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Panel on Global Financial Markets and Public Policy

When economic historians look back at 1998, they will no doubt remark on the dichotomy between the great strength of the U.S. economy and severe financial crises in other parts of the world. The two papers reproduced here from a panel on Global Financial Markets and Public Policy, organized by James Bicksler, reflect this dichotomy. David Jones focuses on the successes of Chairman Greenspan, reflected in the United States' low inflation and high growth in the midst of major challenges to financial stability. Joseph Stiglitz focuses on global financial crises, and he proposes government measures to dampen financial instability and systemic risk, including governmental control over short-term capital flows and modifications of bankruptcy procedures in a crisis environment.

Fed Policy, Financial Market Efficiency, and Capital Flows

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MOST WOULD AGREE THAT Federal Reserve Chairman Alan Greenspan has reached peak form now that he is well into his third four-year term as head of our central bank. In his approach to monetary policy, Greenspan is more of a pragmatist than an idealist. He is respected as a great "numbers cruncher," including even the most obscure economic data in his efforts to assess the health of the U.S. economy. Most importantly, Greenspan has shown remarkable foresight in initially establishing strong anti-inflation credentials and then, more recently, showing acute sensitivity to the global financial crisis and a related shift in the balance of risks to the downside. Moreover, Greenspan has exhibited a refreshing openness in conveying his policy intentions, as well as keen political instincts when dealing with both Congress and the White House. But looking ahead, it is important to note that the Fed Chairman has turned in an "A" level performance at almost exactly the time when central bankers are facing unprecedented global challenges.

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In his countercyclical policy efforts, Greenspan has refined the technique of preemptive policy moves. In this regard, he has shown great flexibility in seeking to anticipate economic problems, taking risks in adjusting policy to remedy these problems, and being willing to reverse field when necessary. For example, during the period from early 1994 through early 1995, the Greenspan Fed launched a series of preemptive tightening actions against the threat of inflation. Global capital markets were initially jolted by these Fed interest rate hikes, but without question this experience heightened the Greenspan Fed's anti-inflation credibility. Moreover, when economic growth subsequently weakened abruptly later in 1995, the Greenspan Fed reversed course and eased. To take another more recent example, Fed policymakers engaged in three rapid-fire interest rate cuts in September, October, and November 1998 aimed at countering financial market instability and a feared pronounced slowing in U.S. economic growth. These preemptive Fed easing steps in turn induced easing actions by major European central banks aimed at countering a threatening slowing in Euroland economic growth. These easing actions by major U.S. and European central banks, in turn, paved the way for central banks in several emerging countries to lower prohibitively high short-term interest rates, previously required to support their beleaguered currencies.

I. Greenspan's Policy Contributions

Above all, Chairman Greenspan has sought to achieve the longer-term objective of maximum sustainable economic growth. This condition of maximum sustainable or peak noninflationary economic growth means that the economy is growing as fast as its supply-determined "trend or true" potential allows.

In this connection, the Fed Chairman has observed that over the long haul, a nation's trend or true potential noninflationary growth is effectively limited to the expansion of its capacity to produce goods and services, which is, in turn, determined by the sum of productivity growth plus labor force growth. From the early 1970s to the early 1990s this sustainable annual pace of trend or true U.S. growth was estimated at an unimpressive 2 percent, consisting of approximately 1 percent annual labor force growth and only about 1 percent productivity growth. However, in his July 1997 Humphrey-Hawkins testimony, Chairman Greenspan raised the possibility that the high-tech business investment boom underway since the early 1990s may have produced a permanent increase in productivity growth which would, in turn, imply a higher pace of trend or true potential for noninflationary growth. Indeed, judging from a sharp acceleration in annual nonfarm productivity growth to around 2 percent during the latest 1996 to 1998 period, it would not be an exaggeration to suggest that the sustainable annual pace of trend or true noninflationary growth is presently closer to a more vigorous 3 percent, consisting of 1 percent annual labor force growth and a higher 2 percent productivity growth.

Most significantly, Greenspan has been among the first of prominent officials to recognize the positive "new era" possibilities produced by a high-tech revolution that has apparently triggered a permanent upward shift in productivity growth. In fact, these positive new era developments have recently made Chairman Greenspan more tolerant of strong growth, even with full employment.

