, Iceland must continue to embrace greater access to international capital markets. I was glad to learn that in 1990 the government began to relax its capital controls in areas such as the right of residents to make foreign investments and the ability of mutual funds to invest in foreign securities. With all limits to be abolished as of January 1993, the length of the transition period appears quite reasonable.

I am also pleased that in the last half of the 1980s your central bank was granted more independence from the government and more control over the monetary policy. As a central banker, I can attest to the importance of a politically independent monetary authority. This principle is fundamental to the Federal Reserve System and is embedded in many ways in its organizational structure. The autonomy we enjoy in the area of monetary policy helps us to avoid the political pressure to inflate the economy that, at one time or another, every government is prone to exert as a short-term solution to problems. This principle of independence helps the Fed pursue monetary policy that works for the country as a whole and for the long term.

Notwithstanding Iceland's advances, I believe that there is more to be done. I understand that certain restrictions still apply to transactions in foreign exchange. For example, residents are not permitted to purchase currencies of other countries for the purpose of holding foreign-currency bank accounts. I am aware that there are short-term costs associated with the complete elimination of capital controls. Kroner will inevitably flow out of Iceland into other parts of the world as Icelandic businesses and households seek higher-yielding investment opportunities elsewhere. In turn, domestic interest rates could rise. In the long-run, however, foreign investment in Iceland is likely to increase, leading to an improvement in your country's current account position with the rest of the world. Freer access to foreign credit markets will not only take the pressure off domestic interest rates but also help Iceland's economy as a whole become more stable and diversified.

All in all, Iceland's demands for funds to support its financing and investment needs will be better served by globally integrated financial markets. You may be curious as to whether these changes have any implications for the supply side of financial markets. In my view, there is not much of a role for small countries to play in this regard. Largely because London was the first to set up its stock market, it now has a lock on the financial markets in the European world. Not even Germany has been able to challenge London's dominance. There is, of course, always the example of Switzerland, which has had a major impact on financial markets through its meticulously regulated banking industry. However, Iceland simply is not as centrally located as Switzerland. It is questionable whether there is another complementary niche. Singapore has

tried to exploit its time-zone advantage by offering round-the-clock trading in certain markets, but it is doubtful whether this role is having a significant local economic impact.

Some small countries have carved out a unique role in banking markets by following a laissez-faire policy of banking regulation. These standards--perhaps I should call them "substandards"--have served to attract some less-than-exemplary financial institutions and activities. BCCI comes to mind as a vivid example of what can evolve out of this kind of home-country regulatory environment. I sincerely doubt that any country wishing to be a stronger participant in international trade would benefit by building its economy on the basis of such a strategy. In fact, the world is going in the opposite direction--toward increased regulatory coordination.

Conclusion

In conclusion, I believe Iceland is at a propitious point in its economic history. Inflation is beginning to be brought under control. A freer flow of international capital transactions has been authorized. You have begun to diversify your economy. Not surprisingly, you have not quite reaped the fruits of your initial labor. You also have more work to do in opening your financial sector. Still, you have made advances that many countries in the world--some much larger than Iceland--have yet to embark upon. Overall, I believe that, with the enhanced access to credit that globally integrated capital markets bring, Iceland will be in a position to play a successful role in international trade. In addition, you are well positioned geographically to take advantage of trade with partners in both Europe and the Western hemisphere. I see no reason

why Iceland should not be able to translate these opportunities for enhanced multilateral trade into solid economic growth and even higher living standards for its people.