A discussion with University of Wisconsin economics professor Charles Engel, a senior fellow of the Dallas Fed’s Globalization and Monetary Policy Institute, ranges from the current financial crisis to the unpredictability of exchange rates.

Q. What are some important themes of globalization?

A. One of them is that global trade is increasing. If you look at importing and exporting as a percentage of world gross domestic product, it’s grown by leaps and bounds over the past 20 or 30 years. That’s been true not only for the U.S. but also for just about everyone else.

From the U.S. perspective, one of the most striking things is how much our trade with China has increased. A lot of that has come at the expense of trade with Korea and Japan, so it’s not just that we’re buying goods from China that we used to make at home.

The other thing is financial markets. They’re much more intertwined than they ever have been. Part of this is because governments have allowed their residents to do more foreign investing and allowed foreign investors to buy more of their countries’ assets. That’s a trend that started in the early 1960s. For the U.S., Western Europe and Canada, most of that liberalization was completed by the end of the 1970s. In Asia, it continued to happen in the 1980s and 1990s.

The trend more recently hasn’t been governments relaxing regulations but just the amount of innovation in financial markets and the willingness of people to invest in financial assets around the globe.

Q. How does this globalization impact the current financial crisis?

A. In general, well-working financial markets perform better if they’re globalized. It’s better to be able to spread risk across a number of countries. It’s better to be able to channel savings to their most productive uses anywhere in the world. If capital markets mess up, if they’re misallocating resources or if there’s something wrong with the financial system, it’s going to be magnified if financial markets are globalized.

Certainly, we’re very aware of the international aspects of this financial catastrophe. We can’t build a wall around American banks. For example, in the current crisis, there’s no way to “rescue” only U.S. banks. If we successfully shore up the balance sheets of U.S. banks, this is good for the global banking system. This highlights why we need international cooperation. There’s a big incentive for each country to sit on the sidelines and let other countries take the risk and incur the expense of a financial rescue. We need some way to get all the major countries committed to a mutually agreed upon scheme to regulate international capital markets and ensure that they function smoothly in the future.

Q. What challenges does this financial crisis present for globalized financial markets?

A. It’s clear we needed more oversight of financial markets. A general worry is that we’ll impose too much, that we’ll throw too much sand in the wheels. Part of that would be stifling globalization. We don’t want to lose the benefits of a globalized financial system.

A separate but related worry is that there’s going to be some kind of economic nationalism, with countries treating domestic and foreign-owned institutions differently. I worry that without international cooperation, each country will try to devise schemes that favor its own banks and citizens at the expense of foreign investors. For example, countries might provide deposit insurance—but only for their own citizens. We could end up taking a giant step backward in the globalization of capital markets.

The thing we have to realize is that our financial system is intertwined with the rest of the world. The failure of a large international banking concern could harm our economy, just as financial troubles in the U.S. spill over into the rest of the world. We need to address this problem systematically, not in the ad hoc way we’re forced to during a crisis.

Q. What are your current research interests?

A. There are two main threads to my research. One is trying to understand exchange rate movements—why they behave the way they do. My work in that area has involved thinking hard about the implications of exchange rates as asset prices, which spills over into the way asset prices in general behave.

Currency values don’t depend only on current economic fundamentals, such as trade balances, money supply and national income. The asset-price approach pays attention not only to current data but also to expectations of what the fundamentals will be in the future.

One of the key things that comes out of the work is the observation that asset prices, including exchange rates, are unpredictable under much more general circumstances than many economists have believed. Simply put, we can’t do a good job of forecasting changes in exchange rates. That has implications for policymakers. It has implications for Wall Street. It has implications for international business.

Q. So the time and effort investors and companies spend trying to forecast exchange rates is just a waste?

A. I do think there are times when currency prices get out of line, and we can forecast an
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eventual return to more sustainable levels. When the euro cost $1.60 earlier this year, I was pretty sure it would come down, just as I was pretty sure it would rise when it was down around 85 cents several years ago.

But I am talking in these cases about a forecast over a long horizon. I sure wouldn’t want to try to predict which way exchange rates are going to go over the next couple of months or even the next couple of quarters.

Asset-price forecasters have a high propensity to fool themselves about how successful their prediction schemes are. A lot of models might look good with hindsight. But there isn’t much rigorous, peer-reviewed evidence that we can forecast exchange rates over short periods.

Q. And the other thread in your research?

A. I’ve been looking at aspects of open economies for monetary policy. The study of monetary policy is really dominated by this closed-economy framework, which is kind of crazy. What economy in the world is closed? Openness matters for monetary policy in a lot of different ways. To what extent, for example, should monetary policy worry about exchange rate misalignments?

I like to use the example of the recent rise in the price of oil from below $20 a barrel to up to $147. In the early part of that period, when it went from the $20s to about $45 a barrel, the price didn’t go up at all in Europe. How is that possible? How could it be nearly doubling for us and not going up in Europe?

The answer is that the dollar was losing value against the euro at a rate equal to the price increase of oil. There’s no economic reason in the world that oil should have gotten more expensive for Americans and not gotten more expensive for Europeans. That’s purely a result of exchange rate misalignments. It leads to an inefficient allocation of resources. There’s no reason Americans should have had to cut back on oil consumption more than Europeans.

It’s exactly because of situations like this that monetary policy ought to worry about exchange rates. Moreover, the exchange rate is something monetary policy can influence—the value of the dollar in terms of the euro, for example.

The focus of monetary policy has been almost completely on reducing inflation, which is important. A credible monetary policymaker has to keep inflation low, but another part of credible monetary policy is keeping the currency strong.

Q. Why should a strong dollar be a goal of monetary policy?

A. I wouldn’t say a strong dollar. I would say that a goal of monetary policy is to prevent large dollar misalignments. We don’t want it too strong or too weak. Remember, in the early part of this decade, the dollar was very strong, and our manufacturing sector was getting hammered. We had a hard time competing in world markets, even in sectors in which the U.S. is a world leader, like aircraft, sophisticated industrial equipment and high tech.

Our economy adapted—resources got shifted into construction and services—but in retrospect maybe the reallocation wasn’t such a great use of our resources. If we had more actively tried to prevent the appreciation of the dollar, that shift in workers and investment away from manufacturing would have been slowed down.

Q. What contribution can the Dallas Fed’s Globalization and Monetary Policy Institute make?

A. As you know, the institute is focused on how monetary policy is influenced by international forces. A great thing about the Federal Reserve System is that it has 12 independent research staffs that provide a portfolio of research skills and policy insights.

I agreed to join the Dallas Fed’s efforts on globalization because I think this subject is crucial, its importance is growing, and there wasn’t enough attention to these issues in the System.

Richard Fisher, the Dallas Fed’s president, has talked a lot about trying to understand how openness feeds into domestic inflation. That’s an important question with obvious relevance to central bankers, but I think there are other important questions that we should be thinking about.

The exchange rate itself, should we worry about that? In thinking about unemployment, do we have to worry about the effects of foreign competition? Beyond those issues, the big thing we need to think about right now is the Fed’s other role—not in setting monetary policy but in keeping a well-functioning financial system intact. There, I think the impact of globalization is enormous.