

Federal Reserve Bank of Cleveland

The Century of Markets

by Jerry L. Jordan

Governments have long pursued policies that determined the degree to which markets have been permitted to operate. But with the rise of global capital markets, we have learned that the opposite is also true—markets can affect national economic policies.

Business people know very well that market forces do not treat kindly companies that fail to satisfy their customers. Politicians also are now learning that global capital markets treat harshly governments whose policies fail to enhance the living standards of their people. Good business practices and good government policies both are essential to sustained prosperity. But there is an important division of labor. Private firms best enhance public welfare by producing goods and services at the lowest possible prices; governments contribute to the common good by establishing well-functioning institutions within which the society operates. Good business practices cannot effectively take root without good government policies.

During the twentieth century there was a massive increase in the intrusion of governments into economic affairs, but it is becoming increasingly clear that this wave has crested; the role of the state in economic affairs has begun to diminish. In the new century and millennium, a growing share of the world will enjoy the prosperity that comes from the “century of markets.”

■ Government Presence in the Economy

Just over 70 years ago, in the autumn of 1929, equity markets around the world entered a period of steep decline—so much so that the label “crash” is often

used to describe the events of 1929–30. Those developments and the ensuing policies brought about worldwide economic depression. Indeed, it is now well accepted that the 1930s were a “watershed decade” in which economic depression gave rise to public support for the nationalization of entire industries, and what remained privately owned was subject to pervasive governmental regulation. For several subsequent decades, decisions about what to produce, who could produce it, where to produce it, what prices to charge, what wages to pay, and many other economic decisions about interest rates, exchange rates, and even profitability were either made by government agencies or were subject to their approval. Remnants of many of those policies haunt us still.

I suggest the 1980s were another watershed decade, marking the beginning of the state’s withdrawal from economic affairs, and argue that recent trends to strengthen property rights and enhance the economic infrastructure of market economies on a global basis will endure for several decades into the future. The financial “crises” of our time largely reflect the breaking up of the old order. Moreover, the vestiges of ill-conceived government involvement in economic affairs will be under continuous attack. Social and political disturbances can be expected—the more highly industrialized countries are not immune—as the relentless pressures of global capital markets confront legacy government programs and agencies. The drive toward greater economic efficiency is an irresistible force, and governmental policies are not, in the end, immovable objects.

We are in the midst of a great transition, from an age in which governments intervened in nearly every facet of economic affairs to one in which market forces not only make political borders transparent to commerce, they shape political policies. This *Economic Commentary* is adapted from the John Bonython Lecture given by Jerry L. Jordan, president and CEO of the Federal Reserve Bank of Cleveland, at the Centre for Independent Studies in Sydney, Australia, in November 1999.

■ Market Forces at Work

From a historical perspective, the age of capitalism is now at most a teenager, and it is already evident that the power of unfettered markets to generate wealth is building momentum. Capitalism requires mobility of resources—goods, labor, and capital—so they may find their highest valued use. But resource mobility is an idea that is more often than not resisted by governments, whether democratic or authoritarian. Governments around the globe have used a variety of methods—with varying degrees of success—to restrict either the entry or the exit of people, goods, and capital. The collapse of the Berlin Wall just 10 years ago serves as a very visible symbol of the ultimate futility of erecting artificial barriers to at least one type of mobility.

Less visible, yet more pervasive, are the countless barriers to the mobility of financial capital. These, too, have been tumbling down in recent years. The process is still in the early stages, and we have no blueprints for constructing market mechanisms to replace ossified gov-

ernment mechanisms. Nevertheless, just as the global political environment has changed dramatically in the decade since the Wall crumbled, the global economic environment has started to move rapidly away from government-controlled markets.

■ The Search for Best Practices

Interestingly, the idea of irresistible market forces meeting seemingly immovable objects is commonplace in the world of business. Innovations continuously bombard the economy, forcing changes in how and with whom we interact. Business leaders are used to the idea that there is a continuous, never-ending search for best practices that can better accommodate new production processes or even produce different goods as consumers' tastes change in unpredictable ways. This is unavoidable because failure to recognize and incorporate superior management processes proves fatal in the marketplace. People in business know that it is not simply the quality and price of the product that must compete at a point in time, but entire business systems. These systems must compete in getting new products to the market and then getting them to the customer—when the customer wants them, how the customer wants them, and where the customer wants them.

Workers are subjected to the same forces, as the demands for what they can do and how they do it change as business changes its way of doing things. In response to the innovations bombarding businesses, the labor market undergoes substantial churning, leading to simultaneous job creation and job destruction. Workers must learn new skills and methods to deliver their services to employers, just as business must learn new processes to deliver its product to consumers. Uncertain and unforeseeable events affect both workers and businesses. There is no escape. Economic prosperity depends on the ability to recognize and react to those forces, whether for an individual in the labor market, a firm in the business sector, or a government in today's global economy.

