Global Economic Integration: Opportunities and Challenges— A Summary of the Bank's 2000 Economic Symposium

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The increasingly integrated global economy presents policymakers with both opportunities and challenges. Global economic integration is widely thought to improve the allocation of resources, promote technology transfer, and enhance living standards. But, at the same time, economic integration has frequently been blamed for growing trade imbalances, increased financial market volatility, and less effective domestic macroeconomic policies.

To better understand how policymakers can maximize the benefits from globalization while recognizing the challenges, the Federal Reserve Bank of Kansas City sponsored a symposium titled, "Global Economic Integration: Opportunities and Challenges," held at Jackson Hole, Wyoming, on August 24-26, 2000. The symposium brought together a distinguished group of central bankers, academics, and financial market experts. Participants at the symposium agreed that globalization has produced net economic benefits for national economies and outlined a variety of approaches for addressing the associated challenges.

Economic integration, financial markets, and trade

The first day of the symposium covered a variety of issues from various perspectives, including those of Federal Reserve Chairman Alan Greenspan, two financial market regulators, and several public-

sector and academic economists. The session started with a discussion of the factors driving global economic integration, then turned to financial market issues. Academic economists gave their views on how economic integration has affected financial market stability, and a panel of regulatory specialists discussed possible policy responses. The day concluded with an overview of trade issues from the perspective of the director-general of the World Trade Organization (WTO).

Driving forces

In his opening comments, Chairman Greenspan defined globalization as "the increasing interaction of national economic systems." He linked this trend to technological progress and to government policies that have promoted deregulation and privatization in markets around the world. In particular, technological improvements have lowered transactions and information costs, promoting the efficient operation of market-based economic systems. The resulting expansion of markets has been associated with increased competition and reduced tariffs and trade barriers.

Looking ahead, Greenspan questioned whether the trend toward global economic integration and free markets would continue as rapidly as in the past. The central tenants of free markets—competition and the Schumpeterian process of "creative destruction"—raise concerns in some quarters about the unequal distribution of wealth and the "civility of society." Accordingly, if the recent period of economic growth were to subside, support for free markets and trade liberalization could fade.

Following Greenspan's comments, Michael Mussa examined various factors that have contributed to global economic integration and are likely to contribute in the future. According to Mussa, factors driving integration fall into three categories—technology, preferences, and public policy. These factors have acted individually and interactively in driving integration.

Improvements in technology have bolstered integration by lower-

ing the cost of transporting goods and people from one place to another and by reducing the cost of communicating ideas. Social and individual preferences for the benefits of globalization—including an increasing variety of goods and services—have also contributed to integration. In contrast, public policy has at times promoted integration while at other times has acted as a barrier to globalization. Given these driving forces, Mussa examined how human migration and increasing trade and financial flows have defined the process of global integration.

In assessing future prospects, Mussa was optimistic. He suggested that the process of integration would continue because of continued technical innovation and favorable public policies. While there is always a risk that those opposed to globalization will gain political support, the economic prosperity that global integration has fostered will likely act as an effective counterweight. Moreover, despite occasional financial crises, most nations have shown little desire to withdraw from the increasingly integrated world economy. In fact, nations that have lagged behind in the process of integration generally want to catch up.

Commenting on Mussa's paper, Douglas Irwin agreed that technology, preferences, and policy have shaped U.S. trade in the 1990s. Irwin made three key points, focusing on trade. First, public policy has driven trade flows in the 1990s both on its own terms and in interaction with technology. Second, public support for integration is more likely when trade is driven by technology rather than public policy. And third, opposition to policies promoting trade has largely come from special interest groups whose influence may be waning.

Irwin shared Mussa's view that the process of integration would continue. While unskilled workers, acting in their own interest, may continue to resist freer trade, Irwin did not expect a resurgence of isolationist policies. The key to enacting trade-expanding policies, he said, is an educated and highly skilled work force.

Effects of increased economic integration on financial stability

After the discussion of factors driving integration, Paul Krugman examined whether financial crises might be an inevitable consequence of globalization. His paper contrasted the view prevalent in the early 1980s that economic integration reduced the risk of financial crisis with the view today that financial crises result from self-fulfilling panics that can occasionally develop in an integrated world economy. The paper then assessed various proposals to reduce the risk of crisis and discussed how increasing trade affects the relative merits of alternative policy solutions.

Krugman concluded that the process of globalization did increase the risk of financial crisis. Moreover, policies that address this increased risk involve trade-offs. Policies that reduce the risk of financial crisis through restrictions on capital flows do so at a cost that increases with trade flows. And, policies that protect against financial crisis through dollarization or "euroization" cause all of the adjustment to real shocks to occur through inflation or deflation.

