



Global Linkages

Vincent Reinhart

Director, Division of Monetary Affairs

Board of Governors of the Federal Reserve

Secretary, Federal Open Market Committee

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Among the many questions asked, I'll address

- ◆ Financial openness and the volatility of real GDP
- ◆ Differences in corporate governance
- ◆ The effects of financial linkages on monetary policy in the core



Financial openness and the volatility of real GDP

Starting with a macroeconomic observation . . .

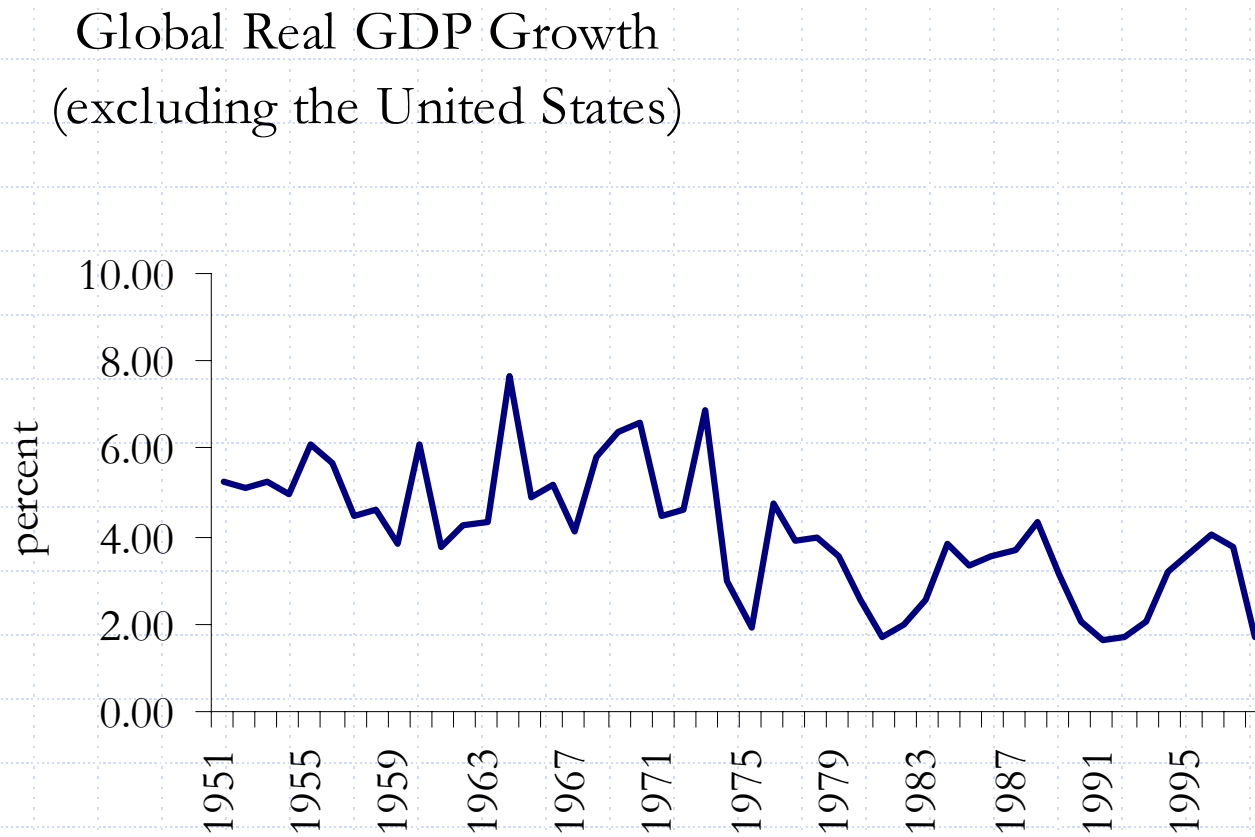


Source: Maddison (2000)

Which is more evident in the formal statistics . . .

U.S Real GDP Growth			
Percent			
		Average	Standard
			Deviation
1951 to 1982		3.5	2.5
1983 to 1998		3.5	1.6
Source: Maddison (2000)			

And even more evident for the rest of the world...



