International Financial Deregulation, Trade, and Exchange Rates

Mervyn K. Lewis

Free trade has long been accepted amongst economists as the desideratum for global prosperity. But if free trade in goods is to be secured it needs to be accompanied by unhindered cross-border movements of money, finance and capital. Considerable progress in freeing up financial markets was made during the 1980s. National banking and capital markets were opened to foreign competition and international financial markets expanded. As a result, banks and other financial institutions operating in the large industrial countries now compete to a considerable degree free of interest rate controls, product barriers, and territorial restrictions.

However, developments in the 1990s suggest some contrary trends, namely 're-regulation' in the guise of the Basle capital standards and the perception that the world economy may be coalescing into a set of geographic trade blocs. The European Single Market project and the European Economic Area, the Canadian-U.S. Free Trade Agreement (CUSTA), the North American Free Trade Agreement (NAFTA) and the Enterprise for the Americas Initiative, and (to a lesser extent) the Asean Free Trade Agreement (AFTA), are examples of efforts to remove trade barriers between the countries concerned, including moves to facilitate inter-regional movements of capital and finance and create genuinely transnational markets for financial and other services. To the extent that these agreements incorporate features and concessions which go beyond what might be contemplated at a global level (concessions to some are effectively privileges being denied to others), there is a danger that the agreements might weaken commitments to multilateralism.

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The author is the Midland Bank Professor of Money and Banking at the University of Nottingham, United Kingdom.

If the formation of these trade areas is followed by currency zones—the adoption within the regions of fixed exchange rates or monetary union—it could lead to major alterations to international monetary arrangements and national monetary policies. Some argue that the world is evolving into a tripolar monetary system with the United States, the European Union and Japan serving as the focal point of North American, European and East Asian trade and currency areas. While this view is a considerable simplification in that it overlooks the forces bringing about trade and financial integration at a global level, it is interesting to note that as long ago as 1960, Robert Triffin argued that the stabilization of exchange rate parities within regional blocs, coupled with somewhat looser forms of cooperation between them, could pave the way to a new world monetary order.

This paper examines the inter-relationships between trade integration, financial integration and monetary integration. It first examines the links between trade and finance and the conditions needed for financial liberalization, which go far beyond that of financial deregulation at the national level. Financial liberalization includes the right to sell financial services cross-border, rights of establishment for foreign enterprises, and the rules and regulations covering the scope of their operations. Important differences are found to exist between the approach of the United States and the more market-based one of the European Union. The section after that considers the effects of financial integration where it is argued that more open financial markets have released a vast quantity of financial assets, altering the methods by which payments imbalances are financed and exchange rates are determined. This leads on to the consideration of exchange rate regimes. Governments have dismantled capital controls and opened up financial markets but have tolerated exchange rate volatility, and in this way they have left in place a potentially significant market barrier in the form of exchange rate uncertainty; monetary integration and currency zones are the topics of the last section.

Financial Integration

In his book *The Rise and Decline of Nations,* Mancur Olson observes that significant periods of economic development have followed whenever a much bigger geographic area is created that has internal free trade, citing for illustration the European Union (EU). This example suggests possible links between trade and financial and monetary integration. For many years the EU was a customs union with limited capital mobility, during which time the provisions implicit in the Treaty of Rome for the freedom of trade in financial services lay dormant.

From this, it has evolved into a single market for both goods and services, free of impediments to capital mobility, and marked by long periods of exchange rate stability. The EU still retains the objective of monetary union in which the single market will be served by a common currency. Thus in Europe trade, liberalization of financial services, and monetary integration are seen as mutually supportive goals. Are the three complementary and does this apply as well in other contexts, e.g., NAFTA? What is needed to bring about financial and monetary integration?

An integrated financial market allows savers to place their funds, borrowers to obtain finance, and banks and other financial institutions to engage freely in financial activities anywhere within the market area. Financial integration consequently requires freedom of capital movements *and* market access for financial services. These two aspects feature prominently—and for good reasons—in recent General Agreement on Tariffs and Trade (GATT) negotiations, and in agreements to establish free trade zones; for example, the text of NAFTA contains chapters on investment, financial services, cross-border trade in services, and temporary access for business persons. Amongst OECD countries, measured output of financial services represents some 5–10 percent of total value added, and the share of the financial services industry in total employment is roughly of the same order. While exchange controls and entry restrictions upon foreign financial enterprises exist, domestic producers of financial services are sheltered from international competition. The benefits of competitive pressures upon domestic financial institutions which come from their removal can be expected to accrue also over time in terms of dynamic efficiency, ensuring that financial institutions have access to newly-developed financial instruments and use best-practice financing techniques. The case of Mexico's financial system under NAFTA comes to mind in view of the relatively underdeveloped markets which exist at present for corporate banking and derivatives.

Liberalization of financial services has significance also for resource allocation in sectors using financial markets. Financial services for the most part fall into the category of services treated by GATT as being complementary to international trade in goods.[1] Also, financial services can be seen as an intermediate input in the production process for non-financial enterprises.[2] On both accounts there must be the

[1]Koekkoek and Leeuw (1987). GATT concepts and the relevance to services are examined by Snape (1990) and Balasubramanyam (1992).

[2]This is a generalization of the idea of putting money balances in the aggregation production function (Prais 1975), building on from the idea of money as a capital good (Friedman 1956).

presumption that liberalization of financial flows is needed to realize fully the benefits of freer trade in goods (and non-financial services) in much the same way as a unified capital market financial system is desired within national boundaries in order to better service the economy.

But what defines appropriate market access for financial services? International financial services are provided in two main ways: through onshore markets on an establishment basis or via offshore or Euro–markets on a trade-in-services basis.[3] Liberalization of financial services flows thus covers two areas: cross-border transactions and direct foreign investment. The first involves the right to sell across borders, the other concerns the right to establish in the host country. While the two raise different conceptual issues, in practical terms they are closely related.

Cross-border Financial Transactions

Provision of services long distance has long been a feature of international banking. During the 1950s and 1960s banks discovered that some wholesale banking services could be produced externally to the home market. Low comparative production costs, low transportation costs, and less costly regulatory requirements encouraged regulatory arbitrage and the diversion of banking services overseas. These offshore financial markets have few equivalents in other industries offering the same perspectives. First, the markets provide a ready illustration to financiers of the opportunities denied by regulation. Second, the emigration of financial business to the markets create a persistent pressure upon authorities to lighten domestic regulations.

Cross-border transactions have not featured greatly in recent trade negotiations. Nevertheless, cross-border finance continues to be a significant factor for domestic banking markets. This is illustrated by recently collated data[4] for the commercial and industrial (C&I) loan market in the United States. The supply of loans comes from domestic and foreign banks, sourced locally or from overseas locations—principally London, Tokyo (the Japan Offshore Market), and the offshore booking centres in the Caribbean—giving a four-way classification. At the end of 1991, the $777 billion of loans were distributed as shown in Table 1.

The statistics are of interest in documenting both the extent to which loans were sourced from overseas (23 percent of the total) and

[3]Traditional cross-border foreign banking accounts for a small and shrinking component of international banking (see Lewis and Davis 1987: chap. 8)

[4]The data were collated by two researchers at the Federal Reserve Bank of New York (McCauley and Seth 1992).

the size of foreign-owned banks' share of the C&I loan market (45 percent); this is a larger foreign penetration than in any other sector of the U.S. economy. While there were cost savings to both foreign and U.S.-owned banks from booking loans offshore and circumventing U.S. regulations, the cost advantage was larger for the foreign-owned banks, and whereas the Fed has discouraged U.S. banks from putting U.S. business through their foreign branches, no explicit guidelines against booking domestic business offshore has been given to foreign banks.

