"Economic Forces versus Monetary Institutions"

by

Jerry L. Jordan
President and CEO
Federal Reserve Bank of Cleveland

presented at

Monetary Arrangements In The Americas After The Nafta

CATO Institute's 12th Annual Monetary Conference

Mexico City, Mexico

May 25-26, 1994

FEDERAL RESERVE BANK OF CLEVELAND
PO Box 6387
CLEVELAND
OH 44101

For better or worse, people have always liked to organize things. Even ancient, primitive tribes sought to organize their activities in order to improve their quality of life. A natural assumption is that if individuals simply cooperate with one another, more will be accomplished. The arrangements we refer to as "government" are a set of rules and organizations constraining the activities of individuals, presumably for the benefit of all.

People voluntarily come together in firms to pool accumulated capital and contribute their labor to produce goods for consumption or exchange. Similarly, political arrangements become a form of "social capital" -- networks of relationships created by past efforts. However, just as a firm with an unprofitable strategy or obsolete product cannot withstand the stiff winds of market forces, government institutions and agencies also face competition. To survive, both firms and government organizations must be "living organisms," capable of adapting to change. When policy design ignores the actions of resourceful, intelligent, opportunity-seeking individuals, it risks being overwhelmed by events beyond the control of even the most authoritarian government bodies.

As we ponder the question of monetary union, we should keep in mind the essential elements of survival of any arrangements in a dynamic global environment. What we have learned from the broad array of experiences with government involvement in economic affairs during the twentieth century is that successful policies have been those that enhance the effectiveness of markets. Those institutional arrangements and organizations that were erected to resist the onslaught of economic forces have crumbled in a heap of obsolete notions about the powers of government.

ECONOMIC FORCES AND POLITICAL INSTITUTIONS

Economic Forces--Many forces have been at work over the twentieth century -- certainly political, social, and religious forces have helped shape the course of events for these hundred years. Here, however, my focus is on those that I call "economic forces." These include technological changes or innovations; productivity increases; lower information, transaction, transportation, and communication costs; the phenomenon sometimes referred to as downsizing; and, of special note as the century draws to a close, the true value added from the rise of knowledge-based industries, as opposed to activities that exploit resources.

In the previous century and at the beginning of the twentieth century, we tended to measure the wealth of nations in tons and numbers: Tons of iron ore, coal, and metals produced, the numbers of logs cut, tons of wheat grown, and so on, combined to make a statement about the output or wealth of countries. But that is no longer appropriate. In today's world, those things produced by companies such as Microsoft -- the world's leader in software -- and other human-capital-enhancing enterprises have assumed more importance in determining the relative well-being of nations. Consider the poverty of some of the nations most rich in natural resources -- Africa, Brazil, and Russia -- versus the prosperity of countries like Japan and Switzerland, whose natural resources are quite sparse.

Political Institutions--Let me elaborate on what I mean by the term *institution*. Generally, an institution (or organization) can be defined as a set of humanly devised constraints. As such, the term includes governments, corporations, and families, but our attention at this conference is on government monetary institutions. In an increasing number of countries, these institutions operate in a broadly defined market environment, affecting men and women who are "searching and groping for opportunities" and who are faced with "resourceful coping with circumstances and environment encountered," as Karl Brunner put it so well.

Political institutions come in two varieties. The first is government organizations -- ministries, bureaus, departments, agencies, and central banks--and international organizations such as the IMF, the World Bank, and the Bank for International Settlements. Even the United Nations and NATO could be included here.

The second variety of institutions in a political context is *rules* -- meaning contracts, generally accepted accounting principles (GAAP), labor laws, laws of incorporation, the judicial system, and the enforcement of property rights. Rules also include various types of economic controls, such as wage, price, credit, interest rate, exchange, and capital controls, or even margin requirements. One would also include restrictions on financial industries such as loan loss reserves, capital adequacy standards, debt limitations, credit allocations, and leverage ratios.

Some of both of these types of institutions -- the organizations that are created and the rules that are laid down -- are intended to improve the workings of markets. Others, however, are geared to inhibit or alter the working of markets because the benefits of intrusion are perceived to be greater than the costs. That is the case when political or social objectives seem to be more important than economic efficiency. Such objectives as income redistribution -- a political decision to give priority to sharing wealth, rather than creating wealth -- result in institutional arrangements that reduce the efficiency of markets. The classic conflict of democracies is between an environment that fosters equality of opportunity versus a structure that seeks equality of outcome.

In selecting the degree of organization characterizing society, there are *trade-offs* between determining structure and preserving individual freedom. The threatening aspect of organizations and rules occurs when well-meaning policymakers start to believe that the solution to a problem always involves creating more organizations or rules. That is, there is a tendency for the public to demand solutions, so it is natural for policymakers to look to political methods of resource allocation instead of market methods.