Despite these policy trade-offs, Krugman suggested that, in the long run, increasing trade could eventually lead to a reduced risk of financial crisis. He pointed to two reasons. First, as trade increases relative to national output, so does the likelihood that a depreciation of the currency will have net expansionary effects. Second, globalization will eventually reduce the risk of financial crisis because it is associated with increased direct investment, which is inherently less risky than portfolio investment.

Commenting on Krugman's paper, Charles Goodhart argued that modern financial crises were not so much the result of global integration but of financial market deregulation and liberalization. Relatively calm financial markets from 1945 to 1973 were associated with a stable system of pegged exchange rates, wide-ranging controls over capital flows, and strict limitations on banking activities. The loosening of these regulations after 1973 produced net economic benefits, but also paved the way for financial crises.

To limit financial crises in the future, Goodhart advocated the development of domestic bond and securitized mortgage markets in emerging economies to reduce the need for bank and foreign currency borrowing. In addition, he argued for broadening our concept of bank and financial market regulation to include mechanisms for limiting volatile short-term capital flows.

How should financial market regulators respond?

Following the discussion of how economic integration affects financial stability, a panel of experts discussed how financial market regulators should respond to the associated challenges.

Andrew Crockett identified the objectives of financial regulation as efficiency, stability, and competitive equity. Efficiency means the price of risk reflects its cost. Stability means striking a proper balance between the inevitable and positive adaptations and changes that occur in a market system while avoiding the kinds of instability that carry unacceptable costs. Competitive equity means a state of "genuine competition among institutions," under which the benefits of competition are maximized.

To ensure efficiency, stability, and competitive equity, Crockett said regulators should not attempt to resist market forces, but rather should address market failures. Specifically, he suggested improving risk management practices at the firm level, improving supervisory oversight techniques, and increasing market discipline through greater transparency and robust accounting practices. Crockett also identified a number of practical issues facing policymakers in a world of increasing economic integration. Among these issues were the role of regulatory competition, the coverage of standards across a variety of financial institutions, and the role of central banks.

Howard Davies argued that there was no "single silver bullet solution" to addressing the shortcomings of the current international regulatory system. Indeed, he suggested a ten-point plan to improve the system. The key points in the plan were: developing globally agreed-upon standards of disclosure; improving disclosure of leverage in the

financial system; implementing standards and codes; giving greater consideration to the practical aspects of supervising complex global institutions; naming a "lead supervisor" for each group of internationally active institutions; increasing "mutual reliance" among supervisors; simplifying and rationalizing national regulatory structures; filling a number of existing gaps in the regulatory structure; improving international enforcement; and educating the public on the implications of globalization for saving and investing.

Randall Kroszner emphasized the role of private-sector "regulation" as part of a complete regulatory system. He put forth the view that the private sector would continue to "demand" regulation even as the world economy became more integrated. But this demand would be met, not just by public-sector regulators, but also through the private sector itself. In fact, as financial market innovation and globalization make traditional public regulation less effective, various private sources are providing a greater share of the supply of regulation. And, competition among the various public and private suppliers of regulation helps increase the benefits and reduce the costs of regulation.

Kroszner identified four forms of private regulation—"members only" organizations, voluntary standard-setting bodies, innovative firm structures, and third- party monitors—that work together and in competition with traditional public-sector regulators. After showing how these private sources of regulation operate in the derivatives and banking markets, Kroszner discussed how public regulators have responded to the globalization of financial markets. He concluded that the financial market challenges of globalization could be met through a "deeper analysis of the robustness of the private sources of regulation and a further understanding of how political economy forces shape the implementation and enforcement of public regulation."

World trade policy

In a luncheon address, Mike Moore focused on the failure of the WTO to launch a new round of trade talks in Seattle. He suggested

that the dynamics of the process had changed in four key areas since the Uruguay Round, making it unlikely that a new round could be successfully launched in the near future. First, controversial issues such as labor and the environment are now part of the negotiations. Second, more parties are involved in the negotiations. Third, popular support for free trade has declined. And fourth, the need for leadership and flexibility has increased.

Given these challenges, Moore concluded that launching a new round would be difficult but not impossible. What is required is "sustained pressure on governments" to generate "the political will needed to adopt more flexible positions in sensitive areas." He drew some optimism from the negotiations on financial services that are currently under way in Geneva. These negotiations are proceeding without controversy. They also are demonstrating the speed with which economic integration has advanced in the last ten years.

Macroeconomic stability and monetary policy

The second day of the symposium focused on macroeconomic issues. It started with a discussion of how economic integration affects macroeconomic stability, then turned to a consideration of how monetary policymakers should respond to the challenges of global economic integration. The day concluded with an overview panel that addressed what the future might hold.