TABLE 1

DISTRIBUTION OF U.S. COMMERCIAL AND INDUSTRIAL LOANS, 1991 (PERCENT)

	U.S.-Owned Banks	Foreign-Owned Banks
Onshore Loans	52	25
Offshore Loans	3	20

Regulatory arbitrage in this form blurs the onshore-offshore distinction and by all accounts the U.S. branches and agencies of foreign banks were closely involved in the growth of offshore loans to C&I enterprises, and for the under-reporting of the loans in previous statistics.[5] Thus it would seem that trade in financial services is greatly facilitated by the presence of foreign institutions in the domestic market. When credit is provided borrowers have to be sought out, contact made, borrowing proposals evaluated, the performance of loans monitored and (possibly) work-out arrangements and repayment 'holidays' negotiated. All of these are aided by the information exchanges in relationship banking (Lewis 1992). Increasingly, also, financial services are sold not bought, and the marketing of loans and other products such as derivatives is facilitated by close proximity, in order to establish and sustain business custom.

Foreign direct investment in banking may range from some low-level presence such as a representative office through agencies,

[5]As the U.S. Treasury wrote: ". . . large amounts of off-shore loans to U.S. non-bank residents are not being properly reported. In large part, under-reporting of foreign loans may arise because the non-bank borrower is unsure where the loan is actually booked. This confusion is particularly likely in instances where a U.S. firm is granted a loan from a foreign source but all loan servicing transactions are handled by a bank or other intermediary in the United States" (Letter from Manager, Treasury International Capital Reporting System, Department of Treasury, 1 May 1986. Reported in McCauley and Seth 1992).

subsidiaries, joint ventures to a full branch operation. The nature of the establishment and the rules and regulations under which the firms operate have to be determined.

Rights of Establishment

When a bank provides financial services across national borders without a presence in the customer's country, it does so under home-country rules. When it does so by establishment, there are three possibilities (or a combination of them): host-country rules; home-country rules; or some agreed or harmonized rules negotiated internationally, bilaterally or as part of an FTA. A number of approaches can be considered.

Most Favored Nation. As laid down in article 1 of GATT, this principle implies that any advantageous measure taken by any contracting party, relating to trade with any other contracting party, shall be applied equally to trade with all other contracting parties. But it is consistent with any domestic policy towards foreign-owned banks. A country is agreeing not to favor banks from one country over those from any other country, not to ensure competitive equality with domestic banks.

Reciprocity. A country may open its financial markets to foreign enterprises because it wishes to gain entry to foreign markets for its own banks. Reciprocity is a mutual concession of advantages or privileges. Some countries may wish to have reciprocity applied with strict numerical parity e.g., bank for bank, branch for branch, and so on. Usually reciprocity is defined as either reciprocal national treatment or as mirror-image reciprocity. Under reciprocal national treatment foreign institutions are given treatment identical to that afforded domestic counterparts in a host country provided that their home country puts banks from the host country concerned on the same competitive footing as domestic institutions. A weaker version—threatened by the United States in terms of the Fair Trade in Financial Services bill—would discriminate against enterprises from countries with financial markets closed to foreigners, not by denying them equal access today but by excluding them from the benefits of any future liberalization in domestic markets unless they first free up their own financial markets.

Mirror-image Reciprocity. This rule would confine the activities of financial institutions in the host country to those which the authorities of the second country allow foreign institutions to conduct in its own territory i.e. country A's banks have the same powers in country B that B's have in A. Use of reciprocity has a number of drawbacks. When two countries or zones seek to apply the principle bilaterally,

and restrictions are imposed on both sides, the least common denominator of activities permitted in each is left. If applied to institutions from a group of countries a hotch-potch of regulatory rules could result.

National Treatment. A policy of parity of treatment between foreign and domestic banks in like circumstances, or national treatment, was the cornerstone of the United States' International Banking Act 1978 (although reciprocity still operates at the state level), and it is the most generally accepted standard in international banking. It applies host-country rules to foreign and domestic institutions, irrespective of the treatment that domestic institutions receive in the home country of the foreign entity. The idea is that the absence of discrimination in law or practice between foreign and domestic institutions promotes competitive equality between the two.

But the difficulty comes in determining like circumstances and national treatment poses special difficulties when foreign and domestic banking structures differ significantly. The rules may not differentiate between domestic and foreign firms, but they have different impacts upon the two. Interest-rate ceilings, prohibitions upon combining banking with insurance and securities, and restrictions upon branching, for example, may hinder banks from freer markets. National treatment is also a narrow concept, for there are no mechanisms embodied in it whereby the different regulatory structures are directly put to a market test.

These inadequacies are clearly revealed in the North American context. Both CUSTA and NAFTA are built around national treatment. Under CUSTA, Canada discriminated in favor of U.S. banks vis-à-vis other foreign banks by waiving various asset, ownership and branching limitations upon U.S. banking operations in Canada in return for a promise that Canadian institutions would benefit from future liberalization of the U.S. domestic market. When the U.S. Treasury banking reform package lapsed in 1991, the expected returns failed to materialize. In the meantime, the Canadians had instituted their own reforms with the 1991 Bank Act. Banks in Canada now have wider powers than banks in the United States. As a result of this disparity, U.S. banks gain more from national treatment in Canada than Canadian banks receive in the United States (Canadian Bankers Association 1991).

Under NAFTA, the Canadian banks wanted national treatment, which they see as working in American interests, supplemented by some form of symmetry or principle of comparable market access. This is the notion that "the concessions or powers granted to a foreign bank in its operations in the host country must be roughly equivalent

to those in the bank's home country" (Ibid: 8). In effect Canada sought, unsuccessfully, better than national treatment for its banks. This would have meant the United States accepting within its borders some firms operating under different regulatory rules—something which the Japanese have done for U.S. banks.[6]

Canadian banks are not alone in having concerns about regulatory developments in the United States. For decades U.S. banks have participated extensively in the financial markets of other countries, employing well-established branch networks and conducting securities, life insurance and other financial activities that are still not permissible in the United States. In terms of both branching and activities restrictions upon banks, the United States is increasingly an outlier amongst OECD countries.

Mutual Recognition. The concept of mutual recognition is a powerful and liberalizing one which goes well beyond national treatment. It is based on home-country rules. Each country maintains its own regulatory approach, but when allowing an institution to operate within its borders, a country recognizes as valid for its territory the laws, regulations, and administrative procedures of the institution's home country, and allows the institution to operate under them. At the same time, it pledges not to invoke differences between its own laws and those of the area members so as to restrict the free access of foreign enterprises to its national markets. This means that the country may be agreeing to offer treatment which is more favorable than the treatment accorded to its own institutions in their home market.

Such differences of treatment are embodied in the provisions of the European single financial market with respect to the operation of branches in intra-European markets. This enabled the member countries to avoid the time-consuming search for complete uniformity. Instead, by being willing to ratify the regulatory decisions of other countries when allowing establishment, firms operating under different regulatory regimes can co-exist. It is this process of putting regulatory structures to a direct market test which distinguishes mutual recognition from the concept which emerged in the GATT negotiations on trade in services, that of effective market access.

