GLOBALIZATION AND THE WORLD OF FINANCE

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It is a special honor and challenge to speak before you in the presence of the man who inspired this annual Hutchinson Lecture, a man I know is much revered on this campus.

I confess it is quite a while since I have read a textbook on money and banking, but I could not resist seeing how Professor Hutchinson might have graded my performance as Federal Reserve Chairman. I discovered what tens of thousands of students must already know: he wrote with great clarity and conciseness about the theory and practice of monetary policy. But I have to tell you he wasn't big on personalities. I did find my name in two rather obscure footnotes dealing with abstruse matters of banking supervision—nothing to justify this Lecture, much less an honorary degree.

One other thing, more relevant to my comments this morning, struck me when looking through the book (at least the fifth, mid-1980s edition). Typical of most textbooks of that time, and of most monetary policy-making to this day, the concentration was heavily on domestic matters. My theme today is that day is passing. I will put the point as simply and as provocatively as I can: Full participation in the world of global finance simply isn't consistent with independent monetary policies by independent nations.

Globalization is a rather ugly five-syllable word that has reached into our daily vocabulary. Ugly or not, it describes a phenomenon that isn't going to go away. That's fundamentally a matter of technology. When it is possible to communicate and to transact business around the world so conveniently, so economically, and so rapidly, the urge to do business is irresistible. Governments can try to slow it down. But that's increasingly difficult to do without a network of controls so intrusive as to imply insulation from the benefits of participation in the global economy. The fact of the matter, of course, is that with the demise of the Soviet Union and the triumph of the ideology of global capitalism, there are very few countries that have any desire to opt for economic isolation.

The benefits of free international trade have long been evident in practice as well as theory. It is not possible, for instance, to think that the "Asian Tigers" of Korea, Taiwan, Hong Kong or Singapore could have reached such high levels of income so rapidly except through trade. Most of the other countries of Southeast Asia and China itself, have gained enormously from access to the markets of the developed world, as we have benefitted from the competition and cheap imports.

The freeing of financial markets in the emerging world, and even in some of the advanced countries of Europe, is more recent, in large part a phenomenon of the

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1990s. It is a development that has been strongly urged and welcomed by most economists, political leaders, and certainly Western financial institutions. The theoretical logic has seemed compelling. Perhaps more to the point, the perception is that there is money to be made. The analysis is straightforward. Capital would flow to the areas of the highest potential return. Emerging economies with abundant and disciplined labor, often with large natural resources, and a growing base of skills and education would be prime beneficiaries in terms of economic growth. The gains would be shared with the investors, and by all of us who benefit from reduced costs and competition.

For a little while, it seemed to work that way. Here in the Western Hemisphere in the early 1990s, Mexico and Argentina were big gainers, and East Asia attracted increasing amounts of capital, helping to finance an investment boom. Private flows to those areas widely exceeded official aid and finance to the point that some began to question the relevance of the World Bank and other official lenders.

But then, quite suddenly, something funny happened on the way to success. First in Mexico, and a couple of years later in East Asia, we learned again a lesson as old as capitalism itself. For all their enormous and really irreplaceable benefits, financial markets are volatile. It's not a phenomenon limited to weak emerging economies. We've had a little taste of it in the bubble and subsequent humbling of NASDAQ recently—and more importantly in our own banking and savings and loan crises a decade ago. You will recall much more recently the concerns expressed about the potential fragility of American financial markets in 1998, in the backwash of the Asian and Russian crises.

But what we found so clearly in the latter half of the 1990s is that those countries that presumably would be the prime beneficiaries of global finance were in fact in the greatest jeopardy. Countries like Thailand, Indonesia, Malaysia and others that had for decades experienced extremely high annual rates of economic growth of as much as 7 or 8 or 9 percent compounded, countries that were praised for stabilizing prices and ending budget deficits, were suddenly plunged into deep recession. Recovery has been uneven. Even now, none have returned to the trend line of growth established in the 1980s and early 1990s.

The obvious difficulty has been the shocks associated with enormous exchange rate instability and related gyrations in interest rates. The result in emerging country after country was the virtual destruction of domestic banking systems. In some cases, there was a strong inflationary impulse and strong budgetary pressures. Those financial strains and disturbances have been inconsistent with sustained economic growth.

The common reaction among officials and financial market participants alike has been to view this all as temporary, a sort of learning process, a transitional stage to the brighter future promised by orthodox analysis. In particular, the instinct has been to point to institutional weaknesses in the emerging nations themselves.

- Banking systems have lacked adequate capital, effective supervision, and experience in risk management.
- Accounting systems are primitive and auditing weak, with lack of transparency.
- Business practices are poorly developed, and corruption is rife.