Source: Maddison (2000)

... which has also had an impressive decline in volatility.

Global Real GDP Growth (excl. US)			
Percent			
		Average	Standard Deviation
1951 to 1982		4.6	1.4
1983 to 1998		3.0	0.9
Source: Maddison (2000)			

A financial economist might speculate . . .

- ◆ Improvements in existing financial markets and
- ◆ The addition of new instruments
- ◆ Has allowed various risks to be traded to those more willing and able to bear them
- ◆ Allowing more effective smoothing of production and consumption

And therefore there is a benefit to the opening-up of financial markets.

But not all countries have shown improvement.
In Latin America, within that total, volatility . . .

Fell

Chile

Colombia

Uruguay

Rose

Argentina

Brazil

Mexico

Peru

Venezuela

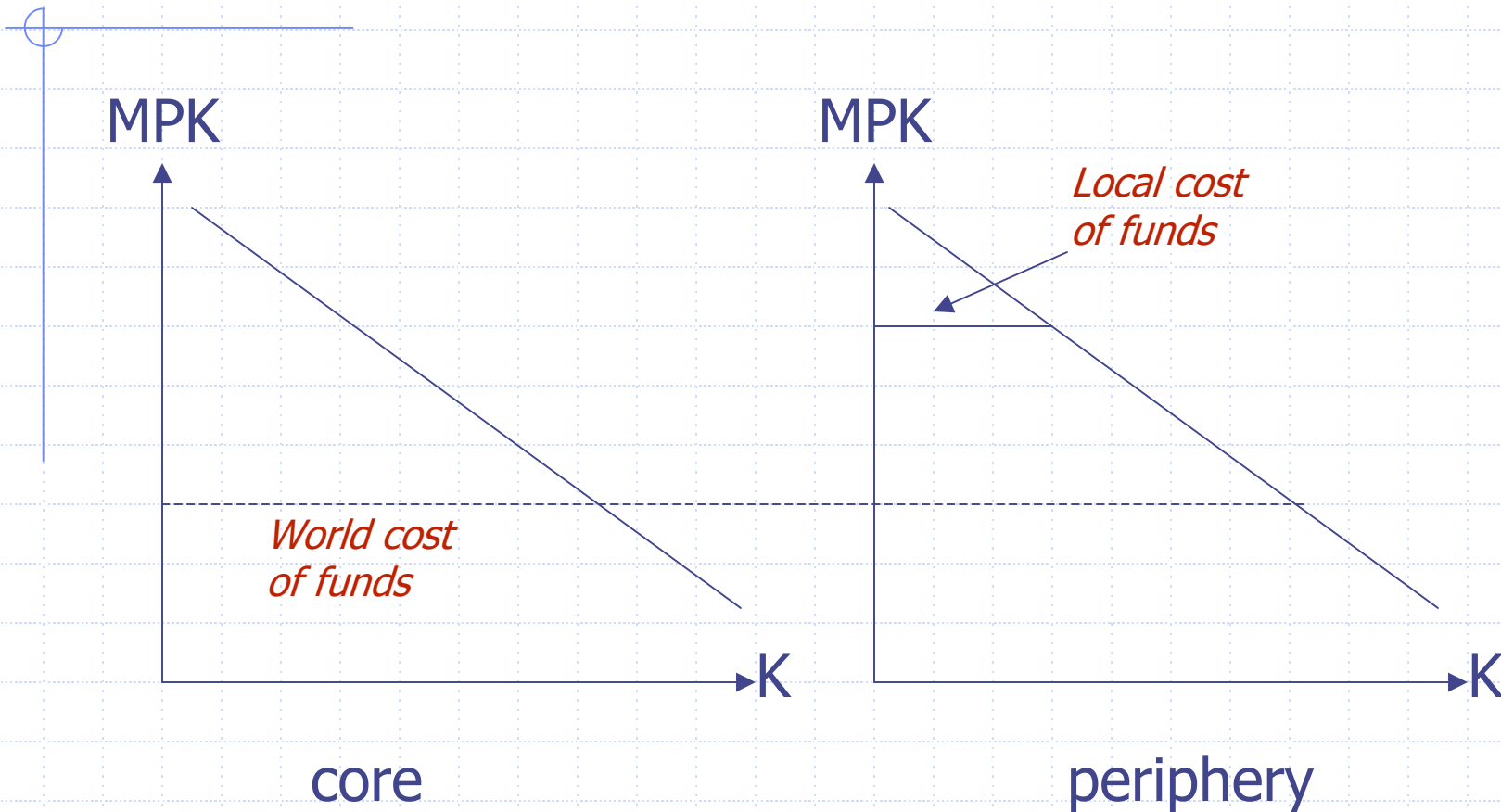
This might indicate that sequence matters:

