

Speeches

Policymaking in the Global Environment

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Thank you for that very generous introduction, and thank you, ladies and gentlemen, for honoring me with your presence this evening.

When Charlie Steindel approached my office about speaking to the Money Marketeers last November, he indicated that you were interested in hearing about what motivates my thinking as a monetary policymaker. Rather than identify a single fulcrum on which policy turns, I'd like to take advantage of this setting—in the financial capital of the world—to talk about globalization.

I realize that at some Wall Street cocktail parties, globalization ranks right up there with Y2K, the wealth effect and the new economic paradigm as conversation fodder. But the ways in which globalization affects the formulation and implementation of economic policy remain relatively unexplored. It's this aspect of globalization that I'd like to discuss with you tonight.

As it's commonly understood, globalization describes the integration of international economies through increases in trade, investment flows and technology transfers. Integration in each of these areas has been facilitated by rapid advances in telecommunications and information technologies and by an international policy environment that emphasizes trade liberalization, privatization and deregulation of financial markets. In addition, the failure of command economies to deliver a standard of living even remotely comparable to the one produced by market economies thoroughly discredited nonmarket approaches to resource allocation and so further stimulated the globalization process.

For money marketeers, globalization provides an environment in which financial resources flow almost instantly to the highest risk-adjusted return. For policymakers, globalization provides a market discipline that is vigilant and unyielding. Because these repercussions are so profound, it's worth considering what market discipline is and how it works.

Simply put, market discipline is a consensus of market participants' expectations as expressed through prices and capital flows. Expectations include (but are not limited to) the current and future actions of a country's public and private sector; the prices and capital flows that reflect those expectations vary as the consensus changes.

Market discipline has been writ large in Asia, where the outlook has been—to put it mildly—substantially revised over the last 14 months. Throughout the region, exchange rates and interest rates—and therefore asset prices—were inconsistent with underlying economic fundamentals, including monetary, fiscal and regulatory policies. The need to attract capital compelled some governments to support exchange rates that were increasingly at odds with these fundamentals. This strategy worked as long as governments were able to commit the resources and maintain the legal and political environment necessary to support their targets. But when they couldn't, and when there was money to be made in exposing the inconsistencies, the actual consensus changed in a hurry.

This episode demonstrates two things. First, governments can sometimes get away with inconsistent policies, depending on their resources and the flow of information. Second, they cannot get away with them forever. When policy inconsistencies are brought to light—as they always are—capital inflows plummet, growth slows (or stops) and unemployment increases. It's a pattern we've seen time and time again, most recently in Russia these last few weeks, Mexico in 1994 and 1995, and the United Kingdom in the wake of its withdrawal from the Exchange Rate Mechanism Accord in 1992. Even countries like Japan, whose wealth allowed it to maintain inconsistent policies for years, are ultimately held accountable by the market.

While the Asian crisis is not yet fully understood, it's all too clear that the miracle that preceded it did not include development of an economic infrastructure sufficient to sustain economic growth. Moreover, too many economic policies in Asia were increasingly at odds with the market's emphasis on transparency and consistency.

Indeed, the market has become much more vigilant about weaknesses in economic infrastructure, including property rights, accounting conventions and bankruptcy and commercial law. It is, of course, perfectly appropriate that discipline be enforced in these countries. One of the market's primary functions is risk pricing, and that's very difficult to do without transparency and the consistency of information facilitated by a developed economic infrastructure. What's difficult, though, is that meaningful reform takes a considerable amount of time and leadership, while the market demands changes now. This dilemma reminds me of that old labor saw: The beatings will continue until morale improves.

In the United States market discipline is ubiquitous but less obvious, probably because it has been embedded in the economic infrastructure for so long. Still, that doesn't make markets any less vigilant or give policymakers any more room for error. Any economy, no matter how developed, is vulnerable to external shocks—not to mention policy errors. And in an environment in which economic conditions are monitored in real time, markets may demand evidence of policymakers' response without regard to the widely recognized policy lag we must contend with.