Interplay of Forces and Institutions -- Some of what I call economic forces are irresistible forces, while some political institutions presume to be immovable objects. Even those political institutions that are intended to improve the workings of markets, and are designed to have a great deal of inherent flexibility, evolve in the latter direction.

In a pure market economy, there would be no institutions that we would call immovable objects. In a total command economy, on the other hand, *all* institutions would take on this characteristic. Ultimately, however, they would prove not to be immovable in the face of the irresistible economic forces in a global economy. The command economies of the former Soviet Union serve as the twentieth century's monument to the fatal conceit of central planning. The architects of new rules or organizations usually understand the need to create institutions that are capable of adapting to changing conditions. This is true not only of constitutions for governing, but also of the various agencies of government with specific missions.

When Markets and Institutions Conflict

People desire a stable framework for their activities. Without a modicum of certainty, people will not undertake investment in human capital, relationships, and physical capital.

The now-classic example of "The Costs of the Absence of Good Law" is provided by Hernando DeSoto, who discusses the resulting lack of investment in housing stock and production in Lima, Peru. DeSoto describes the former situation of "informal" (read illegal) housing in Lima. Property rights did not exist, and there was no recourse if the state or another individual confiscated property. As a consequence, people invested in TVs, cars, and movable goods -- not pipes, drains, sewers, and roofs. When property rights were more clearly delineated and enforced, housing investment was much improved: For the same class of occupants, formal housing was worth nine times as much as squatters' housing. Absence of property rights discouraged other types of investment as well, because informal housing could not be used as loan collateral.

Similar problems plagued the informal production sector in Peru. Again, with no legally binding contracts, investment in production was low and critical suppliers could renege on promises at the last minute, forcing inefficiencies. Informal textile producers, for example, tended to overdiversify suppliers: Instead of buying 1,000 buttons from one firm, they bought 200 from five. Moreover, property insurance was out of the question.

Latin American monetary reforms provide more lessons in how the market disciplines policy:

1) Argentina attempted a currency reform in 1979 , but did not reduce the fiscal deficit, and the reform failed. Chile instituted fiscal reform in the late 1970s and succeeded.
2) In 1985, Bolivia slashed state controls, opened up the economy, and balanced the budget on a day-by-day basis. Inflation fell from 23,000 percent in 1985 to 9 percent in 1993.
3) Argentina, in mid-1991, balanced the budget, deregulated the economy, and began privatizing state industry.

These events show the importance of preserving economic decision-making in markets. If governments presume to make allocation decisions, both in the currency markets and in private capital flows in and out of a country, markets can impose harsh discipline. In cases where monetary policy directly caused hyperinflation, fiscal policy was the underlying culprit. When the government sector was too large and attempted to do too much, it could not finance itself with taxes and resorted to inflationary finance.

In Harmony with Markets

Good examples of political institutions and economic forces working in tandem are the "Asian Tigers"--the nations of Taiwan, Hong Kong, South Korea, and Singapore. A recent World Bank report gives much credit to these countries' free-market pricing of labor, capital and goods, and for creating stable macroeconomic frameworks that also let the markets work. While these nations have used government subsidies and political credit allocation, to a considerable extent they have relied on market outcomes to judge their success. For example, South Korea tried to build a heavy chemical industry in the 1970s, but government support was withdrawn when the effort failed.

Famines also highlight the contrast between using institutions that utilize markets and institutions that resist them. The organizational response to famine is to fly in massive amounts of food. This solution creates refugee camps, pulls people off the land, and occasionally alleviates the problem at high social cost--all of which begs the question of the institutional arrangements that gave rise to the famine in the first place.

In contrast, A.K. Sen shows that the conditions that avoid the circumstances that create famine are democracy and a free press. The unimpeded flow of information via a free press means that people know what is happening, and democracy means that the people are relatively free to act on that information. Sen states, "...no democratic country with a relatively free press has ever experienced a major famine" ("The Economics of Life and Death," *Scientific American*, May, 1993, p. 43). The market disciplines policymakers.

LEGACY OF CONFLICT

Much of the history of twentieth century reflects what I think of as the "contest of ideas"--democracy and capitalism locked in a struggle with dictatorship and socialism. Essentially, it has been a contest for the minds of the people of the world as to the best ways to organize economic and political affairs.

This century has produced two watershed decades in terms of the government's role in the economy-- the 1930s and the 1980s. During the worldwide economic depression of the

1930s, the intrusion of government in economic affairs increased massively. If governments did not outright nationalize and directly control resources in a command structure, at a minimum they set up regulatory agencies to decide what was to be produced, where it was to be produced, how much could be charged for products and paid to workers, and what interest rates could be charged or paid.