- ◆ A mature country with developed financial infrastructure may be better poised
 - to take advantage of new opportunities to trade
 - to fit new instruments into the existing legal structure
 - to use existing instruments better with new opportunities to hedge
- ◆ An emerging financial market
 - may not have the depth to take advantage of these benefits
 - And may be more prone to financial crises
 - *unless* it has a more stable macro climate (Uruguay) or some obstacles to the trade of assets (Chile or Colombia)



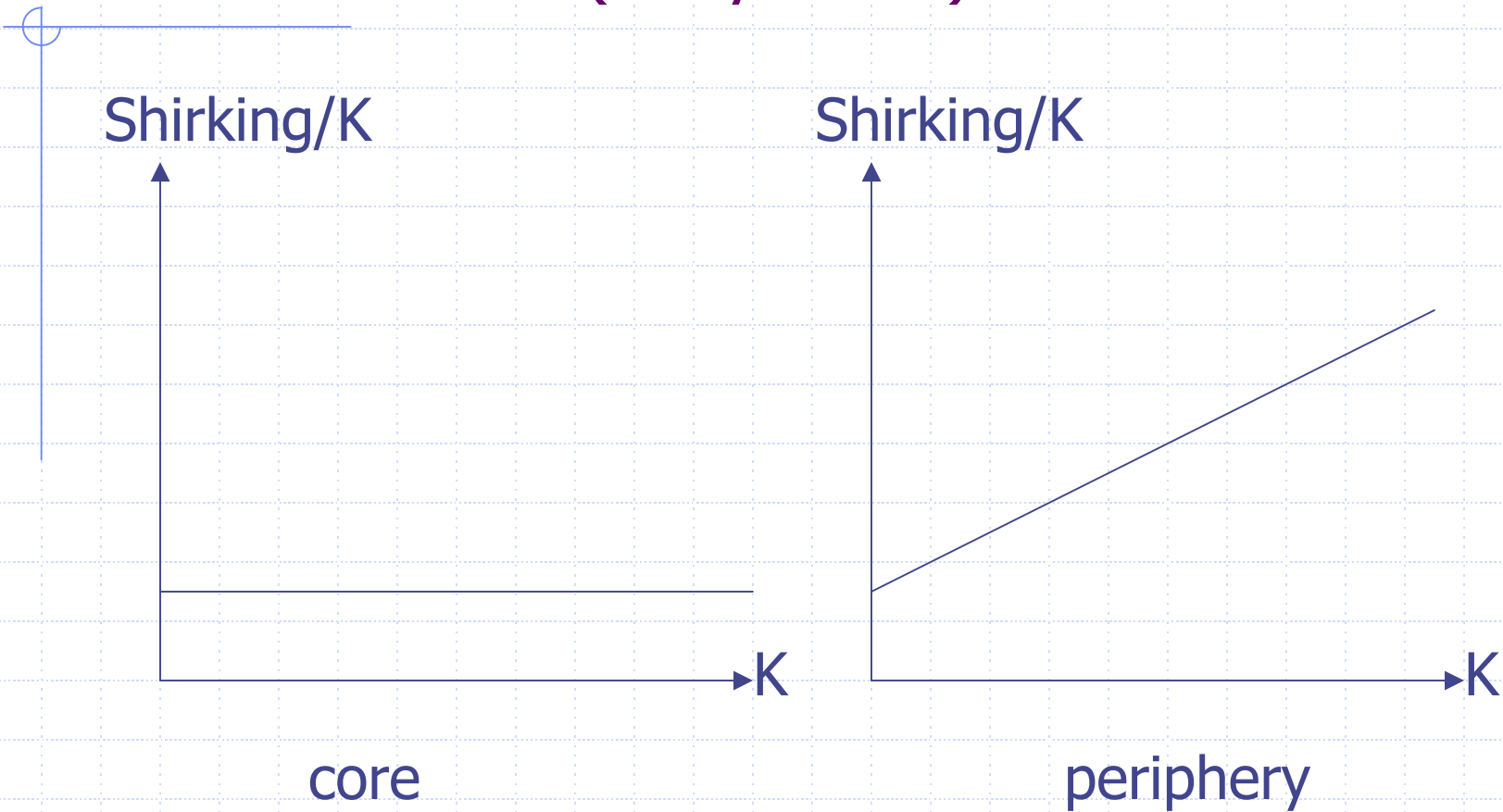
Differences in corporate governance internationally

