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Embargoed until 3:30 p.m. EDT
Tuesday, September 22, 1998

Economic Infrastructure for Global Prosperity

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Tenth Annual International Financial Symposium
Mexican Financial Executives' Institute

World Trade Center
Mexico City, Mexico

September 22, 1998

Good afternoon. Thank you for inviting me to address you for a second time. Two years ago, at your conference in Mérida, I spoke about government's role in job creation. Today, I want to expand on some of the themes in that speech by elaborating on the institutional arrangements that foster prosperity.

In 1776, Adam Smith published *An Inquiry into the Nature and Causes of the Wealth of Nations*. He was interested in explaining the large differences in prosperity observed across economies. That inquiry continues today, and for the same reason: The gap that separates rich from poor economies remains huge. As we approach the end of the 20th Century, the world's richest countries are roughly 30 to 50 times wealthier than the poorest countries on a per capita basis—a truly astounding difference. We see not only large differences in wealth, but also tremendous variation in development. Some developing countries tripled their wealth between 1960 and 1985, while others were three times wealthier in 1960 than they were 25 years later!

If we ask a simple question like, "Why are some economies rich and others poor?" or "Why do economies grow at different rates?" we get a simple answer: Rich economies have greater resources per capita—more capital, both human and nonhuman, and better technology connecting the two. But this answer only begs another question: "Why do some economies have high levels of capital and technology, while others do not?"

The premise of my remarks today is that it is a nation's choice of institutions, the totality of which we call the economic infrastructure, that determines wealth and development. What separates economic "haves" from "have nots" is whether the role of an economy's institutions—particularly its public institutions—is to facilitate production or to confiscate it.

We can describe an economy's infrastructure as the climate created by institutions that serve as conduits of commerce. Some of these institutions are private; others are public. In either case, an institution's role can be conversionary—helping to transform resources into output—or diversionary—transferring resources to non-producers. Most private institutions are sustained by the value they add—either they produce, or they fail. But the same cannot be said of public institutions that are sustained by the power of the state.

Controlled experiments are not possible in economics, but on occasion natural experiments present themselves. During this decade, economists had a unique opportunity to study the economic infrastructure's role in influencing prosperity. At least 15 newly created market economies have emerged within the former Soviet Empire, in addition to the newly liberated Eastern European countries. Perhaps not surprisingly, these emerging economies have experienced vastly varying degrees of prosperity.

Other examples can be found in the East Asian economies, whose spectacular ascent was almost as dramatic as their subsequent collapse. What went wrong? These are all countries that have espoused the philosophy of capitalism without having a culture of capitalism. Here I do not use the term culture in its usual sense—as a set of values and customs that bind citizens together. These, I suspect, are overemphasized, if not wholly unimportant. What counts is a nation's attitude about the free and uninhibited use of private capital—the culture of a market economy.

Most of the economies that have been on the verge of collapse have only recently embraced a market orientation. Their economic turmoil has led some to suggest that it is the capitalist system that has failed. In Malaysia, for example, the President has declared that "the free market has failed disastrously." Has it? Of course not. The economies that failed had tried to paste a free-market veneer over a state-managed economic structure. These were economies where free-market principles were given lip-service, but where a free-market culture was not integral to the economic infrastructure.

A few basic questions can help reveal whether the reliance on markets is real or only superficial. How deep is a nation's commitment to the rule of law and does it have strong, impartial courts? Is there an orderly succession of power? Is there little risk of expropriation through nationalization and confiscation? Do they honor public contracts and uphold private contracts? And are private institutions free from political pressures?

Many of the so-called "miracle countries" of East Asia do not score highly by these factors, despite more than a decade of rapid growth. I think it is clear that their recent implosion was attributable to the lack of a strong economic infrastructure. In many of these countries, there was an indistinguishable line between public and private interests. This was particularly true in banking, where it has been said that "the minister's nephew or the president's son could open a bank and raise money from both the domestic populace and from foreign lenders, with everyone believing that their money was safe because official connections stood behind the institutions."

Implicit governmental guarantees, without adequate market oversight, create the potential for a nation's asset values to be determined by things other than the investment's underlying contribution to the world economy. In most of these countries, institutions similar to the U.S. Securities and Exchange Commission are largely ineffective or nonexistent; internationally accepted accounting standards are not followed; and regulations requiring full disclosure are frequently absent. This means investors have little ability to ascertain an investment's actual economic performance. Regrettably, these shortcomings did not deter foreign lenders and investors, who kept adding to the flow of "hot money" swelling the bubble until it finally burst.