Effects of increased economic integration on macroeconomic stability

Maurice Obstfeld and Kenneth Rogoff argued that globalization has not yet reached the point where large current account deficits can be sustained in the U.S. economy without serious implications for the world economy. As a result, the medium-term macroeconomic effects of a rapid turnaround in the U.S. current account deficit could be "quite dramatic." The adjustment could involve a very large depreciation of the dollar and, at the same time, a sharp drop in the demand for nontradable goods.

Obstfeld and Rogoff based their conclusions on the segmentation—or *lack* of integration—of international markets relative to domestic markets. The segmentation of international markets is evident from a variety of measures, including international price deviations and home bias in the demand for both equity and goods. Such impediments to trade have caused the share of U.S. goods traded internationally to remain relatively small. In addition, segmentation implies that large movements in prices and exchange rates can result from a current account adjustment of 4 to 5 percent of GDP, which is roughly the size of today's current account deficit in the U.S. economy.

Obstfeld and Rogoff estimated that, if the U.S. current account were to move rapidly into balance, the real exchange value of the dollar could fall by as much as 40 percent or more, depending on the monetary policy response of the Federal Reserve. In contrast, they estimated that a more gradual elimination of the current account deficit over a period of three to five years would lead to an adjustment in the real exchange rate of about 12 percent.

Commenting on Obstfeld and Rogoff's paper, Ignazio Visco agreed that international trade was segmented relative to domestic trade but argued that segmentation was gradually decreasing. He argued that the structural imbalance in the U.S. current account might be smaller than Obstfeld and Rogoff suggested and therefore might require a smaller exchange rate adjustment. He examined how stabilization policies might influence the outcome of a large U.S. current account adjustment and described how the economies of other countries and regions could affect, and be affected by, the adjustment.

Drawing on research from the OECD, Visco offered an alternative estimate of the effect of an adjustment in the U.S. current account on the foreign exchange value of the dollar. In arriving at his estimate, Visco attributed part of the current account deficit to cyclical factors, lowering the structural component to around 3½ percent of GDP. Visco also argued that, because of a variety of factors, a small current account deficit of around ½ percent of GDP was sustainable in the United States. Using Obstfeld and Rogoff's model and assuming no

short-run rigidities, Visco estimated that a reduction in the structural deficit from 3½ percent to ½ percent of GDP would require an 8.5 percent depreciation of the dollar—somewhat less than the Obstfeld-Rogoff estimate. But in Visco's view estimates like these may be misleading because the adjustment role of the exchange rate will depend on the type of shock that triggers the current account adjustment and on the monetary policy response.

How should monetary policymakers respond?

Following the discussion of how economic integration affects macroeconomic stability, a panel of central bankers discussed how monetary policy should respond to the macroeconomic challenges.

Donald Brash highlighted four issues related to global economic integration that affect central banks. First, increasing foreign trade is causing greater integration of countries and regions and thereby increasing the appeal of regional currency zones. Second, growing integration may have caused economies to become less inflation prone. Third, global financial institutions are developing at an accelerating rate, raising issues about financial regulation and the transmission of monetary policy. And fourth, the increasing speed with which capital flows around the world is making it more difficult for central banks to achieve domestic objectives.

Focusing primarily on the last issue, Brash described how monetary policy in New Zealand has responded to increased economic integration. Two key challenges are the heightened response of capital flows to changes in monetary policy and the disruptive effects of exchange-rate cycles to the macro economy. Among the key ingredients to successful management of external or internal shocks in an open economy are "clear, transparent, and credible objectives" and "effective risk management." The specific approach in New Zealand has been to adopt an explicit inflation target and to maintain floating exchange rates and an open capital account.

Guillermo Ortiz discussed the benefits and risks of globalization from the perspective of developing countries. He argued that the

most attractive monetary regime for developing counties with open capital accounts is a flexible exchange-rate regime. After reviewing the advantages and disadvantages of such a regime, Ortiz identified policies that would maximize the benefits. He also discussed recent monetary policy in Mexico in the context of a flexible exchange-rate regime, increasing globalization, and high uncertainty.

Ortiz reviewed several benefits and costs of floating exchange rates. On the positive side, floating exchange rates limit the volatility of production and help prevent the buildup of external imbalances. They allow central banks to pursue independent domestic monetary policies. They encourage capital to flow to longer-term portfolio and direct investments, and they eliminate any private-sector perception that the government will guarantee a particular value for the currency. On the downside, flexible exchange rates lead to higher risk premiums and therefore higher domestic interest rates. Flexible exchange rates may contain limited information if markets are thin or dominated by a few agents. And, hedging exchange-rate risk may be costly if derivatives markets are not well developed. While these costs are magnified in financially fragile economies, they can be lessened through public and private-sector efforts to reduce financial vulnerability.