The trade in capital should make everyone better off.



Why these benefits don't accrue is the Lucas paradox.

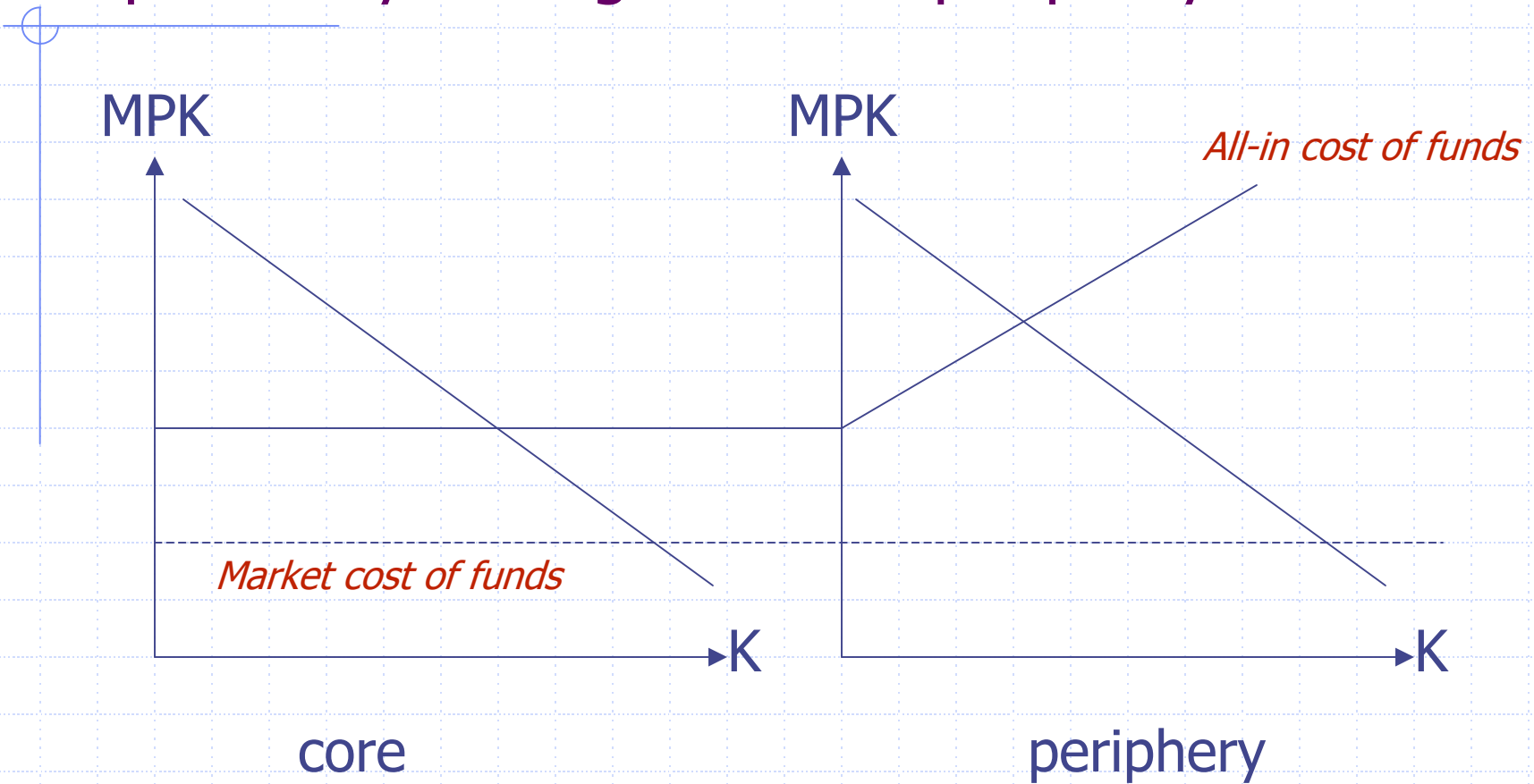
Suppose that managers misuse borrowed funds to some extent. (They shirk.)