Over the course of his tenure as Fed Chairman, Greenspan has put his own stamp on U.S. monetary policy. Most significantly, Chairman Greenspan has sought to make previously secretive policy intentions more open and transparent. With the growing importance of capital market participants' perceptions of Fed policy intentions and related expectations, Greenspan has sought to prepare market participants for upcoming policy shifts through his Congressional testimony or other scheduled speeches.

In his countercyclical policy actions, the Fed Chairman uses a flexible federal funds rate target as his key policy guide. (The federal funds rate is the rate on bank reserve balances held at the Fed that are loaned and borrowed among banks, usually overnight.) The Greenspan Fed typically moves its federal funds rate target in modest but frequent steps, both upward as it tightens in order to counter inflationary threats, and today, with equal dispatch, downward as it eases to counter the threat of recession.

Moreover, during his third four-year term as Chairman, Greenspan has been prescient in emphasizing growth at a time when inflation has remained remarkably subdued. The conceptual basis for such a growth-oriented policy was initially found in the idea of "opportunistic disinflation." According to this concept, when inflation is low, Fed policymakers should be mainly preoccupied with sustaining economic growth rather than fighting to push the rate of increase in prices still lower. Originally, Fed authorities felt that they should wait for an "opportunistic" recession to achieve further disinflation.

More recently, however, we have benefited from a variety of structural forces that have operated to subdue wage and price pressures in the current economic expansion. These more basic, longer-lasting influences include global competition, information technology, corporate restructuring, outsourcing, deregulation, and weakening union power. To the surprise of many, workers appear to be reluctant, despite full-employment conditions, to demand anything but moderate wage increases, and businesses find themselves with diminishing pricing power. As a result, businesses attempt to maintain profit margins by cutting costs and improving productivity. At the same time, consumers remain acutely price conscious, typically waiting for bargain discounts before they buy goods and services. Also helping to moderate overall increases in labor compensation has been greater supply-side flexibility in the labor market, evidenced by increased reliance on part-time, temporary, flex-time, or contract workers, or even by labor outsourcing. Moreover, supply-side flexibility has been enhanced in product markets. For instance, in his July 1997 Humphrey-Hawkins testimony Greenspan observed that producer capacity (plant and equipment) can adapt and expand more expeditiously than in the past to meet demands. Greenspan noted that

". . . [i]n recent years, technology has engendered a significant compression of lead times between order and delivery for production facilities. This has enabled output to respond increasingly faster to an upsurge in demand, thereby decreasing the incidence of strains on capital capacity and shortages so evident in earlier business expansions."

At present, Greenspan does not face the threat of accelerating prices of goods and services, but of an emerging asset price bubble in the form of a speculative surge in stock prices. Perhaps the main threat to the economy in 1999 lies in the fact that consumers have tied their spending to this stock price bubble with a resulting decline in savings out of income to negligible, even negative, levels. In the likely event that the stock price bubble is punctured in 1999, consumer spending will slump, and, as uncertainty grows, individuals will almost certainly seek to increase their abnormally low savings rates. Serving to help deflate stock market optimism in 1999 are likely to be the twin forces of declining profit margins and more flare-ups in the global financial crisis.

Meanwhile, the Fed Chairman is faced with the nearly impossible task of trying to curtail stock market euphoria. Clearly, "jaw-boning" has not worked, as evidenced by the fact that after Greenspan warned of "irrational exuberance" in December 1996, the Dow-Jones industrial average promptly soared from around 6,500 (at the time of the Chairman's warning) to over 9,300 in mid-July and again in mid-November and late December 1998. As stock prices were surging higher in 1997 and reaching triple peaks in 1998, Chairman Greenspan seemed to have second thoughts about challenging the collective judgment of so many buyers and sellers in that market.