Current management literature asserts the existence of business maxims or “first principles” essential to success. In economics there are also maxims or first principles. One is universally used by economists to argue for the elimination of barriers to the mobility of goods. That principle—comparative advantage—

holds that welfare is maximized when unfettered market forces determine where the opportunity cost of producing a good is lowest.

As trade barriers continue to erode and the principle of comparative advantage becomes universally operative, people are becoming accustomed to the idea of consuming goods produced elsewhere in the world. More recently, they have become used to the idea that various services, such as transportation, communications, and banking, may also be best provided by firms headquartered elsewhere on the globe. These trends, of course, reflect the dramatic changes in information and communications technologies that have brought ever-lower costs of comparing products and services over larger regions.

■ Best Practices and the Information Revolution

We all marvel at the new products and services that come from technological innovations. But it certainly is also true that the information technology revolution has accelerated the rate of obsolescence of old ideas and old ways of doing things. The well-known phrase of the Austrian economist Joseph Schumpeter about creative destruction is something that people in business live with every day; new products and new services render obsolete—or at least reduce the economic value of—old ideas, products, services, and ways of doing things.

The half-life of knowledge is getting shorter all the time. What one knows today becomes out of date faster than ever before. The inverse is that new knowledge must be acquired and incorporated much more quickly than before in order to stay in the same relative position. Political organizations and institutions must also change at an ever-faster pace.

There was a time in the not-too-distant past when people in commerce needed to look only at competitors within their national borders—especially in very large countries like the United States. In smaller, more open economies, business people learned early on that best practices were often found in other countries and that failure to respond quickly to them produced a possibly fatal competitive threat.

For a while, the expression “multinational company” described one that

operated internationally. It was a holding company, located in one place, that owned and operated businesses located in various other places around the world. However, in the early versions, there was not much more to it than ownership, since management techniques, labor market practices, input-factor sourcing, product distribution systems, and so on all remained local and distinct from place to place. Over time, though, the spread of best practices resulted in global companies succeeding over multinational companies. In other words, businesses found that what works best in one place works best in every place. The idea of local content or place of national origin became a political obstacle or burden to be overcome but not a desirable management practice.

Ultimately, it seemed to be simply untrue that there were best ways of doing things in Asia and quite different, but still best, ways of doing things in Europe, Latin America, or North America, all of which were different from each other. Instead, best practices meant simply that—it was best, with little regard for local social, cultural, or political settings.

■ Governments and Best Practices

This trend toward borderless commerce means that local political institutions are coming under increased scrutiny as well, and the reforms we are witnessing can be thought of as the sometimes grudging adoption of best practices. For most of history, the evolution of institutional arrangements in the political sphere progressed very slowly. Certain democratic institutions have migrated around the world for hundreds of years since the signing of the Magna Carta, but even in the twentieth century most of the world was not living under what would be considered the best practices of political and economic infrastructure.

There are, of course, many local, institutional, and political reasons for the slow adoption of superior political institutions, but the persistent forces arising from capital markets have meant that reform processes accelerate, forcing many of the old structures to crumble in their path. As informational barriers fall—and indeed we have witnessed substantial declines in the cost of acquiring information—it becomes easier to identify and compare different institutional arrangements, including tax policies, regulations, guarantees,

subsidies, and so on. This more intense international comparison is the additional force giving rise to institutional reforms. As the costs of acquiring information decline, it becomes more difficult to sustain bad practices. This includes more than just monetary and fiscal policies. The costs of engaging in corrupt behavior—as well as pursuing ineffective economic policies—have risen dramatically. In small villages, it has long been the case that “outlier behavior” was subject to discipline. Instant global communications extend the “village effect” into previously isolated places. Inappropriate behavior of both government ministers and business executives now results in “early retirement,” and maybe disgrace, more swiftly than ever before.

Even local judicial systems are not immune. If a country does not have a well-functioning legal system in place that protects property rights, businesses must offer a higher rate of return in order to attract or hold capital in the country. This increases the cost of capital, resulting in lower rates of investment, which will affect profits and the pace of real growth. That means fewer consumption goods and lower income per capita.

As it becomes easier for people to recognize where and how resources will earn their highest return, the half-life of bad government policies will become ever shorter. That is to say, global capital markets can have a major say in determining how long before a poorly performing government is forced to reform or is turned out of office.

Countries whose futures look bleak due to bad policies, such as massive unfunded pension liabilities, double- or even triple-digit inflation, lack of well-defined property rights, and so on, will not attract or keep the resources necessary to foster significant increases in their standard of living. They are destined to fall farther and farther behind in terms of per capita wealth, until the pressures for reform become overwhelming.