With a large pool of potential managers, shirking is a constant-scale problem.

With a limited pool of potential managers, shirking increases with scale.

Most of the benefits of trade in capital would be captured by managers at the periphery.



The trade in disembodied financial capital may not accrue substantial benefits, without perhaps

- ◆ Foreign ownership so that core management is introduced in the periphery
- ◆ Foreign listing to enforce core governance standards
- ◆ Sequencing of liberalization until infrastructure at the periphery is established
- ◆ International codes and standards to establish best practices



Monetary policy at the core

Does U.S. monetary policy lose its effectiveness as global financial linkages increase?

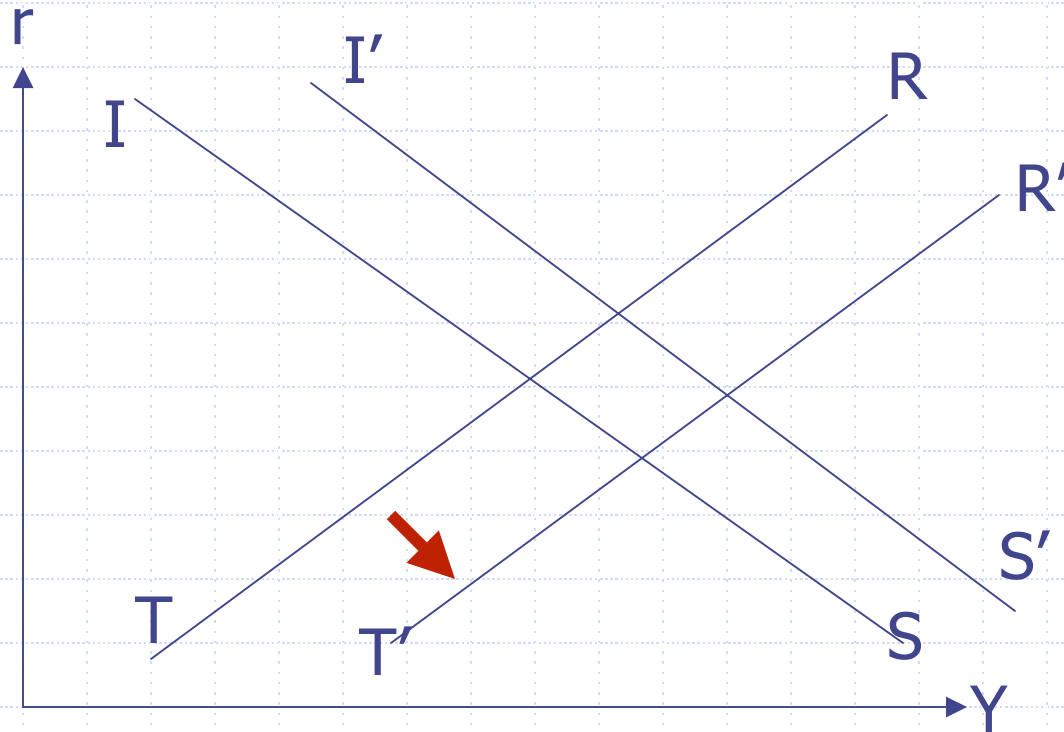
It is hard to predict the effect on international monetary arrangements as financial markets become more linked:

- ◆ It might be the case that
 - An increased menu of financial instruments
 - Deeper markets
 - Tighter arbitrage and
 - More sophisticated market participants
- ◆ Offer increased hedging opportunities
- ◆ Making floating exchange rates regimes more attractive
- ◆ It might be the case that
 - An increased menu of financial instruments
 - Deeper markets
 - Tighter arbitrage and
 - More sophisticated market participants
- ◆ Introduce enough other relative prices that exchange rate change don't have to be relied upon.
- ◆ Making fixed exchange rate regimes more attractive

In either case, for U.S. monetary policy . . .

According to the Mundell-Fleming model with floating exchange rates,

A U.S. monetary policy ease encourages depreciation that improves U.S. net exports. The world benefits because the global money stock increases from the increase by the U.S.

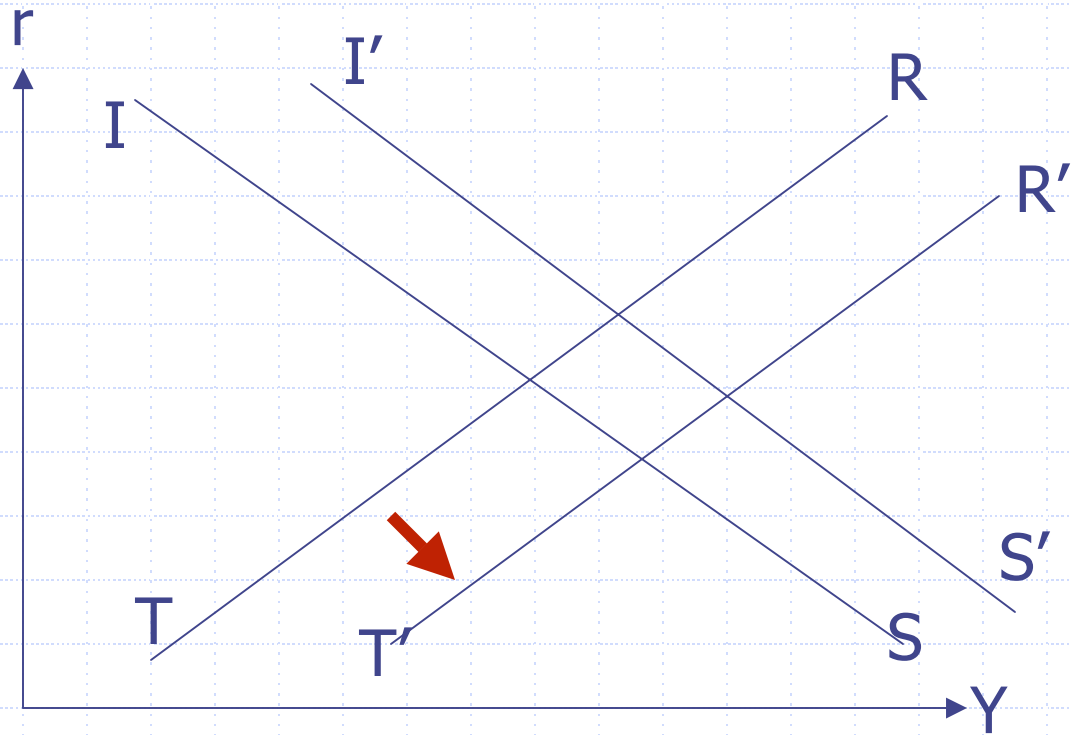


If more countries choose to smooth their bilateral exchange rates with the U.S. . . .

- ◆ It is not a return to a fixed exchange rate regime
- ◆ Because U.S. monetary policy will still be set according to U.S. interests
- ◆ Rather, foreign central banks will have to vary their policies to shadow Federal Reserve policy
 - To maintain their short-term interest rate close to the U.S. short-term rate
- ◆ In that case, there will be a magnification effect of U.S. monetary policy

In the Mundell-Fleming model . . .

