THE GLOBALIZATION OF FINANCIAL SYSTEMS AND THE IMPLICATIONS FOR U.S. BUSINESSES AND POLICYMAKERS

Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
To the University of Georgia International Finance Seminar
Atlanta, Georgia
May 12, 1992

The growing economic integration in the world certainly highlights the need for this conference on measuring and managing foreign exchange risk. Simply put, the more trade there is, the more companies need to learn to deal with exchange rate risk. Meetings such as this are vital to reaching a wider range of businesses that can take advantage of financial instruments. These include not only swaps and exchange-traded futures and options, but also the new exotic options that are now beginning to move from the realm of theory into the marketplace. Since most of your sessions focus on how to manage these instruments, I plan to take a different tack and present my perspective as a policymaker. Although this view tends to be macro rather than micro, I do have a few passing observations to make on the micro level. To set the stage, I would like to start with a brief history of foreign exchange.

Brief History of Foreign Exchange

People have been trading items to satisfy their needs since the beginning of time with no worries about exchange rates. Either they bartered item for item or they paid for their purchases with specie coin that had its own intrinsic value. Even after many economies moved to fiat money, there was little systematic concern about exchange rates because most currencies were tied to a gold standard. Individual countries occasionally experienced problems, but these were usually the result of problems in domestic policies. So it was not until this century that we began to worry about the fluctuations of currency values as the exchange rate system varied between fixed and floating rates.

The modern history of foreign exchange begins with the Bretton Woods system in 1944. After World War II, there was a feeling among leaders of the industrialized countries that letting exchange rates float completely would lead to volatility and would hinder efforts to normalize their economies. Once they agreed to a system in which government intervention would peg exchange rates around the price of gold--or, alternatively, the gold content of the U.S. dollar--leaders could turn to post-war reconstruction. Thus, the Bretton Woods system assured stability in world financial markets by, in essence, pegging currencies around the dollar, which substituted for gold reserves because the U.S. government was committed to redeeming the dollar reserves in gold at $35 an ounce. No other country that had been on the gold standard before World War II returned to it.

Problems with the system began in the 1960s due to inflation caused by attempting to finance the Vietnam War and Great Society programs without a tax increase. By the late '60s, as more countries were coming into their own, economically speaking, nations such as West Germany became unhappy about importing U.S. inflation into their country via dollar reserves. In other countries, domestic problems were causing price pressures to mount, but they were unwilling to preserve their exchange rates by either adjusting their fiscal and monetary policies or devaluing their currencies. For instance, throughout a troublesome economic period in the mid-'60s, the British government put off devaluing the pound for several years until a reserve crisis developed, and it was essentially forced to devalue in 1967.

The strains upon the Bretton Woods system that would lead to its eventual demise in 1973 began to be resolved in 1971. In that year, President Richard Nixon instituted wage and price controls in the United States, took measures to devalue the dollar, and closed the gold window, which meant that the United States would no longer convert dollars into gold for foreign central banks.

Following this action, the industrialized nations fashioned one accord after another to try to make Bretton Woods work, but as economic conditions changed, these accords tended to break down. Then, in the early 1970s two large shocks in the form of an agricultural shock and the oil shock of 1973, brought on recession throughout the industrialized nations. These shocks finally sealed the fate of the Bretton Woods system. Following the dissolution of the system came an experiment with floating rates. In moving from fixed rates to floating rates, the ensuing volatility resulted in uncertainty and higher costs for businesses that were involved in foreign trade.

In response, markets that had experience with forward transactions developed financial futures as a way to help businesses hedge the risk of fluctuations in foreign exchange rates. Both the Chicago Mercantile Exchange and the Chicago Board of Trade had led the way in establishing forward contracts for agricultural commodities. Let me add here that such forward transactions have a long history going back to medieval fairs. In the 13th century, the Magna Carta gave foreign merchants the right to travel to England for such fairs. Although most of the trading was done in spot cash for immediate delivery, this is where the practice of future deliveries began. Halfway around the world, Japan first set up commodity exchanges in the 1700s, and forward contracting in rice on the Osaka Rice Exchange was legally recognized in 1730.