■ Crises and the New Order

In news reports, it is common to see people lament the apparent increased frequency of crises, especially in financial markets over the last decade. To repeat a point I touched upon earlier, a different interpretation of the phenomenon we are witnessing is that a crisis is a breaking down of an old order and the creation of

a new one. The evolving order is conducive to the rapid adoption of new processes and institutional arrangements that are superior to those they are replacing.

In a world with highly mobile resources, the lessons learned in a crisis invariably lead to changes in behavior that prevent a repeat of the conditions that led to the crisis. Once a crisis atmosphere has subsided, we rarely see reinstitution of the practices and arrangements that created the crisis situation.

This interpretation of what we are observing would suggest that the frequency of financial crises is evidence that the pace of adoption of new and better ways of doing things has accelerated. Borrowing from Schumpeter, just as there is a creative destruction in goods and services as new and better products come onto the market, so too in political and economic matters, the replacement of obsolete arrangements with more effective practices is a wrenching process.

It is essential to understand that, in a partial sense, wealth creation simultaneously involves wealth destruction. The true meaning of the expression creative destruction is that when something new and better comes along, the old—whether goods, services, or distribution methods—loses value. That means its economic or market value declines. When an upstart firm—for example, retail-distributor.com—comes along and gets the product to the consumer in a less costly, more timely way, then old methods of distribution are less valuable, and firms engaged in the old methods lose market capitalization.

The same is true of ideas and political and economic institutional arrangements. When new and better methods compete head-on with less effective existing methods, the old institutions must evolve, or they will perish. Foreign trade will be severely hampered in countries whose courts will not enforce the contracts and protect the property of their own citizens. Banks that engage in unsound local lending practices cannot sustain the risk-adjusted rate of return sought by foreign investors—unless government guarantees are involved. Governments with unsustainable fiscal policies, such as promising overly generous pensions to citizens, will find it increasingly difficult—or impossible—to raise taxes sufficiently or issue enough

new debt to meet their commitments. The discipline exerted by global financial markets is beneficial in that it erodes local resistance to more efficient domestic markets.

■ Brand-Name Capital

The erosion of barriers to trade in goods and services offers clues to what we can expect in monetary affairs. Today, brand-name recognition and identification are more important than ever. When a company like Sony produces a new product—a CD player—that is better and less costly than other brands, consumers will want to buy it. Consumers everywhere are the same—they want the best product for the lowest price! Only barriers to trade will prevent a superior product from gaining global market share.

Such “brand-name” identification of goods—which has made a product’s national origin irrelevant to consumers—is becoming evident in financial and monetary affairs. Lack of global specialization in the production of goods was due to governmental and technological constraints. International brand identification evolved as these constraints diminished. As we are now seeing in the monetary arena, brand identification of standards of value—money—also becomes more pervasive as falling costs of information and communications technologies make it increasingly easy to compare the quality dimension of standards of value.

While there are vested interests in maintaining local governmental monopolies over issuing of the national media of exchange, history demonstrates that national currencies inevitably must compete in the international financial arena. Countries whose monetary policies have resulted in large fluctuations in the value of the currency have come under pressure to adopt a system that prevents such behavior. This is just the “brand-name” argument—people want the best product or service. Currency boards and “dollarization” are two outcomes forced on many governments by their inability to assure stable purchasing power for the domestic currency. The “brand name” of currency used to denominate contracts and trade assets is more important than the “local content” or “national origin” of the standard of value.

It seems natural to extend such arguments to forms of government. There are a number of different models of government, just as there are many models of successful business operation. And, as best practices in governing evolve, countries that do not adopt such practices will lose “capitalization”; that is, they will fail to attract and hold a share of the world’s investment capital, and the process will culminate in much lower standards of living.

The expression, “vote with their feet” is still relevant for many less developed places on earth. Oppressed and impoverished people still flee bad governments in search of an opportunity for prosperity. That long-time tradition is now supplemented by the powerful forces of capital markets.

The crumbling of the barriers that have corralled the movement of goods, labor, and capital tells us that the role of government in economic affairs continues to ebb. An economic infrastructure that

best encourages entrepreneurship and wealth creation is becoming more commonplace. Integral to these changes is that fiscal and monetary policies are also becoming less activist and more predictable.

In the final analysis, sustainable long-term prosperity, whether at the global or the local level, occurs when human action is focused on converting productive resources into marketable goods. It is no longer useful to think of the government’s relationship to its citizens as that of an architect, engineer, carpenter, or to use any other metaphor implying activism. Instead, the role of the state is to nurture an economic garden—cultivating the soil to allow growth to take root, warding off pests that seek to feed off the budding crop, and keeping weeds from suffocating the plant before it achieves its potential.

I predict that in the twenty-first century—the century of markets—globalization and technology will force governments to establish the infrastructure that their economies need to thrive.

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

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