Of course, policymakers everywhere worry about shocks. But the role of the U.S. economy in the global marketplace presents an additional challenge for American policymakers. Not only must we consider the effects of our actions in the United States and its trading partners—what I'll call the direct effects—but we must consider the ways in which those actions are retransmitted, the indirect effects, as well. Both considerations demand a global focus.

Let's start with the direct effects. The mandate of the FOMC is chiefly *domestic*. We're charged with delivering the best economic conditions we can as defined by, among other things, the inflation rate, GDP growth, the unemployment rate and the safety and soundness of the banking system in the United States. But the policy

environment in which we attempt to achieve this mandate is global. No economic condition in any part of the world can be considered exogenous. And any action intended to produce a strictly domestic result is almost instantly transmitted around the globe and may or may not be countervailed by a concomitant change in international economic conditions. (I'll revisit these *indirect* effects shortly.)

Globalization also means that in some circumstances a *domestic* result—one intended to benefit the United States principally—might be most effectively obtained by responding directly to developments in international markets. Somehow this view of economic policy has come to be seen as soft, as allowing—even encouraging—countries to escape the consequences of their own bad choices, as exacerbating moral hazard. And it is indeed the case that some international initiatives can do all of these things. But to the extent that an action by the Fed or the Treasury Department ultimately serves our domestic policy objectives, I think it's pretty hard-nosed.

But let me clear about this: An initiative by U.S. policymakers in international markets should not be a matter of indemnifying lenders. That would represent a contradiction of our mandate and would have awful economic and moral hazard repercussions besides. Nor is it a matter of undoing the consequences of another country's bad policy choices. That would be an overly expansive reading of our mandate and ignores the fact that those consequences cannot be avoided. No, an international action by U.S. economic policymakers can serve our interests only to the extent that it contains or reallocates economic losses away from the United States.

Think of the United States and Mexico in 1995. In this case, Mexico endured a deep recession and an acute financial crisis, the consequences of which it continues to struggle with today. It is inconceivable to me that the enduring lesson of that crisis is that the risks taken by Mexican policymakers were justifiable or would be again. If anything, the peso crisis serves as an abiding example of the terrible and unavoidable consequences of bad policies and bad timing.

But, more important, it illustrates that achieving a domestic objective—which, for the United States in 1995, was carrying the current expansion through its fourth year—can sometimes be more satisfactorily achieved through an international initiative.

This idea raises a major challenge to policymakers in a global economy, which is understanding the *indirect effects* of our actions. When markets on opposite sides of the planet have access to the same real-time information, when nothing is exogenous, when the law of physics that says for every action there is an equal and opposite reaction becomes a law of finance, it becomes impossible for us to limit our influence to the American economy, however much we might wish to do so. Markets act, we react, and markets react again. As those policy effects are absorbed by counterparties and trading partners across our borders, they're redirected back toward us and again change the economic environment in which we operate. These indirect effects—the millions of places where, as they say in the South, we meet ourselves coming back—also weigh heavily in our policy deliberations.

So understanding the indirect effects of our actions is one of the most basic and daunting challenges facing policymakers. The standard forecasting models—the ones with the longest track records—were developed for a fairly closed economy and are simply inadequate. But if modeling an economic environment with more than two players is a colossal technical challenge, replicating policy and economic developments in the dominant global player is exponentially more difficult. As I've mentioned, no factors can be treated as exogenous to the economy. And the policy effects and anticipatory policy effects we observe in so much data are nearly impossible to model.

Simply *understanding*, then, remains a primary challenge for economic policymakers. We must better understand how global economic developments affect the U.S. economy. And at the same time, because of the powerful indirect effects of our choices, we must better understand how our policies affect the rest of the world and work their way back home through the global economic system.