Effective Market Access. This concept combines the standard GATT principles of most-favored nation, national treatment, non-discrimination and transparency with a "progressive liberalization of laws, regula-

[6]Japanese authorities grant licenses to securities affiliates of foreign banks, provided that the parent bank holds no more than 50 percent of the equity of the affiliate. Consequently, American and European banks are permitted to conduct securities business in Japan through such affiliates—a privilege denied to the European securities affiliates of Japanese banks.

tions and administrative guidelines relating to banking and other financial services."[7] It is one of the newer principles seeking to go beyond national treatment, based around the argument, noted above, that national treatment may be too narrow a concept when applied to the case of foreign banking organizations entering a highly-regulated financial system; in effect, the extent of adjustment needed by the entrant is so large as to constitute a competitive distortion and market barrier, and some liberalization of the regulatory structure is needed if there is to be meaningful market entry. The General Agreement on Trade in Services calls for successive rounds of negotiations to bring about the liberalization. In this sense, the concept of effective market access is a multilateral equivalent to the regulatory convergence implicit in the EU's mutual recognition and minimum harmonization.

Minimum Harmonization. Mutual recognition has far-reaching consequences for markets because it means that national regulators are surrendering sovereignty not to some overriding federal body, but to regulators of other member states, giving rise to competition among regulations. Naturally, countries are unlikely to recognize rules which are seen to violate necessary minimum standards, leading to uniform legislation on certain fundamental matters. Such minimum harmonization ensures that the most basic rules to which firms must comply are identical throughout the market. Mutual recognition then means that member states are recognizing the *remaining* national rules of other states as equivalent to their own; it is these rules which are subject to the market test.

Regulatory Issues

The process of minimum harmonization requires that interested parties identify those regulations deemed necessary to protect depositors, prevent systemic risk and thus ensure the safety and soundness of the payments mechanism and/or financial system, and to foster competition and an efficient allocation of savings and investment. The difficulty is that countries have different views about how extensive these need to be.

A number of economists have questioned whether banks warrant the attention from government that they have received (see, for example, Capie and Wood 1991). Nevertheless, the notion that banking and finance are somehow special is strongly entrenched.[8] Every country

[7]Statement of the Trade Negotiations Committee of the GATT Uruguay Round, Montreal, 8 December 1988. Reported in *Focus* 61 (May 1983): 15–16.

[8]In particular, Gerald Corrigan (1983, 1986) has argued that banks remain special.

has a banking system (whereas not every country has a steel or motor industry); in most countries—New Zealand is a notable exception—banks are mainly owned and run by nationals (sometimes governments); and in most banking systems, public confidence is ensured by collective support mechanisms (e.g., deposit insurance, central banking).

It is also the case that extensive regulation of banks remains: entry into banking is supervised; business is restricted by a number of asset-composition guidelines; output is constrained by capital-gearing ratios; safety standards are set; and rules govern banks' ownership links with other institutions. To this list can be added the adoption of the Basle capital adequacy ratios by most OECD member countries, a process which has been referred to as re-regulation.

In fact, the decade of the 1980s was not so much one of deregulation, but rather one when the regulatory rules were rewritten, the "age of regulatory reform" (Button and Swann 1989). Regulatory reform is a better description than deregulation which implies the complete abandonment of regulation instead of selective removal and a shifting emphasis. Much of what passes for deregulation consists of a change from regulatory to market actions and within the category of regulatory actions, from structural controls to conduct and protective measures, as the authorities adapt monetary controls in an altered environment. This is because regulatory controls often perform a number of functions, as shown in Table 2. The table considers a number of commonly used regulatory tools and seeks to identify for each the principal aim along with the subsidiary goals or byproducts. Thus liquidity ratios, which were imposed mainly for monetary policy purposes, may have served to re-assure depositors and thus bolster confidence in banks. Interest rate ceilings were used to facilitate the operation of monetary policy, but they also prevented competition for deposits of the sort which took place by U.S. savings and loan associations in the early 1980s. Close quantitative restrictions over bank lending acted as a substitute for bankers' own prudence, so regulated banks were generally safe lenders. In the new framework, capital adequacy ratios ostensibly reinforce bankers' caution, but also act as the principal constraint upon banks' balance-sheet expansion. Further, by giving a low risk weighting to government securities, the new standards may also serve to direct bank resources into the financing of public sector deficits.

Nevertheless, important changes to liberate financial markets have taken place in industrial countries. Controls over interest rates have been either removed or lightened. Selective controls upon consumer installment credit and lending directives are little used. Long-standing divisions between banking and other financial institutions are coming

TABLE 2

CLASSIFICATION OF FINANCIAL REGULATION

	Stability of Payments System	Stability of Financial System	Investor Protection	Competitive Efficiency	Monetary Control
Interest Rate Controls	○	○			◆
Lending Controls, Reserve Requirements	○	○			◆
Prudential Controls					
Supervision of Balance Sheets and Lending Policies	○	◆	○		○
Deposit Protection Schemes	○	○	◆		
Product Market Barriers					
Specialization of Banks	◆	○	○		
Separation of Banking/Securities/ Insurance	○	◆	○	○	
Restriction of Range of Markets		◆	○		
Business Policies					
Bank-commerce Ownership Links		◆	○	○	
Cartel-merger Policies			○	◆	
Information Disclosure		○	◆	○	
International Barriers					
Cross-border Capital Controls		○			◆
Control of Cross-border Financial Services			◆	○	○
Restrictions on External Location		○		○	◆
Restriction on Establishment by Foreign Institutions	○	○	○	◆	○

◆ Represents principal aim of control. ○ Represents subsidiary goal or byproduct.

down. Barriers to the participation of foreign financial firms in domestic markets have been lowered. Exchange controls and restrictions upon capital movements have been eased, although cross-border constraints upon insurance and pension fund portfolios remain. Access of foreign borrowers to national capital markets is much freer.

The extent of financial liberalization is, however, far from uniform. The regulatory divergences across countries are not qualitatively different from those in the markets of the EU, and might be resolved in much the same ways. The administrative barriers which impede the free supply of services across Europe are to be removed through a combination of minimum harmonization and mutual recognition. Certain restrictions are placed upon banks' activities in order to qualify for the 'common passport' which allows the bank to branch across the union.[9] Thereafter, regulatory convergence is brought about by two factors: mutual recognition and competition among regulators. A country is free to institute standards more stringent than those specified in the minimum harmonization rules, but the standards apply only to the operations of its home banks; their firms will prosper if higher standards are valued by the market. Regulation more lax than in other countries could arise where standards have not been harmonized; these firms will gain the business of those unconcerned by the lower standards. At the same time, services can be exported and imported freely across national borders from countries both inside and outside the group. The effect is to allow a variety of regulatory norms to co-exist within the financial markets of the EU. In this way, transactors' freedom to choose the desired mode of financing and type of financial firm with which to deal will to a large degree decide what types of regulations prevail.

Much the same forces can be seen to operate internationally. Some form of mutual recognition is implicit whenever a foreign bank is allowed to enter a country's financial markets. Most prudential rules make sense only when related to the entire, world-wide business of a bank. Capital adequacy is an example, and rather than re-regulation, the Basle standard might be viewed more optimistically as the multilateral equivalent of the minimum harmonization and regulatory convergence implicit in the EU's home-country rules. Much like the application of speed or alcohol limits on the roads, the standards impose collective restraints but otherwise preserve rights of access. A certain guarantee against heavy-handed regulation comes from the globaliza-

[9]These are contained in directives which regulate minimum standards for a banking license, consolidated supervision, published accounts, supervision over major shareholders and participation in non-banks, and capital adequacy requirements.

tion of financial markets and the regulatory arbitrage that it permits. When banks are able, through their overseas operations, to choose the most favorable regulatory environment for any line of business, a government's monopoly of regulation is eroded. The existence of competing regulatory norms also leads to some privatization of regulation by rating agencies, bank analysts, auditors, and various professional bodies. A further element of market discipline comes from the co-insurance inherent in a thicker layer of capital, shifting part of the burden of supervision from the regulatory authorities and onto the market.