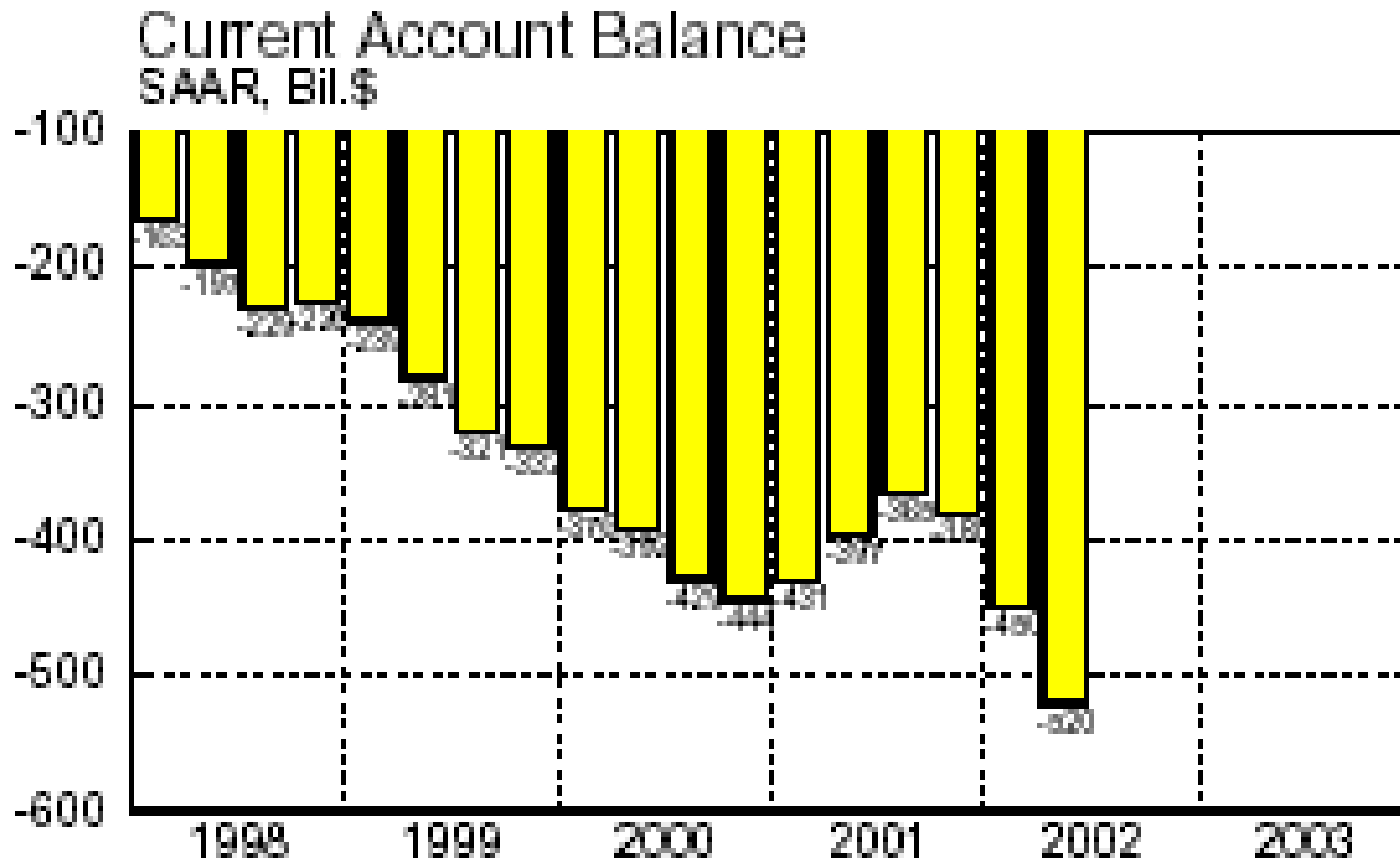
A U.S. monetary policy ease encourages increases in the money supply in other countries, to the benefit of their income and U.S. trade. The global money supply actually increases more.