As one smart economist said, "Things that are unsustainable have a habit of ending." The end for the miracle economies came once it became clear that their governments lacked the resources to support bad investments indefinitely. The collapse of asset prices led to the insolvency of banking institutions and the attempted withdrawal of foreign investors. The real economic costs in terms of lost output and employment are still unknown.

Of course, no nation is immune from self-deceptions. In the 1980s, the U. S. savings and loan industry debacle clearly demonstrated what happens when governmental guarantees are combined with poor market oversight. The U.S. subsequently strengthened banking institutions to safeguard against another such occurrence. For example, publicly insured depository institutions now have to meet stricter capital requirements, and supervisory authorities have less discretion to forbear from imposing sanctions on weak firms.

Unfortunately, the worst may still lie ahead for some, if not most, of the East Asian countries. Many of them lack the mechanisms that allow resources to move freely to their most productive uses. Their economic infrastructure is incomplete. Indeed, if history is a guide, the first recourse of troubled nations is to block the operation of the marketplace by attempting to prevent the outflow of foreign capital. Often they put severe regulatory restrictions on financial intermediaries, nationalize some portion of the financial sector—either explicitly or by bailing out sick institutions—all the while pointing to some foreign culprit to justify the construction of capital controls, trade barriers, and other isolationist measures. In short, they try to circumvent those parts of the economic infrastructure that offer the only lasting solution to their economic problems.

But what are the costs of such policies? Directly, a heavier tax burden is placed on citizens, either explicitly by the taxing authorities, or implicitly by the monetary authorities. I'll return to this topic shortly. But the far greater costs—which will burden these economies for years to come—are the costs of perpetuating the economic crisis by dismantling the market infrastructure. Trade opportunities diminish. Capital flows dry up. The power of the state supplants the power of the marketplace, and incentives to accumulate wealth diminish.

The repeated bailouts of private financial intermediaries have the effect of reducing private banks' incentives to allocate funds effectively among competing financial endeavors. This process stunts development of the banking skills and supervisory arrangements necessary to prevent future crises. In short, the expectation that the state will repeatedly commandeer the nation's resources virtually guarantees more frequent and more serious crises in the future. In the end, a nation is left with an infrastructure that is incapable of supporting a growing and vibrant economy.

There will be no quick fixes to restore prosperity in these countries. The task of restoring—or, in some cases, building from scratch—a sound economic infrastructure is very time consuming, and of course, extremely expensive.

At the most basic level, there can be only two rationalizations for the state's participation in an economy. The first is as a social equalizer, redistributing the fruits of a nation's production under the presumption that a particular social need takes precedence over private desires. The second justification for government participation is the assertion that markets fail to produce an efficient outcome.

Where equity issues are concerned, the role of the state is unambiguous. Society chooses to accept a lower average level of wealth in exchange for some presumably higher social objective.

It is the state's role as a promoter of market efficiency that raises the most complex questions. Even if the objective is to overcome a particular market failure, once the state has involved itself in the economy, its influence will have wide-ranging and unanticipated consequences. And these institutions, which are not bound to obey market forces, exert influence long after their usefulness has passed.

While I doubt that market failures are as common as activist policymakers presume, it is clear that they do occur. The most frequently cited failure involves so-called "public goods," where providing a good for anyone makes it possible to provide it for everyone with no additional costs. A legal system and national defense are such public goods. So too is a stable currency. These functions become part of the economic infrastructure called "the protection of property rights," which means, more or less, that individuals can expect to receive the product of their labor. Although people could privately undertake actions to prevent diversion of their output (by burglary, for example), it is widely accepted that a social institution (such as a police force), is a less costly means of protection. Let us be clear, however. In order to pay for the police, courts, or jails, resources must be diverted to the state from private persons in the form of taxes.

Indeed, once introduced into the economic infrastructure, the state cannot help but tax the system's productive capacity. Sometimes, these taxes are direct and sustain the government activity. But direct taxes are probably only a small part of the overall cost to the economy. Also important are the costs borne by private agents who invest resources to minimize their tax burdens, either through tax-avoidance schemes or through attempts to influence the taxing authorities.

This is the paradox of any state enterprise. While the state may be the most effective instrument for minimizing resource diversions (for example, by protecting property rights and enforcing contracts), it simultaneously introduces the potential for the debilitating diversion of resources for the state's own account. This, I think is where the differences between economies are grossly understated.

A common distinction among governments is whether they are called "capitalist" or "socialist"—terms that broadly define the diversionary appetites of governments. Certainly a government committed to allowing private ownership of capital is, all other things equal, more committed to establishing an economic infrastructure that favors creation over diversion. But this is only part of the story. Laws that protect against the threat of expropriation or government repudiation of contracts—all of the rules that cumulatively sum to the protection of property rights—are important.