Eugenio Domingo Solans discussed an approach to monetary policy called *bounded discretion*. He defined bounded discretion as “a formula able to combine the judgment and flexibility of discretion with the discipline that is achieved in the case of rule-based policy design through the automatic feedback between the target and the instrument variables.” In such an approach, reputation and institutional constraints would substitute for the automatic feedback component of a rule-based monetary policy. Solans argued that bounded discretion corresponded to the monetary policy framework of the Eurosystem.

In responding to the challenges of globalization, Solans said monetary policy should be credible, realistic, and efficient. It should involve “a lack of activism, combined with smoothness, judgment, flexibility, precommitment, time consistency, transparency, and accountability.

These requirements are better fulfilled by a discretionary policy design supported by central bank independence, pre-established prioritized objectives, a clearly specified encompassing strategy, enhanced communication, and democratic control."

Overview panel

The symposium concluded with overview comments and perspectives on the future from Martin Feldstein, Stanley Fischer, and Jacob Frenkel.

Feldstein reviewed several benefits of economic integration that are often overlooked. First, greater international capital flows allow investors more opportunity to reduce risk through diversification. Second, integration has spread Anglo-American concepts of corporate governance, accounting practices, and legal traditions. And third, integration has constrained governments' ability to enact bad fiscal and regulatory policy.

Feldstein also described several benefits from globalization caused by increases in foreign direct investment. In particular, foreign direct investment fosters technology transfer. It allows the labor force in the host country to become better trained. It generates profits and tax revenues in the host country. And it allows the foreign owners of capital to exploit economies of scale. While the host country may tax profits from foreign direct investment, the source country benefits when the investment is financed by funds borrowed in the host country.

Feldstein then gave his perspective on the causes of recent economic crises and policies to prevent them in the future. The domestic causes, which he said were exacerbated by the IMF's response, fell into three groups—exchange rate misalignments that created current account imbalances, a mismatch between short-term foreign exchange liabilities and foreign exchange reserves, and weak banking sectors under poor supervision. The way to prevent crises in the future is to avoid exchange-rate misalignments and balance-sheet mismatches and to strengthen banking systems and regulations.

Fischer discussed how globalization affected people's daily lives and why globalization generates political controversy. He distinguished between valid concerns for *better* globalization and concerns that were purely self-serving. He then proposed measures to address the valid concerns and pondered the future.

Fischer argued that globalization and the institutions involved in making it work better should be defended. But, at the same time, he suggested several areas for improvement. International labor and environmental standards could be crafted in a reasonable and non-protectionist way. Volatility of international capital flows could be reduced by the abandonment of "fixed-but-adjustable" pegs in favor of either floating or clearly fixed exchange rates. Advanced countries could reduce trade barriers in agriculture and textiles—areas of key concern to developing countries. International organizations could consider giving developing countries more decision-making influence. And, local and national cultures could be maintained and nurtured.

Fischer noted that, despite complaints, trade liberalization is continuing and most emerging market economies are maintaining open capital accounts. Looking ahead, he predicted that if policymakers managed the process well, globalization would potentially benefit all countries and likely benefit most.

Frenkel discussed how economic integration was shrinking distances and compressing time. Well functioning capital markets transform future expectations into the present, causing small policy changes to affect the market not just through demand effects but also through expectations of future policy. As a result, financial market volatility is amplified. The compression of time also means that with the benefit of technology and access to information, emerging market economies can jump across stages of development without going through the entire development process. In addition, because expectations of the future affect the economy today, policymakers have greater incentive to take the right actions. The benefits from doing so accrue faster than in the past.

Frenkel also drew implications for exchange-rate regimes from the compression of time. In effect, the short run is determined by the long run and there is no in between. Thus, if an exchange-rate regime is nonsustainable in the long run, it will not work in the short run. For example, a pegged-but-not-fixed exchange-rate regime will eventually attempt to peg the exchange rate at the wrong level for too long. The regime will collapse and credibility will be lost. Because the regime is not credible in the long run, it will not be credible in the short run. Therefore, countries will have to adopt either "very fixed" or "very flexed" exchange-rate regimes. By the same logic, Frenkel argued that exchange-market intervention is futile.

Frenkel concluded by urging policymakers to address problems now while the world economy is relatively strong. "You should fix the roof on a sunny day rather than on a rainy day." The only issue, he said, is political will.

Editor's note: George A. Kahn is a vice president and economist at the Federal Reserve Bank of Kansas City. Edee Sweeney, a research associate at the Bank, helped prepare the article.