Welcoming Remarks

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Philadelphia Fed Policy Forum
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Welcome to the second annual Philadelphia Fed Policy Forum: "Crises, Contagion, and Coordination: Issues for Policymakers in the Global Economy."

The purpose of our Policy Forum is to bring together widely recognized experts to discuss the important and timely policy issues of the day. This year, we concentrate on issues central to policymaking in an increasingly global economic and financial environment. Our hope is that this forum will be a catalyst for both greater understanding of today's global economy and more critical thinking about a properly constructive role for policymakers, both nationally and internationally.

The issues we will discuss today are timely and important. Economies around the globe are becoming more tightly linked. Financial systems around the globe are becoming more closely integrated. Accordingly, political and economic events around the globe can have important economic implications at home.

Recent history provides many examples, from the Asian crisis of the late 1990s, to the continued recession in Japan, from the advancement of the EuroZone to the recent events in Latin America. All of these developments have had repercussions on the global stage. Consequently, national and international economic policymakers constantly face new challenges and must strive to find better solutions.

And challenges will continue to present themselves. Why? Simply because global integration is a fact of life.

Strong forces push us toward greater globalization. Technology is at the forefront. Advances in telecommunications have improved the speed and span of information. Increased efficiency and networked systems are reducing the cost of trading both goods and services globally.

Policymakers are contributing as well. Trade barriers have been lowered or eliminated. Deregulation and privatization of enterprises give a broader role to the global marketplace.

And, of course, there are market forces themselves, in the form of financial market innovations and development of multinational business models.

As a result, national economies are linked ever more closely into a global network. Dramatic events call attention to these tighter links. Economic and financial shocks in one country or region propagate more quickly and more broadly to other countries. But the process manifests itself every day, if less dramatically, in rising trade-to-GDP ratios and soaring volumes of cross border financial transactions.

As economists, we recognize the benefits to national economies globalization can offer. In simple terms, it offers the promise of higher returns and a lower variance in economic performance than any one country could achieve on its own. Through greater exploitation of specialization and comparative advantage in a global marketplace, countries can achieve more rapid growth in real output and higher living standards. Through participation in integrated global financial markets, they can diversify risks and reduce the impact of any one shock.

But as a practical matter, globalization has its shortcomings, too. Tighter linkages heighten prospects for contagion, turning regional crises into broader events, even global events. Some claim globalization increases the fragility of national economies by fostering trade imbalances and financial market volatility, while robbing domestic policies of their potency.

In short, globalization can be a two-edged sword for any nation's economy. My sense is that on balance globalization is a strong positive for national economies. Nonetheless, we should take the costs of globalization seriously and work hard to mitigate them.

The policymaker's role is to maximize the benefits and minimize the costs of global integration. How do we fulfill that role? In broad strokes, the direction is clear: Create infrastructures that allow markets to function efficiently; contain the system in times of crisis; and control the impact of cyclical fluctuations.

When it comes to building infrastructures that foster market efficiency, recent history highlights a number of the most important elements. The evolution of Eastern Europe and the former Soviet Union illustrates the importance of a legal system that establishes property rights and enforces contracts. The corporate scandals right here in the U.S. highlight the importance of transparency in financial markets and the need to adopt international financial disclosure requirements.

A well-functioning financial system is important not only for supporting economic growth but also for preventing financial crises. There are strong linkages between the health of a nation's financial system and the ability of the country to withstand external shocks. Financial crises, and more specifically banking crises, often precede currency crises.

Consequently, improving financial regulation is a pressing need around the world, especially in emerging economies. Basel II serves as a blueprint for improving bank regulation. Under Basel II, bank regulators worldwide will use a combination of capital requirements, supervisory oversight, and exposure to market discipline to induce their financial institutions to use advanced risk management techniques.

Of course, no matter how sturdy the economic and financial infrastructure, crisis situations are bound to occur. In times of crisis, it is incumbent upon policymakers to stabilize the system. They must stand ready to act to contain the situation and control its impact.

At the same time, policymakers must always be cognizant that their actions affect incentives. Policies must be time consistent, for the actions a policymaker takes to alleviate a crisis today may create the expectations that deepen, or even precipitate, a crisis tomorrow.

Crisis situations aside, policymakers also assume the traditional stabilization role: helping to mitigate cyclical fluctuations. Clearly, policy actions in one country affect economic performance in others. This suggests coordination of policies among countries may improve welfare in all countries.

But whether policy coordination is beneficial on net is not clear. Some say coordination is costly and unnecessary, as long as central banks follow sound policies nationally. And, they argue, in some situations, policy coordination may even prevent national policymakers from delivering the best domestic policy for the situation. Accordingly this is still an open issue, as some of our speakers today will illustrate.

Indeed, the overarching question for policymakers in all three dimensions -- strengthening markets, weathering crises, and dampening business cycles -- is the degree to which effective performance requires international coordination of activities. Some would even question whether government intervention is required at all.

For example, Yaron Leitner, one of our own Philadelphia Fed economists, in a forthcoming *Business Review* article, suggests that the heightened threat of contagion can galvanize an effective private-sector response. Close linkages among financial institutions may increase incentives for healthy institutions to bail out those hit by bad luck. So a type of mutual insurance system could spring up.

In short, globalization opens a broad array of issues for researchers and policymakers alike. Today's Policy Forum will address a number of them. Among those I consider most basic and most important:

1. In what ways are economic and financial linkages among countries tightening? How is this affecting economic and financial performance around the world?
2. What kinds of institutional arrangements will help the world's economies maximize the benefits these linkages offer and minimize the risks they present?

3. What conditions foment financial crises? What conditions make them contagious?
4. What can policymakers do to prevent crises? Failing that, what can policymakers do to contain them when they occur?
5. Can policymakers be more effective when they coordinate their actions? In what ways and under what conditions?

These are important and timely issues. I know the presenters and participants assembled in this convention center are those very best qualified to discuss them. So I look forward to an informative and rewarding day together.

I'd now like to turn it over to Loretta Mester to open our first session. Thank you for attending the Policy Forum. I hope it challenges your thinking and presents you with many new ideas and fresh perspectives on policymaking in a global economy.