II. Changing Monetary Policy Transmission Mechanism

Today, capital markets are playing an increasingly important role in the transmission of monetary policy. The modern-day process for transmitting the effects of monetary policy shifts is primarily through capital market asset price adjustments (i.e., bonds, equities, commodities, foreign exchange, etc.) rather than mainly through the traditional channel of the cost and availability of bank credit. To underscore this point, the bank share of total credit intermediated in support of economic growth has fallen dramatically to only about 33 percent at present from as high as 55 percent in the mid-1970s.

Contributing to this declining bank share of total credit has been globalization, securitization, and financial product innovation. Among the major new nonbank institutional suppliers of credit through the capital markets are mutual funds, hedge funds, pension funds, finance companies, and insurance companies. Through securitization, for example, banks are able for a fee to originate and pool their mortgage loans, auto loans, or credit card receivables and move them off their balance sheets to form capital market instruments such as mortgage-backed securities or asset-backed securities into which individuals can invest their savings either directly or through mutual funds. Also, in present circumstances, mutual funds are eager to purchase in the capital markets large amounts of initial public stock offerings (IPOs) by smaller businesses that in the past could raise funds only by borrowing at banks.

Because of the rapid pace of financial innovation, Chairman Greenspan can no longer rely, at least in the short-term policymaking context, on a single intermediate policy indicator such as monetary aggregate growth to accurately predict economic activity or inflation. As a case in point, in the period immediately following the mid-August 1998 Russian devaluation and debt moratorium, the Fed Chairman sought to assess the impact of extremely volatile and less accommodative U.S. financial conditions on future economic growth by closely following such esoteric intermediate policy indicators as credit spreads and liquidity premiums. Credit spreads, which widened dramatically during this period of sudden investor risk-aversion, are typically measured by the difference between yields on Treasury securities (posing no credit risk) and yields on junk bonds or lesser-rated corporate debt (posing greater credit risk). Liquidity premiums also surged during this unstable period as fear dominated greed and many investors sought to completely disengage from the market. The liquidity premium can be measured as the gap between on-the-run Treasury securities yields (offering the best liquidity) and yields on the infrequently traded off-the-run Treasury securities (offering less liquidity).

In addition, Chairman Greenspan and his fellow policymakers have focused intently on lender attitudes, which have recently turned more restrictive for larger business borrowers, as revealed in the Fed's quarterly senior bank loan officer survey. Specifically, Fed policymakers observed in connection with their October 15 cuts in the discount rate and in their federal funds rate target that "[g]rowing caution by lenders and unsettled conditions in financial markets more generally are likely to be restraining aggregate demand in the future."

III. Massive Global Capital Flows

Perhaps the most sobering lesson for modern-day central bankers is their reduced effectiveness in controlling massive global capital flows and related financial asset price bubbles. In today's environment of market deregulation, financial innovation, integrated global financial markets, and advanced information processing and communications technology, there is a massive pool of liquid, mobile capital that relentlessly seeks out countries where business activity generates the highest possible return for a given degree of perceived risk. Partly because technology has lowered the cost of moving funds across national borders, these powerful global capital flows have mushroomed in the 1990s. Evidencing this explosion in global capital flows has been a sixfold increase in net private investment in developing countries from $50 billion in 1990 to a whopping $300 billion in 1997. About half of this 1997 total consisted of short-term, highly mobile financial investment flows (i.e., bank loans, stocks, and bonds) and half represented longer-term direct investment. Moreover, in 1997, the bulk of this net private investment total was flowing into Asian developing countries.

The Asian financial contagion, which began in the summer of 1997, underscores the diminishing influence of central banks and the increasing dominance of global capital flows. The Asian financial turmoil began in the small but rapidly growing country of Thailand and spread initially to other Southeast Asian countries and then to additional East Asian countries including South Korea. These developing and newly industrial economies had benefited from an abundance of private foreign capital. But the heavy private financial capital inflows eventually resulted in excessive growth, mounting trade deficits, and rapidly inflating asset price bubbles unusually manifested in frenzied local bank-financed speculation in local real estate and equities.