Of course, as financial markets become more tightly linked,

- ◆ U.S. economic conditions are more likely to be influenced by foreign factors
 - U.S positions in foreign assets
 - Foreign ownership of U.S. intermediaries
 - More correlated movements in asset prices
 - Potential for financial crises to spill over to the U.S.
- ◆ U.S. monetary policy will have
 - To gauge the effect of those influences on U.S. activity and inflation and
 - Base policy on that forecast.

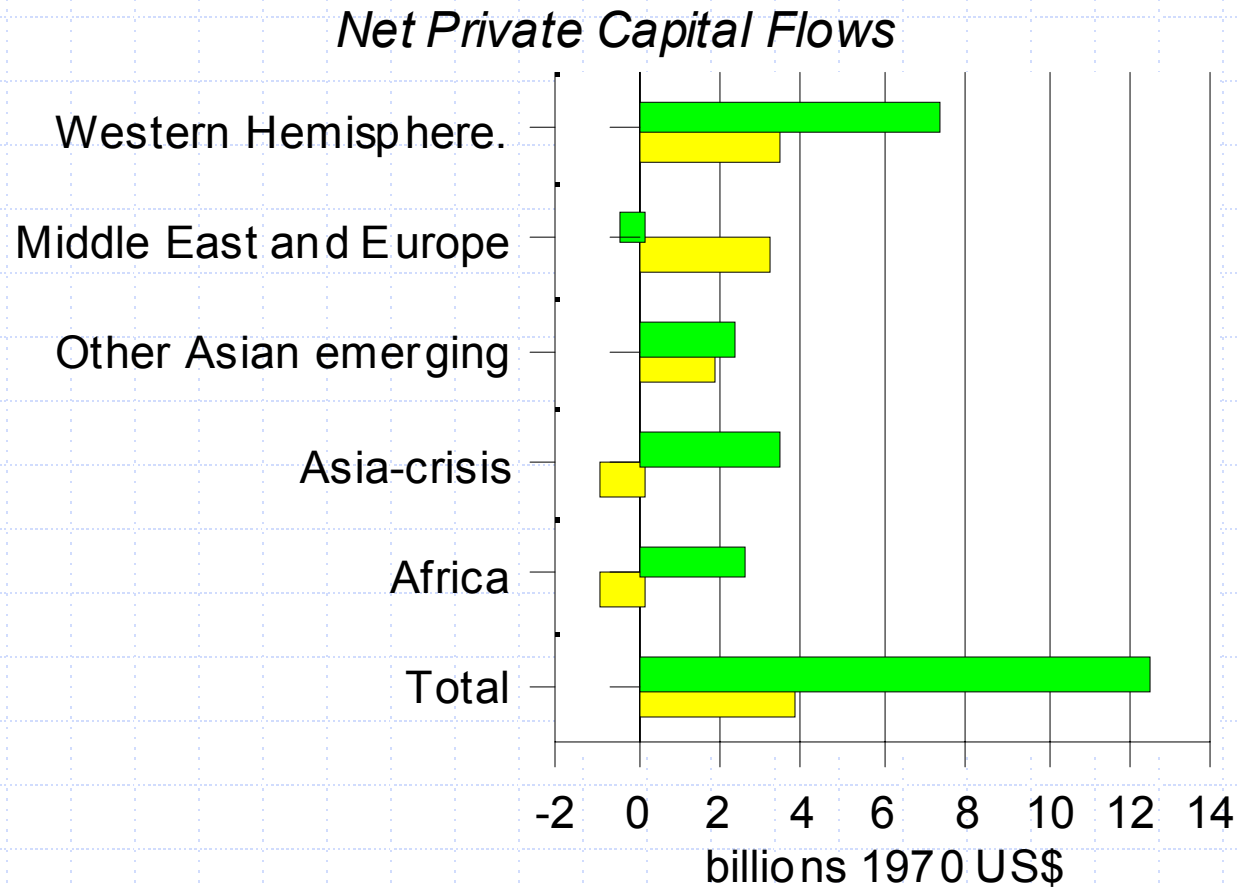
The sad fact is that the U.S. has strong interest in deepening markets abroad . . .





As to monetary policy at the periphery,

U.S. monetary policy has always been an important influence.



easing



tightening