As time has passed, there has been a certain amount of introspection as well. How is it that large and sophisticated financial institutions in the developed world—with state of the art regulation, model systems of risk management and the rule of law—permitted themselves to get so exposed to structurally weak emerging economies that their own stability was jeopardized? Much effort is underway to review capital standards, to develop and enforce more uniform accounting practices, and to search for better risk management techniques.

Now, I don't want to question the relevance of all that. After all, I spent most of my life concerned with questions of financial regulation and supervision. I am a believer. It is also true that my professional life extends back over half a century. And as Yogi Berra once said, "you can observe quite a lot just by watching." It is precisely that experience that has made me skeptical—skeptical to the point of disbelief—that the intellectual and official analysis of the recent financial crises has been at all adequate.

It may be comfortable for us in the developed world to think that weaknesses peculiar to Asian or Latin American institutions, or lapses in the supervision of our own institutions, were the essence of the crises we have seen in the last half of the 1990s. But if that was true, how do we explain that most of those Asian economies had sustained such high growth rates long before their financial markets were opened?

I referred earlier to the fact that we had banking and savings and loan crises in the United States itself in the 1980s and early 1990s. Not so many years ago, the Scandinavian countries experienced the virtual bankruptcy of their banking system, and we read almost every day about the seemingly endless travails of the Japanese banks. It is an interesting and, I think, significant fact that those financial crises in the developed world have not had the devastating effects on economic stability and growth that have been characteristic of the emerging world.

How do we explain the difference? What strikes me about the emerging nations as much as their institutional weaknesses is a fact so obvious that we overlook the implications. Their financial institutions and markets are small—tiny on a world scale. Typically, their *entire* financial system is composed of institutions that in the aggregate amount to only a fraction of the size of a *single one* of the large financial institutions in the developed world, for some countries only a small fraction. A single regional bank in the United States is apt to have more assets or deposits than all the banks in most of the countries of South America or Southeast Asia. And I would point out those regional institutions in the United States or Europe are rapidly consolidating, for fear that they are too small to compete effectively in turbulent world markets.

The clear implication is that the emerging markets and their institutions are particularly vulnerable to the sometimes abrupt shifts of sentiment and funds characteristic of open markets. I liken it to sailing a small boat in the ocean: when the winds begin to blow, the Coast Guard properly sends out *small* craft warnings; only an extreme storm would concern the Queen Elizabeths of the world.

We've seen enough over the years to realize the pattern is repetitive. The strong potential of a high growth, reasonably managed emerging market attracts foreign funds. More lenders and investors enter with funds that may be marginal from their individual point of view. But cumulatively these same funds are large relative to the size of the emerging economy and its banking system. At first markets boom, interest

rates are held down, the exchange rate is relatively strong, and growth is enhanced. But sooner or later, something happens—a growing sense of inflationary and balance of payments pressures, perhaps the perception of political instability. Sentiment changes and funds flow out even faster than they entered. Interest rates soar, and the exchange rate may drop by 20 or 30 or even 50 percent or more in a matter of weeks. Official rescue efforts may or may not mitigate the crisis. But typically the economic damage is severe.

The lesson I draw is not that we can or should draw back from global markets: the potential for enhancing growth is real and the technological forces driving the process are too strong to resist. But neither, in my judgment, can we sit back and assume that events, and the efforts of individual countries, will take care of themselves. What is at issue here is whether a world of global finance will in practice bear out the rhetoric about the glories of free markets. Obviously a lot is at stake, politically as well economically, in the answer to that question.

Well, what to do? Slowly, there is greater recognition that the question revolves around the exchange rate system itself. The favored official answer—and certainly the typical academic answer to the systemic question—seems to be floating currencies. And there isn't much doubt that, in the absence of other perceived alternatives, governments in crisis are driven to that approach. But that also seems to me a counsel of despair in terms of a satisfactory policy over time. Nothing in the practical record of the past quarter century lends support to the theorizing that floating exchange rates will also be relatively stable.

It is also obvious that the typical small emerging economy isn't comfortable with that answer. Their economies typically lack diversification, are open internationally, and are much more heavily dependent on imports and exports than the United States, the European Union or Japan. They are engaged in highly competitive markets, with their industries sensitive to the price changes imposed by large currency fluctuations. They do not have a strong track record of internal stability to anchor price expectations. And, as I argued earlier, their financial institutions are inherently small and vulnerable to big changes in interest and exchange rates. So it's no wonder they are not very happy about the fashionable advice of economists. They long for stability. And they will naturally seek ways of attaining it.

One striking reaction by a number of emerging nations to the recent crises has been a reversal of long-standing policies to insist on national ownership of banking institutions. In the face of turbulent markets, the instinct to seek stability by increasing the size and diversity of financial institutions is surely sound. For a small country, the surest way—maybe the only way—to achieve that size and diversity is, in effect, to import it, by permitting their bank to become foreign owned. How could it be otherwise? It is exactly that instinct that is driving so many of the mergers and consolidations in the developed world, where institutions are so much larger to begin with.