In the several decades following the 1930s, the role of the nation-state in economic affairs became ever larger. Much of the underlying conceptual framework was based on what I think of as the "stagnation thesis," as set forth by John Maynard Keynes in *The General Theory* in the 1930s. Its premise is that even economies that are based on private property, and that rely on market forces to allocate productive resources, tend to stagnate at less than full potential in the absence of government initiatives to cause growth. Notions about "market failure" and "insufficient aggregate demand" permeate the literature.

In other words, a view widely held through much of the past century--one that may even continue to be held today by many people--is that governments cause growth. The so-called economic "policies" of government are viewed not only as appropriate, but even as necessary for influencing economic activity.

The rival conjecture from the 1930s, which had little following for most of this century, was the "inherent resiliency proposition" associated with thinkers such as Ludwig von Mises, Friedrich A. von Hayek, and William Hutt. It holds that an economy that relies on a price system to allocate resources in a market environment, and that protects private property rights, tends to be inherently resilient. That is, it naturally gravitates toward full utilization of its productive resources without government pump priming. Whenever shocks of various types -- oil price increases, droughts, wars, or perverse government policies -- knock the economy down, growth naturally begins anew as the negative effects dissipate.

Common attributes of the contest of ideas in the twentieth century are as follows:

(1) political and economic institutions tend to become rigid over time, mainly because organizations created and operated by people become resistant to any change in the status quo; and

(2) the fundamental economic forces -- technological innovation, declining information and transaction costs, increasing economies of scale and economies of scope of production, and globalization of goods, financial, and asset markets--are *dynamic and global*. Terms such as "global village," "borderless world," and "twilight of sovereignty" express this view. Organizations impose constraints on the not-formally-organized sector, composed of resourceful, intelligent people who seek ways around the constraints. Market forces can overwhelm the constraints, or yield unintended consequences.

There is a positive way to state this point. Essentially, markets discipline policy. With the free flow of information, goods, labor, and capital, bad policy is eroded in the marketplace. The challenge for the future is to set up institutions that use market discipline in a *positive* way.

The ultimate implication of the conflict between irresistible economic forces and the political institutions that take on the characteristics of immovable objects is that institutions must change, or they will fail. Joseph Schumpeter said, "The essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process . . . . Capitalism, then, is by nature a form or method of economic change and not only never is, but never can be, stationary."

Schumpeter's observation applies equally well to all of the institutions that define the parameters of our global economy. Propelled by technological change and chance economic events, these institutions undergo a continuous process of change. Those qualities that enhance economic well-being tend to survive, and those that do not eventually disappear. People develop institutions -- laws, rules, conventions, and customs -- to define and enforce property rights and, more generally, to reduce the costs of economic exchange. The various laws, rules, conventions, and customs that define money, protect its purchasing power, and govern its use are examples of such institutions.

MONETARY RULES AND ORGANIZATIONS

International monetary developments in the past couple of years can be explained in terms of these general ideas about institutional transformation. What appear to be conflicts between global monetary integration and regional monetary autonomy are artificial, resulting largely from vested interests in maintaining local government monopolies over the issuance of the national media of exchange. History demonstrates, however, that national currencies inevitably compete in the international financial arena.

Following Hayek, approaches to international monetary relations that foster competition among alternative currency units and vehicles for asset management are more likely to enhance world welfare, compared with systems like Bretton Woods that mandate change directed by supranational governmental bodies, which tend to ossify over time.

Economists think of money as primarily an institutional convenience for greatly reducing the costs of transactions. Overall, a stable monetary unit allows greater specialization in production and wider choices in trade, thus enhancing the associated economic benefits.

Building on these ideas, many economists and political scientists erroneously contend that monetary integration over a greater geographical area would confer significant gains on the residents of that area.

Monetary integration can take two institutional forms: The first is complete monetary union with a common currency and a single central bank. That has been the ultimate objective of the European Monetary Union. A second and weaker form of monetary integration is fixed exchange rates, such as experienced under the gold standard or the Bretton Woods System, as well, of course, as under the European Exchange Rate Mechanism. The conditions under which either form is viable need to be addressed.

Although a system of fixed exchange rates could confer significant benefits on participants in terms of reduced transaction costs, it also imposes specific costs in terms of monetary sovereignty and macroeconomic adjustment. The external value of a national currency ultimately reflects the relative internal purchasing power of that currency. So, to maintain an exchange rate, participating countries must coordinate their monetary policies to generate similar inflation rates. Monetary sovereignty -- or autonomy -- is incompatible with fixed exchange rates. Inflation convergence is crucial to a pegged exchange-rate regime.