Financial Integration and the Balance of Payments

Financial liberalization and the increased integration of banking and capital markets, either globally or across free-trade areas, have important implications for economic policy and exchange rate determination. Because of the competitive threat of offshore banking, monetary policy mechanisms which involve a tax effect are of limited use. Currency substitution may yet restrict further the utility of domestic money-supply targeting. Policymakers may also find themselves in the unfamiliar position of having the capital account drive the current account, rather than the reverse causation implied in old Keynesian models, and this can lead to policy confusion about the balance of payments.

Payments Imbalances

With the onset of floating exchange rates in 1973, the current account replaced the overall balance of payments as an indicator of the need for adjustment in a country's macroeconomic policies.[10] A current-account deficit is the deficiency between exports and other overseas earnings, and imports but it is also the difference between a country's domestic investment and savings. In the new environment of international financial laissez faire (Corden 1983), saving and investment decisions are made by 'consenting adults' who, we must presume, know what they are doing. The current-account surplus or deficit simply reflects, in the aggregate, these individual saving and investment decisions.

[10]See Salop and Spitaller (1980). The current account is a leading variable among the list of indicators for disciplining international policy coordination (see e.g., Crockett and Goldstein 1987); and current-account developments, actual and prospective, are a prominent component in the IMF's conjunctural review and medium-term projections in its annual *World Economic Outlook*.

Three equivalent definitions can be provided for a current-account deficit (*CAD*):

$$CAD = Z - X = K - \Delta Res$$
$$CAD = (C + I + G) - Y$$
$$CAD = (I - S) - (T - G)$$

The first is obtained from the balance-of-payments identity and defines the current-account deficit as the private capital inflow and borrowings from overseas (K) net of the authorities' addition to international reserves (ΔRes). The second expression relates the deficit to the excess of absorption, $A = C + I + G$, over domestic income (Y). In the third equality, the current-account deficit is presented as equal to the excess of private sector investment (I) over private sector savings (S) and the government budget surplus ($T - G$).

During the late 1980s and early 1990s the main current account deficits were accounted for by the Anglo-Saxon countries—the United States, Britain, Canada, Australia, and New Zealand. Policy discussion invariably centered around a number of national issues. One strand emphasized the need for overseas borrowings to finance the adverse growth of imports relative to exports, and questioned whether the borrowings were desirable or sustainable. Another focused on the trend of spending relative to domestic production, with the current-account deficit sometimes simply equated with a national price-level or inflation rate which was too high. However, the developments must also be seen against the backdrop of the removal of exchange controls, deregulation of credit in the banking and financial system, and increased financial integration at regional and global levels. The deficits that a country incurs on the current account of the balance of payments must of course be matched by surpluses on the part of countries with which it has trading and financial relationships. These individual national relationships form part of a global pattern and can be understood only within the framework of a general equilibrium involving the spending and saving decisions of nationals of many countries.

In models of intertemporal equilibrium (e.g., Sachs 1981; Frenkel and Razin 1987), the price of present consumption in terms of future consumption is the real rate of interest, which will be the higher the stronger the community's preference for present goods. But individuals have very different sets of preferences for present and future goods, and by means of the exchange of financial assets they may trade present current-account deficits/surpluses for future surpluses/deficits in much the same way as they trade goods and services. It then follows that if the comparative advantages in present and future goods differ widely across countries (as they surely do between, say,

Japan and the United States) then even large current-payments imbalances among countries can persist, contrary to those views that focus only on the current transactions of the balance of payments. Neither the supposed prodigality of some nations, nor the thriftiness of others, should serve as the norm of internationally responsible behavior, since presumably citizens of the countries can be adjudged to be making decisions which accord with their own best interests.

What further follows is that if such imbalances are to be reduced, it is not sufficient to correct the imbalances resulting from merchandise and service-trade flows, ignoring the disparities between national preferences for present and future goods; the current-account balance, however defined, can no longer be reliably targeted by traditional instruments such as monetary policy. Suppose, for example, that it is the capital account that overshoots; that is, more capital is brought in than is required to finance a given current-account deficit. If the authorities, fearing that the resulting current appreciation would widen the deficit, jam on the monetary brakes and push up interest rates in an attempt to control the deficit by dampening domestic demand, they only make things worse by encouraging capital inflows.

Viewed in this global setting, the use of macro- and micro-policies *purely* to reduce the size of the current-account deficit to some tolerable level is neither practicable nor desirable. Given the level of world saving, investment expenditures for any one country will be governed by the marginal productivity of capital domestically relative to that of other countries, the current-account imbalance always matching ex post the gap between domestic investment and saving. Reduction of the current-account deficit below that level would reduce economic welfare both in that country and the world. Those who frown upon current-account surpluses or deficits are saying that there should not be any net international lending or borrowing.

The process of global financial integration makes the essential assumptions of intertemporal theory more nearly realistic and the policy conclusion succinctly put by Richard Cooper (1981: 269) more relevant:

> In the context of overall savings-investment analysis, countries should not take any particular view of their current account positions at all. Some will draw savings from the rest of the world, others will invest in the rest of the world. Nothing is wrong with this. It is as it should be.

The conclusion is that the authorities should confine themselves to the task of monitoring the internal balance, leaving the current-account imbalance and the level of private debt to adjust to their policy setting. It is in this policy sense that the deficit "does not matter".

Exchange Rates

The processes outlined above imply that any increase in spending and decrease in saving by the deficit countries reflects a decrease in spending and increase in saving by the surplus countries. To the extent that such changes simultaneously alter both the capital-account and the current-account balances, the international economy is spared the shocks of exchange rates adjusting too sharply to bring about short-term adjustments to trade flows. The clearest illustration of such a smooth payments mechanism (where adjustment costs are either absent or minimal) is an association of regional economies in a monetary regime with a single currency. In a regional payments system, a member economy may indeed sustain current-account deficits with other regions more or less indefinitely, since the deficits are always automatically financed by capital inflows from the other partners. It would be regarded as the height of absurdity, for example, for California to worry about its state of payments with other parts of the union. One reason is because the free movement of goods and labor across state borders helps keep regional prices and wage costs in line with those of other states, so that differences in competitiveness which give rise to trade imbalances are less likely to occur.

But the main reason why regional payments imbalances are ignored—to the extent that there is no attempt to even keep statistics on them—comes from the high substitutability between financial claims issued in the different regions. In response to a payments deficit, members of a region issue liabilities or draw down assets, or do both, in order to finance the imbalance. If the securities were exactly those which members of the surplus regions wanted to buy, their prices would remain unchanged, and the current-account disequilibrium would be exactly matched by offsetting transactions on the asset account which left the local economies unaffected. In practice, not all assets are readily transferable (for example, real property). Nevertheless, relatively minor changes are likely to occur in the prices of those assets which are free to move between regions.