In South Korea, in particular, banks engaged in heavy short-term dollar borrowing in support of speculative stock market and real estate activities, thereby assuming potentially fatal foreign exchange risks. The financial crisis in these countries was triggered when escalating trade deficits and thinning foreign currency reserves scared away global money managers, triggering a rapid depreciation in local currencies, and rapidly rising interest rates. As the financial bubbles burst, real estate and stock prices plummeted. This unforeseen instability posed a major threat to the affected countries' banking systems, as bad debts mounted. To the surprise of many, this financial contagion has spread worldwide, engulfing Russia, Brazil, Hong Kong, and even mainland China. This global financial turmoil could not have come at a worse time for Japan, the second largest economy in the world, which was continuing to suffer from government indecision in dealing with a weakened financial system and depressed economy, arising from the bursting of its own huge asset price bubble, which reached maximum size in the late 1980s.

The point is that when asset price bubbles burst about all a central bank or the International Monetary Fund (IMF) can do is to serve as a last resort lender of liquidity. There is, however, the attendant "moral hazard" of sometimes excessive, ill-advised risk-taking by global investors who assume that central banks or some supranational authority like the IMF will bail them out. More generally, central banks can, of course, attempt to facilitate the smooth functioning of the credit intermediation process from lenders and investors on the supply side to borrowers on the demand side by ensuring that banks make sound credit judgments and capital markets function smoothly with adequate transparency and price discovery. The central bank can aid in this process by being as transparent as it can about its own intentions, as has been the case with the Greenspan Fed.

IV. Capital Market Efficiency

Without question, in the longer run, Fed-induced price stability (or an absence of consumer and business inflation expectations) is essential to contain speculation and allocate funds through the efficient functioning of the capital markets in support of sustainable growth. In turn, capital markets that efficiently allocate funds to the sectors of the economy promising the highest risk-adjusted returns are absolutely crucial to the wealth-creating success of modern capitalism.

The lesson of the 1990s is that it is not merely aggregate domestic savings that counts most in sustaining longer-term investment and growth but rather a nation's capital market sophistication and efficiency. In the United States, such capital market sophistication and efficiency has been responsible for generating a huge pool of risk capital and allocating it to promising, high-return sectors such as information processing, communications, and biotech. Only the United States, among major industrial economies, has developed a true "equity culture" so crucial to capital market efficiency. Essential to an "equity culture" are effective rules covering corporate governance, transparent accounting, reporting, and securities regulation. As the single-currency European block of 11 countries comes into existence in January 1999, it appears that they will try to develop such an "equity culture."

In contrast, Japan has generated a high rate of aggregate domestic savings but is still lacking in the wealth-creating potential of efficient capital markets. Indeed, in the past, Japanese capital markets have been overregulated and underdeveloped. For this reason, Japan has lagged behind in the high-tech revolution, as risk capital has remained scarce. This problem has been compounded by excessive reliance on an overregulated banking system to allocate credit. Hopefully, the "big bang" banking and financial market reforms currently underway in Japan will eventually remedy this situation, though progress so far has been extremely slow.

In conclusion, Fed Chairman Greenspan has reached peak performance at almost precisely the time that central bankers are facing their greatest global challenges. Central banks have diminishing influence over a massive pool of mobile, liquid capital that can be moved around the world by global portfolio managers at virtually the speed of light, seeking maximum returns but fleeing turmoil. Moreover, this process has been facilitated by technological advances that have lowered the costs of cross-border borrowing and lending. To be sure, central banks have by no means been powerless in dealing with the current global financial crisis, as evidenced by the Greenspan Fed's well-timed easing moves this past September, October, and November, which, in turn, triggered rate cuts by European and other central banks that have lessened the downside risk to the global economy. Additionally, there is the "safety net" of last resort lending by central banks and/or the IMF.

Nevertheless, the persistence and shocking pervasiveness of the global financial crisis suggests that central bankers and other government policymakers must come up with new ideas. They must seek to maintain the free private global capital flows so critical to sustained global growth and development. At the same time they must strive to lessen the potential for severe economic and social disruption of the type currently being experienced in many countries as a result of the lingering global financial crisis. Perhaps greater regional coordination and cooperation in matters of financial rescue, supervision, and disclosure would help. Also, central banks must at least attempt to ensure that the global credit intermediation process so crucial to sustained growth is operating smoothly, with adequate transparency and efficiency.