More directly in the exchange rate area, we are seeing another way to "import" stability—the extreme opposite of floating. A number of countries have decided to cling to a larger more stable currency by means of "dollarization" or "euroization" or by the old-fashioned but newly revived technique of a currency board. That's not a decision to be taken lightly. It involves political as well as economic costs, and it brings me back to the question of monetary policy. For a country to adopt the dollar, or another foreign currency, means to abandon an independent monetary policy. In effect, for those countries, at least 50 percent of Harry Hutchinson's textbook becomes irrelevant.

The loss of monetary independence has been equated with loss of control over a nation's economic destiny. But for some countries it's fair to ask whether the perceived loss of national autonomy is real or illusionary. Can in fact a small and open economy effectively have an independent monetary policy and control its financial destiny? Can Indonesia, or Thailand, or Mexico, or Argentina really have freedom of choice in a world of globalized finance? Or, does the market itself (or when the crisis arrives, the IMF) impose limits—limits that may be more arbitrary and seemingly capricious than use of a foreign currency? The point can be put more positively. Wouldn't the benefits of the currency stability and lower interest rates inherent in linking the dollar or the euro be more beneficial to growth and efficiency over time than the purported loss of monetary autonomy?

None of this is of much direct concern to the biggest economies of the world—certainly not to the United States or the European Union. They are diversified, relatively closed, continental size economies. By their nature, they already have the benefit of a common currency, a common currency extending over hundreds of millions of people and trillions of dollars of GDP, and over 50 states and 11 nations. Only the most extreme changes in their exchange rates with the rest of the world arouse strong political or economic concerns. They have, by their behavior, demonstrated their determination to "go it alone".

The trouble is they have become almost totally passive with respect to management of exchange rates. That leaves us with a systemic problem. Passivity in the face of even large exchange rate changes among the United States, Europe, and Japan poses intractable problems for many small emerging economies. Those problems directly undercut the potential benefits of global finance.

How can the small exposed countries rationally stabilize their exchange rates, or passively let them float, when their major trading partners themselves have currencies that swing in value by 25 or 30 or even 40 percent or more over the course of a year or two? The inevitable result is abrupt changes in the competitive position of their industries and in the costs of imports—changes over which they have no control or influence. Their industries, with committed capital investments, supply relationships, and sales patterns cannot easily adjust, certainly not in a year or two, only to see the exchange relationships reverse.

I must emphasize what is apparent to any observer. Changes of the magnitude we have seen in the dollar/yen or the dollar/euro exchange rates simply can't be explained by so-called fundamentals or unexpected shocks. They have continued at a time of general price stability. Growth patterns among the major economies have differed, but without changing suddenly. We have had a decade remarkably free of outright recession among the major nations. We have had, in fact, the most stable economic environment in decades.

So why don't we do something about it? There is the belief that the global markets are simply too big to manage, that the potential flows of funds are so massive that any

attempt to fix exchange rates is bound to fail. Influencing exchange rates has implications for monetary policy, and no really large country will contemplate giving up independence in monetary policy.

But I observe that precisely that kind of commitment is in fact being made unilaterally by a number of smaller Latin American, Asian, and European countries that have opted to attach themselves to a strong currency. Countries with a history of inflation, instability, and weak governments sense an urgent need for both currency stability and the lower interest rates that stability would foster. That need seems more pressing than concerns about monetary autonomy—an autonomy they recognize that has become as much illusion as reality in a world of global finance.

What is equally clear is that the sustainability and value of a link to a major currency is related to two important conditions. The first, of course, is that the anchor currency is itself reliably stable in terms of purchasing power and widely usable, qualities associated with the U.S. dollar and potentially the euro. The second condition is that financial and trading relationships with the anchor currency are close and dominant. Otherwise, the exposure to big fluctuations among the major currencies will create difficulties. The present problems of Argentina are a case in point. The attachment of the peso to the dollar a decade ago was hugely successful in stabilizing prices, encouraging industrial reorganization and financial discipline, and promoting growth. But the persistent depreciation of the euro, compounded by the devaluation of the Brazilian real has gravely weakened its competitive position in the past few years, recreating a sense of crisis. Plainly, it is that second condition that limits the practicality of many countries finding refuge in dollarization, euroization, or a currency board.

But that doesn't mean that things aren't changing. The most striking change is not in the emerging world but within Europe itself. There, 11 members of the European Union have made a decisive break with the past, giving up national monetary autonomy in favor of a common currency, the euro. That is a recognition of the fact that a true economic union with completely open borders and free flows of finance is simply not consistent with extreme volatility in exchange rates. And the ultimate protection against that volatility within Europe is a common currency.