This process can conceivably continue until lenders in other regions are unwilling to lend further, or members of the region run out of assets which can be sold off or borrowed against. Most likely, well before these limits are reached, and in response to the growing repayment burden and decline in net assets and wealth, members of the region will revise their economic plans, cut costs and prices, thereby adjusting expenditures and correcting the imbalance of payments. Notably, this correction is brought about without government intervention. It is prompted by no more than the self-orientated behavior of individuals and firms looking to their financial positions in response

to changes in the physical quantities of the assets in their portfolios. And it may involve little in the way of changes in asset prices so long as members of the deficit regions and financial intermediaries hold large stocks of transferable assets, and portfolio preferences are regionally unbiased.

Something akin to these results obtains for a currency union of sovereign states whose currencies are pegged unalterably against each other. A historical analogue of such a system is the gold standard. Fixity of exchange rates promoted a high degree of integration of goods markets so that prices for tradable goods moved broadly in step with purchasing power parity. At the same time the gold standard was an era of unimpeded international capital movements with capital naturally flowing to regions with high economic returns (Feldstein and Horioka 1980; Bayoumi 1989).

A currency area such as the present European Monetary System (EMS) is different again. So long as each member-nation retains complete *political sovereignty over its money supply*, differential rates of inflation will make periodic exchange rate adjustments among members inevitable, thus introducing exchange risk. The distribution of saving and investment over the whole region will then be conditioned by what view the different transactors take of exchange risk; thus, chronic deficits of, say, Portugal may make German nationals very unwilling to invest in that country if they wish to consume the fruit of their savings somewhere else. In order to overcome the currency risk and all other factors making for a lack of substitutability between claims on the different countries, interest rates in the deficit country must rise, forcing some of the adjustment onto the prices of domestic assets, credit conditions, and incomes and expenditures.

Nevertheless, the general point remains. The growth of international banking, together with the liberalization and globalization of securities markets, can be seen as taking the existing modes of international adjustment some way toward the situations above and seem likely to have altered, in a fundamental way, modes of exchange rate behavior. When Milton Friedman (1953), James Meade (1955), Harry Johnson (1969), and others presented the case for flexible exchange rates, they envisaged that trade flows would dominate foreign exchange markets, so that trade imbalances and purchasing-power parity would enable speculators to judge whether the exchange rate was high or low, and so stabilize its behavior. Now trade surpluses and deficits are being balanced to a large degree by flows of private capital, as under interregional adjustment. To that extent, the need for movements in exchange rates to bring about short-run adjustments to trade flows is largely obviated. Exchange rates will be responding more to lenders'

preferences for assets denominated in the various currencies than to the trade flows which supply the assets; here we have the basic insight of asset approaches to exchange-rate determination.

Some entities will have a surplus of savings over investment, while others will have more investment opportunities than they can finance and if the area of integration crosses national boundaries, savings and borrowings will also cross national boundaries, sometimes for substantial periods of time. Limits to financing exist internationally as they do domestically, depending on the stocks of internationally transferable assets and the attitudes of borrowing and lending entities to a wide range of economic and financial parameters: private credit can finance deficits up to the point when creditors judge their debtors' positions as being too risky. Currency risk adds an extra dimension, and this leads us into the question of monetary integration.

Monetary Integration

Trade, financial integration, and monetary integration are discussed in one breath in the European context, but, in principle, they are separable. Substantial trade can take place under freely floating rates, as now occurs between Canada and the United States, while virtually complete financial integration of money markets can exist alongside flexible rates, as shown by the Eurocurrency markets. Yet many would question whether a truly free economic market can exist between countries without a common currency, or fixed exchange rates, to facilitate cross-border trade and investment and intensify financial links. As Alan Greenspan (1991: 2–3) notes, "Since the United States is both a free trade zone and a single currency zone, I cannot dismiss the proposition that a single currency is an important ingredient in a successful free trade zone."

Moves towards increased monetary integration between two or more countries can occur in a number of stages. One country may simply give a large weight in its monetary management to the exchange rate of the other country—much as Canada does already with the U.S. dollar. Next a country may unilaterally peg its exchange rate to that of the other country or, like Mexico, fix the speed of a crawling peg link. At the next level, the exchange rate may be jointly set and varied only by common consent, as in the Exchange Rate Mechanism of the EMS. The peg could be soft or hard, the latter implying a nearly permanent link. The exchange rate might then be permanently fixed. Finally, there is a currency union with a single currency and a common central bank.

Exchange Rate Systems

Fixed parities are regarded as desirable because it is believed that they offer internationally much the same benefits which come in domestic markets from having a uniform national currency. There are economies of information in having a common medium of quotation. As a unit of account, money is needed for pricing commodities and services, for valuing aggregates, and for making the price comparisons needed for international trade and finance. Flows of goods and services should be governed by price- and cost-levels and changes in these, otherwise a country's comparative advantage cannot be known; similarly, capital transactions should be determined by interest-rate differentials. These calculations ought not to be disrupted by major fluctuations in exchange rates. Transactions as well as calculation costs are reduced by having a single medium of exchange. Finally, having a common standard of deferred payments and the reduction of exchange rate risk facilitates long-term planning and the entering into long-term contracts.

Admittedly, fixed exchange rates are not the same as a common international currency. Nevertheless, as we move from floating exchange rates as experienced since 1971 to credibly fixed exchange rates, as under the classical gold standard, information costs, transactions costs, and exchange rate uncertainty can be expected to fall commensurately. Under the classical gold standard there was no essential distinction between domestic and international money. Gold coins circulated freely in the major countries and gold formed the basis, if not the actual means, for the settlement of international transactions. By contrast, under the present 'non-system' there is no recognized international money as such and a variety of different national fiat currencies contribute to the international money supply and serve as standards for international trade and capital transfers. These are the two polar cases and the ranking of the other actual and potential systems compared in Table 3—the gold exchange standard, Bretton Woods, the EMS and European Monetary Union (EMU)—depend much on their perceived characteristics and workings. The table compares the various systems in terms of exchange rates, reserves, inflation control and monetary independence.

The basic case against joining any sort of fixed exchange rate regime is that while a country retains all of its existing policy targets, it loses the exchange rate as a shock absorber, through variations in which the objectives may be achieved. Put another way, it would seem that adding the exchange rate to the list of policy objectives 'uses up' a policy instrument. For reasons now to be explained, any such counting rule argument needs to be treated with care, since the transition from

TABLE 3

COMPARISON OF DIFFERENT MONETARY SYSTEMS

	Gold Standard 1879–1914	Gold Exchange Standard 1925–31	Bretton Woods 1945–68	Dollar Standard 1968–71	The "Non-System" 1972–	EMS 1979–	EMU
Exchange Rate Regime	Fixed gold parities	Fixed gold parities	Fixed gold parities	Fixed parities	Floating	Fixed parities	Fixed parities/ single currency
Exchange Rate Variability	Within gold export and import points	Gold bullion shipping points	±1 percent	±1 percent	Complete	Bands of ±2.25 percent, ±6 percent, ±15 percent	None
Exchange Rate Realignments	Parities irrevocable		One-sided at discretion of individual country	Possible for non-U.S. currencies	Complete	Require a common decision of all members	None; common currency or irrevocably fixed parities
Nature of Reserves Regime	Gold institutionalized	Gold and gold-backed currencies	U.S. dollar institutionalized	U.S. dollar	National fiat currencies	Mixed; ECU official reserves balances; DM and U.S. dollar used for interventions.	To be determined

Key Currency	Sterling	Dollars and sterling	U.S. dollar institutionalized as intervention and vehicle currency	U.S. dollar	U.S. dollar as vehicle currency	None institutionalized: evolves to country with strongest currency e.g., DM	New ECU
Balance of Payments Adjustments	Symmetric rules of game	Asymmetric due to sterilization policies	Burdens fell on deficit countries	Burdens fell on deficit countries	No rules of game	Symmetric intervention obligations of all members; but asymmetric sterilization	As in region of country
Inflation Control	Depends on gold price	Link to gold weakened	Relied on United States maintaining gold convertibility	Relied on United States	Depends on individual country	Relies on Germany	Depends on ECU issuing authority (ESCB)
Monetary Independence	Restricted	Limited	Limited	Limited, except for United States, without controls	Possible	Limited, except for Germany	None: centralized monetary policy

one regime to another seems likely to alter market mechanisms (the Lucas critique) and may enhance the working of other policy measures.