In the United States, forward contracting was routine in Chicago as of 1833. The Chicago Board of Trade was founded in 1848 and dealt mainly in grains. The supply-and-demand problems created by the Civil War brought about the development of futures contracts by the late 1860s. Late in the century, the Chicago Mercantile Exchange began life as the Chicago Butter and Egg Board. Following its name change in 1919, the Merc slowly began to add futures contracts in other commodities such as cheese, apples, and frozen turkeys.

It was near the beginning of the end of the Bretton Woods system that the Merc recognized the possible need for developing forward transactions in financial commodities like foreign exchange. In 1972, the International Monetary Market began trading seven foreign currencies. (The Board of Trade also helped to establish the domestic importance of financial futures in 1975 when it introduced interest-rate futures, starting with Ginnie-Mae (Government National Mortgage Association) certificates and later adding U.S. Treasury bond futures.)

Meanwhile, the world did not stand still. A number of European countries devised the Joint Float Agreement in 1972 as it became clear that the Bretton Woods system was failing. At this point, the Smithsonian Accord had allowed currencies to vary 4.5 percent against the dollar. Since the European countries thought a variance of 9 percent was too wide and unstable, they agreed on a fluctuation around established rates for EC currencies of half that amount while keeping the overall variance around the dollar. This arrangement came to be known descriptively as the "snake in the tunnel" because, when charted, the curves of the movements of the EC currencies appeared to look like a snake inside the fatter tunnel of the 4.5 percent dollar band. Eventually, the Joint Float proved to be unworkable as five EC members withdrew for various reasons.

Following the final collapse of Bretton Woods, the oil shock, and the volatility ensuing from floating rates in the 1970s, nine European countries banded together to form the European Monetary System (EMS) in 1978. These countries agreed to keep their bilateral exchange rates within narrow target zones while continuing to have flexible rates with outside currencies. The EMS appears to have been a logical progression from the fixed rates of Bretton Woods to the "snake in the tunnel" to fiscal coordination and closer integration of the economies of these European countries. In fact, the EMS has been fairly successful because its member countries have been prepared to implement and maintain domestic policies that are broadly consistent with those of the other member countries and so with closely aligned exchange rates.

Policy misalignments elsewhere in the world created the need for the Plaza and Louvre accords, which were a retreat from free-floating rates. These accords addressed specific imbalances in world economies, such as the obvious over-valuation of the dollar in the early 1980s. While the Plaza accord of 1985 called for the dollar to depreciate while the Deutschemark increased in value, this accord would not have succeeded without the United States' promise to restrain fiscal policy, although we have not yet come to terms with this serious issue.

As I see it, the next big watershed for the system of foreign exchange rates will be the advent of the European Community at the end of this year. EC 1992 presents new challenges and opportunities. The possibility of a single EC central bank and a single currency will obviously smooth payments transactions among the European countries. At the same time, however, it will require more fiscal discipline than many European countries have been willing heretofore to impose on themselves.

Where Do We Go From Here: The Increasing Role of Free Trade

Where we in the United States go from this point will be dictated by the increasing role of free trade in the world. Besides the emergence of EC '92 as an important new trading force, the United States itself has gone through a big transformation on trade. This country is doing much more trade than it did 30 years ago. With some allowance for fluctuations, exports as a percentage of gross domestic product (GDP) have gone from around 4 percent in 1960 to nearly 8 percent in 1991, while imports have gone from nearly 3 percent in 1960 to almost 9 percent in 1991. In fact, recently, exports has been one of the strong points in our economy that helped to dampen the recent recession. Real export growth will continue to outpace overall GDP, despite the relatively sluggish economic performance of Europe and Japan. The strong demand for capital equipment in Latin America in particular has the added benefit of having boosted manufacturing in the United States to meet this export demand.