Under certain circumstances, however, the costs of integrating monetary policies across countries can exceed the benefits. Countries are most likely to form a successful monetary union with other countries if:

(1) all regions in a monetary union have the same preferences for inflation, reflecting similar theoretical or conceptual views of monetary policy; and

(2) all regions within a monetary union experience similar macroeconomic conditions.

While common experiences with economic shocks are a desirable condition to enhance the likely success of monetary integration, they are not necessary. Regions of the United States often experience different economic conditions, especially in response to energy-price shocks, defense spending increases or decreases, and so on. What *is* crucial is that other avenues for adjustment between regions are available so that exchange rate changes are not the issue.

In the 1980s, the United States had a bicoastal economy: California and New England were booming, while depressed conditions existed throughout much of the middle part of the country. In the early 1990s, the tables have been turned: We have seen severely depressed economic conditions in California and a continuing recession in New England, while the Rocky Mountains and the Midwest have been, by comparison, considerably stronger.

If it were not for the political integration and the associated high degree of resource mobility (investable capital resources as well as labor resources), then it would be more tempting for various regions within the United States to contemplate devaluation of their currencies in such an environment. In the 1980s, for example, devaluing the Texas dollar or the Michigan dollar against the California or New England dollar would have seemed an attractive option. Similarly, the severe recession in California in the early 1990s might have led some to believe that devaluing its dollar against the Ohio or the Rocky Mountain dollar would be sensible. But because of political unity and resource mobility, these options were not considered.

The recent history of our global monetary systems suggests that attempts to achieve monetary integration by way of fixed exchange rates are not likely to succeed in the absence of political integration. In part, this results because regions of the world that experience disparate economic conditions and low resource mobility can adjust to economic shocks more efficiently by allowing their exchange rates to fluctuate. Furthermore, monetary integration cannot proceed in a credible manner, even among regions in which it is feasible, unless governments first adopt domestic institutions that credibly assure their commitment to maintaining domestic price stability.

Institutions, including those that determine the use of national currencies, inevitably compete, leading to the emergence of efficient wealth-enhancing institutional forms. To create greater international stability and integration, we should encourage such competition. This requires, above all else, the free movement of resources through the elimination of artificial restraints on the movement of capital, goods, services, and labor. A free flow of resources fosters a convergence of institutional forms across participating governments as they compete for these resources by providing stable economic and political environments. Countries whose governments fail to provide such an environment will lose resources as markets vote on policies. The resulting convergence of monetary and fiscal regimes will achieve the highest sustainable rate of real growth in an environment of monetary stability.

CONCLUDING REMARKS

When some observers look at the divergent forces at work in various regions of the world, there seems to be a conflict. For example, in examining the efforts under way to achieve European Community objectives -- economic integration and perhaps ultimately political integration among twelve or more European nations -- in contrast with the political and economic *dis*integration of the former Soviet Union, it might appear that these trends are going in opposite directions. On the contrary, I find common elements in both developments.

In the case of Europe, the move toward political and economic integration involves a large number of specific steps to *reduce* the role of the participating nation-states in economic affairs. In other words, actions are being taken to improve the workings of the markets within Europe -- to strengthen property rights and to eliminate a host of rules, regulations, and obstacles to the free mobility of goods, labor, and capital.

In contrast, in the former Soviet Union we see that political and economic disintegration is also a process of tearing down the highly centralized command and control socialist economy. It is a process of searching for ways to make markets flourish in the fifteen or so republics of the former Soviet Union, as well as in the eastern European countries of the former COMECON.

Viewed in this way, the moves toward economic/political integration in Western Europe and disintegration in the former Soviet bloc are both market-driven. Both seek to foster a strengthening in private property rights and to ensure that the price system is the primary mechanism for allocating resources to their most productive uses. Both look toward greater mobility of goods, labor, and capital.

In this final decade of the century, it seems that the clearest trend around the world is to reduce the role of the nation-state in economic affairs. Deregulation, denationalization/privatization, and tax reduction/tax reform are all part of a process of economic regeneration -- to restore the wealth-creating capability of markets. Resources, especially investment capital, move quickly to those regions that are making the most progress--such as today in Mexico, Argentina, or the Czech Republic -- while resources move away from those regions making little or no progress. This competition of political institutions--both of the organization type and the rules type--is a part of what I consider a healthy process of reinstituting nineteenth-century economic liberalization. The result will be a freer and more prosperous world, with the ultimate autonomy not in the nation-state, but in individual choice.

Attempts to achieve monetary union without political integration are not likely to be successful. Certainly, monetary union is not a necessary condition for achieving free movement of goods, labor, and capital. Furthermore, competition among alternative national currency units can impose a healthy discipline on policymakers. That competition, in turn, promotes relative price stability and a wealth-enhancing environment. Finally, institutional arrangements such as enforceable property rights are much more essential to economic development than are politically created and controlled organizations, no matter how well-intentioned their missions.