This effort to understand the direct and indirect consequences of our policy choices is vitally important—and not just as an academic exercise. We need look no further than Asia in the last 15 months and Mexico earlier this decade for a reminder that for policymakers, what goes around, comes around.

At the Atlanta Fed, we're trying to add some understanding of our own. We don't know nearly enough, but we are not completely in the dark, either. Economists in our Research Department are working on several projects that I believe will contribute to a more thorough discussion of the impact of globalization on the policy environment. Some of our findings are decidedly unconventional, but all of them raise questions that sorely need to be addressed. With your indulgence, I'd like to share some of our (more provocative) work with you.

It is an article of faith on Wall Street that open capital markets—those markets in which financial capital moves with a minimum of legal, regulatory and operational restrictions—best serve investors and recipients. And in countries where the economic infrastructure—capital markets, bank supervision, property rights, etc.—is well developed, this is indeed the case. But recent research by Atlanta Fed economist Marco Espinosa argues that, in countries where the banking infrastructure is not well developed, completely open capital markets may be something less than optimal. Banks may over-rely on short-term liabilities, which, in turn, make them much more vulnerable to changes in market sentiment and expectations. Espinosa's analysis suggests that providing incentives for banks to lengthen the average maturity of their liabilities may contribute to more stable economic growth. In other words, under certain circumstances and at certain stages of economic development, some countries may benefit from some degree of (government-imposed) financial interdiction. I should emphasize, however, that Marco's work is *not* an argument for closed capital markets; it is widely accepted that capital controls impose long-run costs. It is, instead, an argument that financial liberalization, or market liberalization, should be pursued simultaneously with improvements in the economic infrastructure.

Other work examines the effects of international illiquidity on a banking system. A mismatch of short-term international obligations can allow a currency crisis to become a banking crisis as well. Theoretical work by Atlanta Fed economist Roberto Chang and visiting scholar Andrés Velasco—and later tested using data from Latin America and Asia—goes a long way toward explaining recent crises by clarifying the connection between currency crises and banking crises. It has strong policy implications for preventing crises and for rectifying them when they emerge. The work suggests, for example, that during a currency crisis, the first priority should be the provision of liquidity. Otherwise, the banking system will be pulled into the maw as well. Structural reform may be essential, but in the heat of a currency run, financial obligations must be honored first in order to prevent a problem from spreading.

Finally, the Atlanta Fed's Latin America Research Group has been examining, among other things, the efforts of Latin American governments to reign in spending, which has been the primary impetus for inflationary finance. In addition, the Latin America group has been examining the impact of accounting reforms on reported past-due loans at banks, and so forth. Lately, this work has helped us draw important inferences about the vulnerability of Latin American countries to financial crises in other parts of the world and the possibility that these vulnerabilities will spill over into the United States.

This work does not address all the questions surrounding economic restructuring, nor is it intended to. But it does demonstrate the kinds of issues that policymakers—monetary, fiscal and business policymakers—must consider in the real world.

Taken as a whole, our research reinforces our enthusiasm for market liberalization. It also suggests, however, that financial liberalization must be engineered carefully if a country is to reap its full benefits, and that adjustment costs must be accounted for when implementing market solutions. Structural reforms that are beneficial in the long run may be detrimental in the short run; opening financial markets to outside investors, for example, can make an economy—however well developed—vulnerable to a banking crisis. Among other things, our research can be taken to support the careful coordination of financial liberalization with structural reform in the banking system. These insights ought to give us pause the next time we consider recommending liberalization in a country that is not ready or able to strengthen its banking system; this may make the risks of liberalization unmanageable. Finally, the research suggests that if structural reforms are to yield any net improvements, they must establish momentum and fortify the banking sector first.

Globalization complicates the policy environment. It presents enormous opportunities for capital. But it also presents equally formidable challenges for those of us whose job it is to sort it all out, to take advantage of it or to understand where the policy action is. In the global economy, our policies are more influential than ever, although the equation through which we calculate them is more complex. Understanding that equation is the challenge.

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