The great strides we are seeing in the economies of many Latin American countries promise even wider avenues for trade. I am pleased that initial steps have been taken close to home, with Mexico and Canada, in the form of the North American Free Trade Agreement (NAFTA). It also looks as if the former communist bloc countries are making steady progress toward market-based economies. That means there is great potential to bring these countries into the family of industrialized nations over time.

Above all, we must remember that free trade is of utmost importance because domestic markets have become saturated in the industrialized countries. Here in the United States, it does not help our economy significantly to sell yet another pair of expensive running shoes to the same customer who bought some last year. What we need most are new customers in new markets for our goods and services, and the greatest opportunities for such growth are in developing countries. That is why I strongly believe that the nations of the world must solve their disagreements and sign the General Agreement on Tariffs and Trade (GATT) as a fundamental step toward global integration.

Challenge to Policymakers and the Financial Marketplace

The challenge to policymakers is to determine the kind of policy setting vis-a-vis exchange rates that is appropriate to continue fostering this growth in trade. Even if we were able to achieve zero inflation--an ideal situation for foreign exchange because there would be no need for currency realignments--this challenge would remain important because many developments could have different impacts on different countries. Supply shocks, for example, could upset the balance among countries, just as we saw in the 1970s between oil-exporting and oil-consuming nations. With our more open economies, the ramifications of such shocks would be even greater than before.

In a sense, it seems we are experiencing the after-effects of a shock right now. During the 1980s, several large industrialized countries had stimulative policies and a good degree of leverage in their economies. Now these countries, especially the United States, are going through a period of de-leveraging and fiscal restraint to correct the imbalances associated with the policies of the last decade. As I mentioned, we are also seeing EC ’92 as an effort to impose fiscal self-restraint on Europe.

The result of this de-leveraging, however necessary it may be, is slower growth than that to which people have become accustomed. In turn, the effects of slow growth--higher unemployment rates and slower growth in personal income, for example--have led to a rise in nationalism and protectionism. When people feel vulnerable, they look for protective mechanisms, both on the personal and national level. This situation also causes people to worry only about the short term to find ways to make their lives better. That is why the real challenge to policymakers is to let this very positive de-leveraging process play itself out. While the process may need to be slowed somewhat through policies that mitigate the transition pains, we must guard against adopting "quick fixes" that undo the groundwork that has been laid. Business people, voters, lobbyists--all of us--must come to accept the fact that central banks and governments cannot create a world free of economic risks.

Turning to the private sector, there is an equal need for self-restraint in the way these sophisticated financial instruments are marketed. If those who are buying and selling such instruments do not understand them well, there will be more room for costly errors and bad judgment, similar to what occurred with the repo market in the mid-1980s. The purveyors of financial instruments have a responsibility to keep clients apprised of the risks they are taking. Those who are selling these financial futures must educate their customers, not merely sell to them.

Conversely, customers, too, must realize that by using a financial future to hedge their foreign exchange risk, they are not home free. After all, they are dealing in a market for forward contracts as well as an organized exchange. Even if they succeed in hedging exchange rate risk, they cannot hedge credit risk. If we could find a way to do that, banks would be in much better shape than they are today.

The point I would like to make from all this is that if both parties do not act prudently, and a financial debacle results, regulation will surely follow just as we have seen again and again in the financial services industry. Although regulation is important for the safety and soundness of the banking industry, too much regulation tends to make transactions more cumbersome.

Conclusion

In conclusion, many of us in this room may sense that we have entered a brave, new world filled with ever more intricate financial instruments. But we cannot lose sight of the very reason we find ourselves in this challenging situation, and that is because international trade has become more commonplace and more important to our prosperity. We are all gathered here because we share a commitment to free trade--through GATT, through NAFTA--and because we know that open markets serve the world best. Policymakers can help ease concerns about foreign-exchange rate risk by keeping inflation to a minimum. It is equally true, however, that market participants must also act responsibly so as to prevent the distortion of an innovative and truly free-market creation.