These are the common set of characteristics that make an economic infrastructure successful. According to some studies, these characteristics are substantial enough to explain most—if not all—of the differences in prosperity that separate nations today, and I suspect that the same set of characteristics separated the wealth of nations in Adam Smith's time.

One thing that has changed since the time of Adam Smith is money. Economic exchange involves information and transaction costs that require real resources. These costs, which influence the extent of trade, the degree of specialization, and the economic benefit derived from goods, stem primarily from the difficulty of acquiring information about the quality of the goods—their true worth as opposed to their money worth. The lower the information and transactions costs, the greater the opportunities for individuals to undertake exchanges that maximize mutual welfare. When we find ways to conserve productive resources that had been devoted to gathering information and conducting exchange, we liberate them and make them available for creating consumable output. In this way, sound money promotes prosperity.

Of course, a nation must be concerned not only about the integrity of its money, but also about the stability and reliability of its financial system. The condition of a nation's financial intermediaries and financial (asset) markets may influence a monetary authority's policy actions, but need not compromise its objectives. Unsound financial institutions and inefficient financial markets may impede, but do not preclude, the achievement and maintenance of a stable currency. Nevertheless, if ex ante concerns about, or ex post responses to, the condition of financial intermediaries, or markets, divert monetary authorities from a disciplined, sound policy stance, then overall financial instability can result. While adverse real economic effects of shocks to the financial sector can never be eliminated, their disruptive influence can be minimized if monetary authorities continue to provide a stable monetary unit.

Economists are accustomed to talking about the quantity of money; I suggest thinking more deeply about its quality. A society will choose to use as money that form which enables people to gather information and conduct transactions with the minimum use of resources. Indeed, the worldwide use of the U.S. dollar alongside local currencies illustrates the point that monies do compete along the quality dimension.

When a currency's purchasing power is unstable, price changes do not function efficiently to provide information about the relative values of goods, services, and assets. When the public sees that the money prices of virtually everything continually rises—the condition called inflation—they project this trend into the future and alter their behavior. The quality of the services provided by the nation's money erodes, transaction costs rise, and the benefits of specialization and trade diminish. In short, the market system becomes less effective.

For their part, central banks have begun to understand the long-term efficiencies that stable money can provide; but, they are also part of a fiscal regime that includes strong incentives to violate the public's trust by generating unanticipated inflation. Through unanticipated expansions of fiat money, central banks can levy an unlegislated tax, reduce the real value of the government's outstanding debts, or attempt to exploit a short-term tradeoff between growth and inflation. Governments, and especially those that heavily discount the future, will always be tempted to instruct or pressure their central banks to issue excessive amounts of money.

The effects of such short-sighted government policies are transitory at best. As people alter their behavior in the face of inflation, there is an increase in the costs of conducting exchanges. The additional resources expended on gathering information and on protecting the real value of wealth would otherwise have been available for growth-enhancing activities.

Governments with a longer view typically attempt to ensure the quality of their monetary unit by adopting institutional arrangements that restrict their own monetary discretion. Certain types of rules can enhance a central bank's reputation by signaling the government's intention of maintaining the quality of its currency. Examples include explicit price-level targets or other legal imperatives that place monetary stability above other objectives. Such arrangements may be particularly important because a reputation for monetary integrity is built very slowly.

CONCLUSION

Globalization is a common buzzword in political economy circles today. It means an increase in both private-sector and public-sector competition as people and resources move freely across borders. Given the choice and the opportunity, individuals gravitate toward the institutional arrangements that best reduce transactions costs and raise their living standards. This includes the monetary units in which they denominate their wealth and conduct their transactions.

Central banks are successful when households and businesses base their decisions on the assumption that all observed changes in money prices are relative price changes, and all observed changes in interest rates are real changes. Fortunately, global competition among national monies seems to be imposing a discipline that cannot be ignored.

I began my remarks today with a simple premise—that the economic infrastructure plays a major role in determining economic prosperity—and that infrastructure depends crucially on the culture of the institutions that are supported by the state. The best economic performance occurs where the state has fostered an infrastructure that functions as a "market economy without adjectives."

Protections often taken for granted—patents, copyrights, and other intellectual property rights—are largely unknown or are ineffective in many places in the world today. Without such protections, incentives for creative talents to design and develop new products and services are substantially weakened.

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 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. Simply espousing the virtues of a market economy, without establishing the proper economic infrastructure is like planting one seedling in a rocky, infertile ground. We would not expect either to survive for very long.