Exchange rate adjustment is not necessary for external equilibria if wages and prices are flexible enough to move up and down in response to economic shocks (Mundell 1961). Nor does exchange rate devaluation shelter those involved from reductions in real incomes and loss of spending power. Rather it is a device for achieving flexibility of real wages and debts more conveniently when prices and wages geared to the local currency are sticky: conditions which apply to large economies with a low degree of openness to trade. In the context of integrated markets and the loss of currency illusion, the effectiveness of the exchange rate weapon is reduced; nominal exchange rates may feed quickly into home prices, creating demands for a further dose of devaluation. There are also some other consequences from the loss of the exchange rate instrument to be taken into account. Eliminating or reducing exchange rate risk in financing decisions makes it easier to finance regional payments imbalances, since debt in one currency is more nearly a perfect substitute for debt in another country.

Changing the exchange rate regime also alters the nature of inflation control. One way of thinking about the implications for inflation control is to note that whether its exchange rate is fixed or floating a country is still responsible for its inflation performance. The issue is whether to do so by means of internal or external stabilization. *Internal stabilization* of the value of money means keeping the purchasing power of national money reasonably stable in terms of goods and services on domestic markets, disconnecting domestic prices from external developments. Thus the freeing of monetary policy under flexible exchange rates makes each country's inflation rate depend essentially on its own national policy (we ignore here complications posed by currency substitution).[11] *External stabilization* involves fixing the value of the domestic monetary unit relative to foreign moneys and foreign prices. The requirement of balance of payments equilibrium without unlimited reserves means that the quantity of (base) money can no longer be used for inflation control. But this sacrifice of monetary autonomy serves to tie the country's inflation rate to that of the fixed exchange rate system.[12]

[11]Under floating rates, the more the portfolios of transactors are diversified among highly substitute assets denominated in different currencies (i.e., the greater is currency substitution), the more the price level in any country becomes the result of the joint outcome of the monetary policies of all countries, as under fixed rates.

[12]Robert Mundell (1969) argued that the true instruments for the respective regimes are the *price* and *quantity* of money. The exchange rate, according to Mundell, defines the price of one money in terms of others. Under flexible rates, this price adjusts to bring

Fixity of exchange rates under external stabilization is not in itself sufficient for price stability. Some common anchor is needed to ensure that nominal as well as relative price stability results from the common stance of monetary policy. A stable fulcrum could be provided by an outside asset or commodity such as gold, a national currency such as the dollar or Deutschmark, a created reserve currency such as the Special Drawing Right, or a group of national currencies. Where there is one country whose monetary policy serves as the anchor, monetary regimes are sometimes characterized in terms of 'hegemons' and 'implicit contracts' (Frenkel and Goldstein 1988). On this interpretation, as the provider of the key currency in the Bretton Woods System, the United States had an obligation to peg the price of the dollar to gold and conduct stable policies. Other countries accepted dollar leadership to gain the benefits of having a stable international money. The system began to break down in 1968 when the link to gold came under doubt and the subsequent dollar fiat standard fragmented when the United States was seen as generating inflation rather than price stability.

The succeeding 'non-system' can also be interpreted in this vein. Despite having no acknowledged leader, the anchor comes from national policies and especially those of the United States, Germany, and Japan which form the major trading blocs. Success of the system required that these countries follow cohesive, stable macroeconomic policies with stability of exchange rates emerging as a byproduct, and this can be looked upon as its implicit contract. When huge trade imbalances and exchange rate fluctuations put the system under strain, pressures developed both for a new implicit contract in terms of the Plaza Agreement and Louvre Accords, and for stability through other mechanisms such as the EMS and other regional trade arrangements.

Tripolar Currency Zones?

Here we return to the question of whether the formation of free trade areas may signal the development of currency zones and a tripolar international monetary system. There are historical parallels which can be cited, for earlier monetary regimes such as the gold standard were far from universal. An international gold standard was not in place until 1879 and then only the United States, Britain, and Germany permitted full and automatic convertibility. France,

about equilibrium in the balance of payments, while the quanitty of money is used as the instrument for achieving the desired rate of inflation. On the other hand, under a fixed exchange rate regime the price of money is used to tie domestic prices to external prices, while the quantity of money must be varied to keep the balance of payments in equilibrium.

Belgium, Italy, Greece, and Switzerland constituted the Latin Monetary Union and were effectively on 'limping standards'. Sweden, Denmark, and Norway formed the Scandinavian Monetary Union. There were also countries on a silver standard, notably China and India. As is the case now, small countries usually linked themselves to a convertible currency or had inconvertible currencies. For most of the 1930s and during the Bretton Woods era, the Sterling Area operated and included, at one time or another, Britain and the Commonwealth (excluding Canada), the Scandinavian countries, Iceland, Japan, Argentina, Egypt, and Turkey. Free movements of capital took place within the area, and exchange controls and trade restrictions were applied to other countries. These various sub-systems were motivated by a mixture of factors, including reserve-pooling and trade.

In at least one respect, it is difficult to see how a free trade agreement such as NAFTA can avoid some discussion of monetary issues. Exchange rates can be used as means of trade protection, so that countries in an FTA cannot disregard what happens with exchange rate policies. (For instance, article 107 of the Treaty of Rome declares that each member state must treat its policy with regard to exchange rates as a matter of common concern.) Also, movements of capital and financial services associated with financial liberalization have consequences for exchange rate management. But there is a more compelling reason. Two-way flows of foreign direct investment between the United States and Canada increased substantially once the CUSTA negotiations began as companies positioned themselves to operate in a larger and more competitive market. Similarly, progress toward NAFTA has been accompanied by a record increase in U.S. direct investment in Mexico. Such flows, along with increased trade, expand the groups which are exposed to exchange rate movements and widen the support basis for more predictable (and less costly) monetary exchanges.

In other respects, the arguments for a common currency at the level of an FTA parallel those given above. They stem from the stimulus to intra-area trade by doing away with costly currency conversions, from eradicating exchange rate uncertainty, and by allowing savings and investment to flow more freely. The promotion of trade, in turn, leads to greater competition and increased specialization in areas of comparative advantage, assisting the integration of regions of the FTA into a single, efficient economic market.

Considering the three zones, establishment of a European currency zone—perhaps amongst an inner core of EU countries—still seems the most likely, notwithstanding recent upheavals in the exchange rate mechanism of the EMS. By far the least probable is an East

Asian trade and currency zone. Trade in East Asia is strongly inter-regional, representing over 32 percent of exports in 1990, and there has been a steady increase in the yen's use for the invoicing of trade and finance in the region, and in some countries' exchange rate policies, although most generally link their currencies to the U.S. dollar, not to the yen (see Frankel 1993). Japan is also quietly replacing the United States as the key partner in the development of East Asia in aid, trade and direct investment, but this is not the result of any deliberate policy initiatives by the Japanese government which has generally resisted internationalization of the yen.