Among the nations of Southeast Asia, where trade with the rest of the world is so widely diversified, there is discussion about the possibility of emulating the European approach by forming a regional currency in an attempt to provide a measure of stability. Success in that effort would be, to put it mildly, surprising. Unlike Europe, intra-regional trade is limited. There is an absence of both a strong national currency and a well-developed financial center to anchor the system. East Asia would remain exposed to the wide fluctuations in exchange rates among its major suppliers and export markets.

What those events and yearnings do suggest, however, is the strong possibility that over time we will see regional economic areas built around zones of free trade and close currency relationships. That tendency will be encouraged by NAFTA and a wider Western hemisphere free trade zone. In larger Asia, in the decades ahead, it could be the Chinese yuan rather than Japanese yen that emerges as the regional anchor.

Then a larger question is posed. Will those regions remain open to each other and third nations, and thus be stepping stones toward a truly global system? Or will they gravitate, with or without conscious purpose, toward inward-looking blocs in political as well as economic regional isolation? I have come to the conviction that the full implication of a truly global system of trade and finance will ultimately be a common currency encompassing most of the world. But I am realistic enough to know that is not a project for my lifetime.

What we can do, and should do to achieve the benefits of global finance, is work toward greater stability among the major currencies. We could begin modestly. We don't need to know precisely what the right exchange rate is. We can allow for the fact that a presumed equilibrium rate could change over time, guided in part by persistent market trends. We can recognize the value, given the inconsistencies and vicissitudes of economic and political life, for some meaningful flexibility in exchange rates. But at the same time, we should be able to resist the extreme swings in exchange rates among the dollar, the yen, and the euro—swings that are driven more by the herd behavior of markets, and by the recurrent swings in market mood from exuberance to fear, than by any reasonable evaluation of a sustainable equilibrium.

Suppose, to be specific, the G-7, or the Big Three, the United States, Japan and Euroland, took the position that fluctuations in their currencies beyond a band of, say, 20 or 25 percent should be resisted. That's a pretty wide margin for market flexibility, but much smaller than the swings we have seen. Larger changes would be resisted, if necessary, by direct intervention in the market. No doubt, to be successful and credible, that intervention would need to be supported by an understanding that monetary policies would, if and as necessary, also take account of the desirability of greater exchange rate stability. The main central banks would be encouraged to consider how they might coordinate policies to that end, a process that has been only isolated and sporadic in the past.

Therein lies the point of contention—that the domestic aims of policy would be subverted. I cannot deny the obvious, that points of perceived conflict could arise. But my own experience suggests something else. More often than not, strong movements in exchange rates suggest a need for rethinking and modifying monetary and fiscal policies in the interest of domestic as well as external stability.

In ordinary circumstances, the kind of rather wide exchange rate band I have in mind would leave a lot of room for cyclical differences in monetary policy. Central banks would not need to move continuously in lockstep. Indeed, a growing sense in the market that exchange rates would revert toward a "central tendency" or sustainable equilibrium would in some instances free the hands of the monetary authorities.

In one sense, the aim would be modest: to avoid the extreme fluctuations that, in fact, bear no relationship to differentials in interest rates or inflation rates or to more fundamental shifts in competitiveness. But the consequences, in making it possible for emerging countries to live more comfortably with freedom of international capital movements, would be substantial. In the technical terms of economic text books, what it comes down to is whether markets, by sensible international policies, can be dominated by stabilizing speculation—a tendency for market operators themselves to step in against extreme movements for the simple reason that profits can be made. Plainly, more often than not it is the opposite that has been happening. The perception is that,

in the jargon of the market, "the trend is your friend"; the way to make money is to join, even lead, the herd.

What will count in the end is credibility—a recognition that there is national interest in greater stabilization and a willingness to act. That credibility will require time to attain. I would argue that it is attainable. We have attained it in an area at least as difficult, turning away the inflationary expectations that dominated and constrained monetary policies a couple of decades ago in my country and many others. The Europeans, recognizing the risk of currency instability tearing apart the common market, went a long way toward establishing the necessary credibility within their regional market even before taking the leap into the common currency. The Swiss, among others, have demonstrated that it is feasible even for a small economy.

The kind of approach that I have suggested is much less demanding than the European experience. But if successful, it can be an important way station toward the much more distant vision of a true world currency. In the meantime, I believe that it can be—in fact, it must be within our lifetimes—a critical ingredient in a truly effective global financial system, a system that works to the benefit of all the countries of the world, large and small.

NOTE

This is the speech given by Paul A. Volcker at the University of Delaware on Monday, 30 April 2001. Mr. Volcker was awarded an honorary degree and gave the annual Hutchinson Lecture, named in honor of Harry D. Hutchinson, who taught economics for 30 years at Delaware and was well-known for his concern for students and his money and banking textbook.