A Lemon-Free Marketplace: Or the Fruits of Transparency in a Global Economy

Remarks By Jack Guynn
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
Carter Center’s Conference on Transparency for Growth in Latin America
Atlanta, Georgia
May 4, 1999

President Carter, President Mahuad, Prime Minister Musa, President Robinson, members of the Council of Freely Elected Heads of Government and distinguished guests: It is an honor to join you this afternoon.

I know that the purpose of this conference is to evaluate specific anti-corruption efforts in Latin America and the Caribbean, but I’d like to begin with a general acknowledgment of the progress we at the Atlanta Fed have seen in this area. Through our supervision of the U.S. operations of many Latin and Caribbean banks, we’ve become familiar with many of the anti-corruption initiatives in your countries, and, from our perspective, the region is substantially better off than it was 10 years ago. I know that many of you here today are personally responsible for these gains, and I congratulate you for your heroic efforts.

But my purpose today is to talk about transparency less as an element of criminal or civil law (I’ll leave that to the legal experts) than as an element of resource allocation—of economic law.

The role of the Federal Reserve System is to help ensure a smooth-functioning, stable U.S. economy. This mission includes maintaining economic growth, full employment and low inflation at sustainable levels, and we attempt to fulfill it through the combination of monetary policy and bank supervision. Of course, the immediate goal in each of these roles is different—we affect national purchasing power through monetary policy and help ensure the safety and soundness of the nation’s financial system through bank supervision. But the long-term goal—economic stability—demands that we execute both successfully. And we cannot do either without accurate, timely and relevant information.

This afternoon, for the benefit of those of us who do—but shouldn’t—take transparency for granted, and for the benefit of those of you who wish you could, I’d like to recount briefly the theory and some recent history that remind us that our economic fortunes cannot be separated from the free flow of accurate information.

For economic policymakers, transparency refers to the availability of accurate and timely information that enables businesses, consumers, investors and policymakers to make informed decisions. But only someone who’s lived in a transparent environment long enough to take it for granted would think that implementing transparency is as easy as describing it. Because transparency—while worth it in the long run—is not for the faint of heart in the short run.

The reason is that implementing transparency almost always requires the individual who controls information to sacrifice the potential for personal gain for the broader benefit of shareholders and ultimately the economy at large. And while policymakers tend to emphasize that transparency is not without its costs—both financial and otherwise, particularly since compilation and dissemination of accounting and related information is often very expensive—I believe these concerns are misplaced.

My argument today is that the economic case for transparency is overwhelming; that the benefits of transparency—including lower costs of capital, more efficient allocation of resources and lower costs to taxpayers—for outweigh the costs; that in the long run all of these things lead to greater economic growth and stability; and that the benefits ultimately accrue to the individual and society as a whole.

All of these conclusions follow directly or indirectly from ideas best articulated in an interesting and very influential article written by an economic theorist. Twenty-nine years ago, economist George Akerlof wrote a paper on the used car market called “The Market for Lemons: Quality Uncertainty and the Market Mechanism.” In the United States, defective products are often called “lemons,” and Professor Akerlof demonstrated that in a market for goods in which quality varies and in which the seller has more information about the quality of the goods being offered than the buyer, good products and bad products must sell at the same price. When buyers have no way to distinguish between products—when they are forced to assume the worst—the market price tends to be the lemon price, and good sellers eventually leave the market. Thus do bad cars, bad money—bad whatever—drive out the good.

“The purchaser’s problem,” as Akerlof put it, “is to identify quality.” Akerlof said, “There may be potential buyers of good quality products and there may be potential sellers of such products in the appropriate price range; however, the presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.”

In essence, what Akerlof is describing is the situation faced in any market in which there is incomplete, inaccurate information—where there is a lack of transparency. Whenever the buyer knows less about the market than the seller—regardless of whether the seller intends to mislead or simply does not know—the buyer must assume the worst. When he does, prices will not reflect the true values of goods, whether those goods are stocks, bonds, commodities, labor or any production process input or output. Moreover, we understand that the buyer will overpay for inferior goods and underpay for quality goods, and, in general, aggregate demand will decline; buyers and investors will suffer losses; and a significant percentage of legitimate enterprises will simply go out of business or never arise to begin with. In short, this simple framework suggests that lack of transparency will lead to mispricing of goods, misvaluation of investment projects, higher prices for inferior goods, lower investment and, ultimately, less economic growth.

This dismal picture does not lead to the pessimistic conclusion that markets will fail—just the opposite, in fact, because the dire predictions of the consequence of the lack of transparency also suggest that, under certain circumstances, natural market mechanisms, if encouraged and supported by government policies, will be mobilized to rectify the lemons problem.

In particular, owners of superior goods will find it advantageous to reveal to the public the quality of the goods being placed on the market, even if they have to incur...
real costs to do so. It is not uncommon, for example, for sellers of used cars to make all maintenance records available to prospective purchasers or to purchase extended warranties, which can be transferred to buyers.

Clearly, in the case of companies, release of accurate and timely information on their performance to shareholders will serve to lower the costs of capital—provided that lemons companies don’t attempt to release misleading information to confuse the public. And it’s here where government intervention—call it information policing—can benefit private firms and society as a whole. For example, policies to ensure that firms release and disclose accurate and timely information can keep bad firms from misrepresenting themselves and ensure that resources are devoted only to productive information purposes.

So far I’ve discussed the lemons problem in terms of the individual firm. But the role of transparency applies to governments and central banks, too, particularly as markets become more global in nature, and its absence can help explain recent events in international financial markets.