A common currency for North America seems an unlikely development just now, although some nearly fixed exchange rate link—a *de facto* dollar bloc—is not improbable in view of the closeness of trade links (in 1990, Mexico exported 71 percent of its goods to the United States and Canada). In many respects, the position of Canada and Mexico relative to the United States in NAFTA seems not unlike that of the Nordic countries vis-à-vis the EU. They are also small economies next to a large neighbor, with which they have opted for free trade and closer economic integration. To this end monetary policy has been conducted 'as if' they were members, endeavouring to eliminate exchange rate variability relative to the EU. As economic integration in NAFTA increases, the pressures for exchange rate stability may grow. Paul Volcker, for one, has predicted a fixed exchange rate link between the peso, the U.S. dollar and the Canadian dollar by 1996 (Volcker 1991).

Are Fixed Parities Possible?

The Nordic example, and the EMS itself, illustrate the difficulty of maintaining a credible commitment to fixed parities. The policy dilemma can be described in terms of the 'inconsistent quartet' of desirables for international economic relations: namely fixed exchange rates, free trade, full mobility of capital, and an independent monetary policy (Wallich 1972). At best only three of the four can be achieved. Under the gold standard, monetary autonomy was sacrificed. Architects of the Bretton Woods System envisaged that official controls over capital flows would reconcile the inconsistency. The EMS also began with extensive restrictions on capital movements in place. With their removal, (most) member states accepted that the scope for monetary policy independence had to go. But this surrender of sovereignty was not believed by the markets and government resolve was eventually put to the test and found wanting.

One response might be simply to dismiss fixed exchange rates as a constraint on the free working of markets. But that is to ignore that

under the gold standard there co-existed fixed parities, extensive free banking, and the free movement of capital. Perhaps the sheer volume of internationally transferable funds creates a new problem, yet that ignores the fact that capital flows were extensive in the gold standard era. How was it possible to stabilize exchange rates within narrow bands under the gold standard? Much rested on the mystique of gold: countries on gold were expected to be so forever, and moreover at the same parity. When countries did suspend convertibility temporarily (e.g., the United States during the Greenback era, Britain in the Napoleonic wars and after the First World War), such was the attachment to the historic parities that resumption took place at the old levels. The pound effectively had the same official metallic value from 1717 to 1931, the dollar from 1834 to 1934. As people became convinced of the fixity of rates, the process became self-reinforcing and, to borrow Sir Roy Harrod's (1969) description, capital movements were helpful to the authorities when protecting parity.[13]

The perceived permanence of the arrangements, including the parities, is nowhere more eloquently described than in Keynes (1919: 9–10):

> The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, and in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could despatch his servant to the neighboring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.

This mystique has gone[14] and perhaps with it the possibility of achieving a non-political monetary solution. A government can jettison

[13]Striking evidence of the stability of exchanges under the gold standard is presented by Alberto Giovannini (1992).

a commodity standard if it gets in the way and it can agree to abide by fixed exchange rates but not follow through with the internal discipline which is necessary for external stabilization to work. People have learnt that governments can alter parity, tamper with the rules of the game and change the monetary system. It follows that hankering after a non-political mode of inflation control is hopelessly naive: adopting a monetary reform is a political act; so is continued adherence, in the face of alternatives, to the rules of a new system.

Without a credible commitment to fixed exchange rates—such as might come from a monetary union which fixes parities irrevocably—many of the benefits of fixed exchange rates discussed above are lost in the sense that the relevant comparison is then not floating versus fixed, but between exchange rates that fluctuate daily and those adjusted by substantial amounts at longer intervals, often after sustained speculative pressures. Floating exchange rates may not be the best approach, but in such circumstances merely the least bad.

Conclusion

A number of points are suggested by the preceeding analysis:

- A free market in banking and financial services is a natural extension and complement to free trade in goods and it features in GATT negotiations, the European single market, and NAFTA.
- Financial integration requires that financial enterprises be allowed to compete free of price, product, and territorial restrictions. While some financial services can (and are) provided cross-border without an office in the customer's country, a commercial presence is needed for many core banking activities, and rights of establishment are important.
- National treatment, the cornerstone of U.S. policy, is a narrow principle which does not provide effective market access for foreign banks when there are substantially different regulatory regimes and market practices. The integration of financial services markets is better promoted by allowing some room for different regulatory structures to co-exist and compete. This will encourage regulatory convergence.
- Increased regional and global integration of banking and finance has undoubtedly widened the range of internationally transferable assets and brought financing modes closer to those which typify

[14]This is evidenced by the remark of Sidney Webb (Lord Passfield) following Britain's suspension of convertibility in 1931, "Nobody told us we could do this" (quoted by A.J.P. Taylor 1965).

a national economy. To that extent, trade imbalances lose their policy significance and have the potential to be corrected without large exchange rate movements.

- Free trade areas in Europe, North America, and East Asia are based around the liberalization of trade and services, but seem likely to work best with some form of monetary integration involving exchange rate harmony. There are historical precedents for sub-systems within an international monetary system, and with or without NAFTA, Canada and Mexico would seem to constitute part of a dollar bloc.
- Fixed exchange rates are not necessarily at variance with free markets and offer many of the benefits of a common currency, but only if they can be maintained credibly. Otherwise the choice is between (not so) small, continuous movements and larger, intermittent exchange rate adjustments for which the balance of benefits and costs is unclear.

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International Financial Liberalization and Exchange Rate Policies

Anna J. Schwartz

Mervyn K. Lewis's paper covers a lot of ground. It describes the course of international financial liberalization during the 1980s as an extension of free trade in goods and services. The paper speculates on the shape of the world economy if geographic free trade areas, such as the European Single Market (ESM), the North American Free Trade Agreement (NAFTA), and Asean Free Trade Agreement (AFTA), adopt fixed exchange rates or monetary union within the regions. Trade and financial integration at the global level might still develop if the regional blocs did not rule out cooperating with one another, but it is too early to reach a conclusion in this regard.

My comment is organized in three sections. The first one examines links between trade and financial integration. The second one examines the relation of financial integration to the balance of payments and exchange rate policies. The third one examines whether trade and financial integration foster monetary integration.

Financial Integration and Trade

Lewis is straightforward in tracing the advantages of capital movements across countries comprising a free trade area. He shows that cross-border finance to domestic banking markets has grown in importance. Foreign-owned banks supplied almost half the loans extended to U.S. companies, booking significant amounts offshore, unlike domestic-owned banks with mainly onshore loans. The reason for the difference is that the Fed has urged U.S. banks not to book business through foreign branches but has not similarly instructed foreign banks—not a level playing field.

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The author is a Research Associate of the National Bureau of Economic Research and a Distinguished Fellow of the American Economic Association.

In outlining six different approaches to the rights of establishment of foreign financial institutions in the host country, Lewis illuminates what an outlier the United States is in imposing a regulatory burden on its banks. When the establishment rule is national treatment, so that foreign institutions must adapt to local regulations, U.S. banks gain from participating in financial markets of other countries, where they are allowed to branch and engage in securities, life insurance, and other financial activities not permissible in the United States. Foreign entities in the United States by the same token have to adapt to restrictive regulations here.

Lewis classifies regulatory controls according to their function in providing stability to the payments system or the financial system, investor protection, competitive efficiency, or monetary control. I am skeptical that these controls actually serve these functions. Lewis details changing aspects of financial regulation for each of seven countries, and observes that most of these have been eased, although financial liberalization is far from uniform. He suggests that globalization of financial markets and regulatory arbitrage give institutions an opportunity to escape government overregulation. U.S. banks still are prisoners at home if not abroad of regulatory fetters.

Financial Integration and the Balance of Payments

Lewis next examines the implications for economic policy of increased integration of banking and capital markets. The analysis is first rate. He questions whether it is any longer useful to accept the distinction between internal and external balance as the appropriate policy framework. Since the current account surplus or deficit simply reflects in the aggregate individual saving and investment decisions, the only reason to regard it as a high priority is externalities in the borrowing process, which would need to be identified to justify intervention. Monetary policy cannot target the current account balance. If in deficit, attributing it to inflation or excessive liquidity, would lead the authorities to raise interest rates, but the effect would be to encourage capital inflows. If in surplus, attributing it to tight monetary policy, would lead the authorities to lower interest rates, but the effect would be to encourage capital outflows.

Capital market deregulation, moreover, removes protection of local savers from foreign competition, since residents of surplus countries can make their savings available in international markets at a higher interest rate than would be possible under restricted capital movements, and residents of deficit countries can borrow more cheaply.

Since comparative advantage in present and future goods differs widely across countries, current payment imbalances can persist. It

is not only imbalances resulting from merchandise and service and trade flows that need to be reduced but also disparities between national preferences for present and future goods. To object to current account deficits is tantamount to objecting to net international lending or borrowing. Current account imbalances in this sense have no policy significance. They have enormous significance, however, with respect to the industrial structure of the economy. The U.S. current account deficit from 1980 to 1985 imposed a burden on exports that fostered protectionism and foreign exchange market intervention.

I agree with Lewis that there is no case for market failure in the international savings and investment process. I doubt, however, that the authorities will therefore monitor the internal balance and pay no attention to the current account imbalance.

Growth of international banking, accompanied by liberalization and globalization of securities markets, according to Lewis, has altered modes of exchange rate behavior. The case for flexible exchange rates in the 1950s was based on trade flows dominating foreign exchange markets, so speculators could judge from trade imbalances and purchasing power parity whether the exchange rate was high or low and so stabilize its behavior. Since funds flow from the surplus to the deficit regions to finance the imbalance, there is no need for movements in exchange rates to bring about short-run adjustments to trade flows. Exchange rates will respond to lenders' preferences for assets denominated in various currencies rather than to trade flows which supply the assets. This is truly an asset approach to exchange rate determination.

Private credit can finance deficits up to the point when creditors judge their debtors' position too risky. Lewis judges that currency risk adds an extra dimension to this evaluation but, as I note in the concluding section, he exaggerates the importance of currency risk.

Trade, Financial and Monetary Integration

Lewis finds the theoretical charms of fixed exchange rates and a single world currency more alluring than I do. He asks whether it is necessary for a common currency or fixed exchange rates to exist in order to facilitate cross-border trade and investment by nonfinancial enterprises and intensify financial links. Although he acknowledges that substantial trade can take place under freely floating exchange rates and that complete financial integration can exist with flexible rates, he makes the concession with what seems to me regret. It would be more appealing to Lewis if monetary integration could be achieved.

He envisions the stages that would follow, starting with independently floating exchange rates, leading to monetary integration between two or more countries. Canada, for example, gives a big

weight in its monetary management to the U.S. exchange rate. Alternatively, it could presumably unilaterally peg its exchange rate to that of the United States or fix the speed of a crawling peg link. Another possibility would be to link the exchange rate jointly with that of the United States and then fix it permanently. The final stage would be a currency union with a single currency and a common central bank.

Lewis sees reason to welcome loss of the exchange rate instrument under any sort of fixed exchange rate regime: eliminating or reducing exchange rate risk in financing regional payments imbalances, "since debt in one country is more nearly a perfect substitute for debt in another country." He notes that fixing exchange rates is not sufficient for price stability, since monetary policy across the exchange rate system could be highly inflationary, as happened under Bretton Woods.

In the "non-system" that followed, according to Lewis, the United States, Germany, and Japan were expected to pursue stable macroeconomic policies that would produce stable exchange rates. Instead, huge trade imbalances and exchange rate fluctuations put the system under strain. The result was the Plaza Agreement and Louvre Accord, and a movement for stability through other mechanisms such as the European Monetary System (EMS), and regional trade arrangements.

It is not true, however, that the Plaza and Louvre Accords of the 1980s were prompted by the perception that international trade had been upset, as Lewis states. If anything, these agreements were political actions in response to political motives, namely, that the United States was not confronting its current account deficit while other countries did not have such an option. The political response betrayed a lack of understanding of the view that Lewis has eloquently presented—a current account deficit is not a policy issue. The U.S. political response reflected the loss of export markets by the smoke stack industries.

EMS was a political document to establish a zone of monetary stability among European currencies. Who can believe that Europe is moving toward credibly fixed exchange rates, much less to a common international currency? A single market for goods and services does not require a monetary union. We have the Canadian-U.S. Trade Agreement (CUSTA) and NAFTA, yet no one believes that Canada, the United States, and Mexico should form a currency union. Lewis, however, wonders how a free trade agreement can avoid discussion of exchange rates. Increased trade, he suggests, expands the groups which are exposed to exchange rate movements and widens the support for more predictable and less costly monetary exchanges. I am unaware of such discussions in this hemisphere.

The view that currency risk inhibits trade and therefore that eliminating currency fluctuations would increase trade among members of the free trade area is not borne out by the record. Currency risk has not interfered with spectacular growth in U.S. and Japanese trade despite volatility of the dollar and yen.

Under a currency union nominal exchange rates cannot adjust to change the real exchange rate. Domestic prices and wages must change to achieve the needed change in real exchange rates. Which is the more desirable adjustment, moving the nominal exchange rate or domestic prices and wages? Is there any doubt that the United Kingdom and Italy helped themselves by leaving the Exchange Rate Mechanism (ERM) in 1992 and that allowing a 15 percent band around the parities of most of the remaining countries will enable them to attend to their pressing national priorities?

Lewis does not give adequate attention to the role of economic shocks that are not uniform among individual countries that adopt a single currency, and the degree of mobility of the labor force as imposing disadvantages on a currency union. The advantage of an independent currency is that it makes possible a countercyclical domestic monetary policy and shifting the real exchange rate without a corresponding shift in the level of domestic prices.

Lewis dismisses exchange rate adjustments as a solution to changes in competitiveness in the face of shifts in relative demand between countries. In integrated markets, he maintains, nominal exchange rate changes create demands for a further dose of devaluation. His emphasis on reduction in information and transactions costs and trouble and inconvenience from doing away with currency conversions is belied by the growth of medium and long-term futures markets.

Lewis regards establishment of a European currency zone amongst an inner core of countries as still most likely, and a nearly permanently fixed exchange rate for North America as not improbable. I am skeptical on both scores. After suggesting that the relevant comparison is not floating versus fixed, but between exchange rates that fluctuate daily and those adjusted by substantial amounts at longer intervals, often after sustained speculative pressures, Lewis concludes that under the circumstances floating exchange rates may be the least bad approach. The conclusion, I believe, comes from the head, not the heart.

In my view free trade is achievable without fixed exchange rates or monetary union. Fixed exchange rates have economic costs, and monetary union is a political pipe dream. Currency risk is not an overwhelming concern of business men.