For example, in July 1997, the Thai baht fell nearly 32 percent after it was revealed that the Central Bank of Thailand in fact held far fewer reserves than it had been reporting. Thailand, you’ll recall, had been selling the baht in the forward markets but was not deducting its forward position from current reserves. When the market learned of Thailand’s practice after the reserves were exhausted, it responded by driving the baht even lower. Thus did the scenario that Thai policymakers most want to avoid become the worst kind of self-fulfilling prophecy. At the close of 1997, the baht had fallen 91 percent and the Thai stock market 31 percent.

Having been sold a lemon in Thailand, the market suddenly and dramatically reassessed the information it was getting throughout much of the rest of Asia. And as Akerlof might have predicted, the market assumed the worst. By the close of 1997, currencies had fallen 150 percent in Indonesia, 90 percent in Korea, and 58 percent in Malaysia from July 1997. Stock markets fell in a similar fashion as investors suddenly reassessed the quality of the information they had access to and decided that they could not distinguish between solvent and insolvent institutions and governments, and in the short run it was too costly to attempt to resolve the information problem.

Now, to be sure, much of this reassessment simply reflected the fundamentals. That is to say, markets readjusted to the true underlying conditions in these markets because they were bad, and not just because they were more transparently bad. Greater transparency did not cause the fundamentals to suddenly get worse. But it is also clear that more transparency to begin with would have made it much less likely that financial or economic bubbles would have formed in the first place. Transparency also would have mitigated substantially the impact of the market’s retrenchment (if, indeed, a retrenchment had been required at all).

Of course, in Thailand it turned out that officials avoided transparency because they had something to hide, as did the Suharto regime in Indonesia; as did Prime Minister Muhammed in Malaysia, as did bank administrators in Japan, etc. And while the object of their obfuscation ranged from earlier policy choices (in the case of Thailand) to apparent outright theft (in Indonesia), the repercussions to society—and to the parties engaged in the cover-up—were ultimately far more serious than the thing being covered up. In Malaysia, GDP growth went from 7.7 percent in 1997 to negative 6.7 percent last year. Indonesia went from 4.6 percent to negative 13.7 percent, Thailand from negative 0.4 to negative 8.0 percent, and South Korea from 5.5 percent to negative 5.8 percent. Unemployment exploded across the region. In short, the real costs of the absence of transparency were ultimately borne by the society as a whole, and not simply by those few who benefited from the initial absence of transparency.

All of this suggests (as Akerlof’s study did too), first, that greater transparency can not only improve pricing and asset valuation but can also help prevent policy mistakes and corruption from occurring in the first place and, second, that transparency helps deter an overreaction when problems (inevitably) do occur.

The United States’ own experience underscores both conclusions. The most obvious recent example, of course, is the savings and loan crisis of the late 1980s. Clearly, the implicit moral hazard created by mispriced deposit insurance was at the root of the thrift crisis, but Congress and regulators perpetrated an absence of transparency by tolerating accounting conventions that concealed the actual financial condition of many thrifts from investors and other creditors.

As some of you will recall, during the 1970s, there was a run-up and inflation of U.S. real estate values, which were financed by short-term interest bearing liabilities. As rates continued to rise, portfolio returns shrank, and by 1981 many thrifts were economically insolvent. At first, they tried to grow their way out of their problems, even supported by borrowing under special programs from the Federal Savings and Loan Insurance Corporation. At the time—and this is the transparency part of the disaster—regulatory accounting practices even allowed these borrowings to be included in capital. Ultimately, what this did was obscure the extent of the problems in the S&L industry and make a very bad situation much, much worse.

For the United States, the S&L crisis was a reminder that transparency is not an either-or, yes-no proposition. It is, instead, a process that lies along a more-or-less continuum and that must evolve with the economy and with the evolution of the financial services marketplace. What was transparent yesterday, in other words, might not be transparent today.

It’s interesting to note how a few of the responses to the thrift crisis reflected a better understanding of the importance of transparency. The deposit insurance system was overhauled, and regulatory mechanisms were established to ensure that federally insured institutions would not be permitted to operate with negative net worth. In addition, by making regulators publicly accountable to Congress whenever taxpayer funds are expended on troubled institutions, Congress gave regulators the incentive to address those institutions promptly.

The more you consider the implications of Akerlof’s model and the ways in which markets seek and require information, the more powerful its framework becomes in helping us to understand economic events and propose solutions to problems. Two inescapable conclusions from the recent global financial crises are, first, that countries that seek to promote economic growth by importing foreign capital will not be able to avoid the discipline of the market and, second, that the less transparent policies are, the less capital will be attracted and the higher its cost will be.

One final thought: my premise today has been that a commitment to greater transparency is ultimately motivated by a nation’s rational self-interest, that it is a cause, a means to a self-serving but beneficent end. I should note that in countries where transparency doesn’t exist—or is on the lower end of the spectrum—lack of transparency is often an effect, a result, a symptom of other underlying problems. In these countries, citizens may still be burdened with the memory of their own history: maybe they’ve had property confiscated, or information they’ve provided (voluntarily or under duress) has been used against them by the government. This problem suggests that the process of transparency—especially establishing it in the first place—is part of a larger process of establishing the credibility of government. This process includes submitting to the accountability provided by the democratic process and the legal recourse provided by an independent judiciary. For this reason, among others, it’s especially appropriate that the Carter Center should be advancing the transparency agenda.
For policymakers, transparency means giving yourself no place to hide and others no reason to doubt what you say. It means, in other words, allowing the facts to speak for themselves. And while operating in the sunshine can be inconvenient, expensive and often personally uncomfortable, there is—practically speaking—no other alternative. To operate otherwise is to demand that the market assume the worst, and that assumption, ultimately, will be far more inconvenient, expensive and personally uncomfortable than anything that could happen in plain sight.

I commend you for your work on the critically important issue of transparency, and I thank you for the opportunity to share the theory and history that underscores its urgency.

CONTACTS
Jean Tate
404-498-8035