Opening Remarks

Alan Greenspan

It is a pleasure to be here with you once again. As at past meetings here, the Federal Reserve Bank of Kansas City has arranged a particularly challenging and stimulating program--one that commands our attention despite the attractions and distractions of this magnificent setting. Let me take a moment to add a word of special thanks to Roger Guffey for his part in overseeing the whole series of symposia here at Jackson Hole that many of us have found so informative and valuable over the years. This will be his last meeting here as official "host," as his tenure as president of the Federal Reserve Bank of Kansas City is coming to an end. We thank you, Roger, for this meeting and those of past years and wish you well in your post-Federal Reserve endeavors.

With movements toward trade zones proceeding in many parts of the world—the single market program and economic and monetary union in the European Community (EC) and the Enterprise for the Americas Initiative and the proposed North America free trade area here in this hemisphere—it is both timely and appropriate that we consider the economic factors behind these efforts and their implications for global markets and for policy formulation. The outcome of the Uruguay Round of multilateral negotiations unfortunately is still undetermined. Against this background, we need to learn why the impetus has shifted to regional agreements; what precisely are the benefits those agreements offer; and how to ensure that the benefits of the regional trade agreement do not translate into global losses as a result of trade diversion and resource misallocation.

The dividends offered by free trade zones are primarily microeconomic in nature—greater economics of scale in production, more competitive industrial structures, improved labor and capital mobility, and more efficient allocation of investment throughout the region. These gains come about as barriers to the flow of goods and services are lowered and as restrictions such as those on foreign ownership of domestic firms and on repatriation of earnings are removed. Inevitably, during the process of adjustment some workers and owners of capital in place will regard themselves as "losers" in the move to a free trade area. On balance, we expect the microeconomic gains to translate into a healthier macroeconomic performance as well, with an improved outlook for long-term growth.

How do we estimate ahead of time the net gain in welfare for each of the members of a proposed free trade area? What policies are appropriate for ensuring that in response to lower trade barriers capital and labor successfully move from industries where they are no longer competitive to those where they can be efficiently and profitably employed? At what stage of economic development is a country ready for participation in a free trade area? Can countries of different size or at different stages of development all benefit from forming a free trade area with each other? What should be the policy of participating countries in their trade with countries not in the free trade area?

These are all important questions that we might usefully take up during our two days of discussion. They are questions that the member states of the European Community have dealt with over the life of the Common Market and are grappling with again as the now-larger EC proceeds to shape the terms of the single market by the end of 1992. Indeed, they are questions that those responsible for negotiating the North America Free Trade Agreement will need to answer in concrete terms for Mexico, Canada, and the United States.

Our agenda extends beyond free trade areas to a consideration of currency zones as well. The relationship between the two is a topic that is still much debated. Since the United States is both a free trade area and a single currency zone, I cannot dismiss the proposition that a single currency is an important ingredient in a successful free trade zone. A single currency makes it possible for producers and consumers to eliminate the risk, uncertainty, and expense associated with transacting in several currencies and with protecting against potential exchange rate variability. A single currency simplifies somewhat the problem of planning by enterprises and of making investment decisions. It reduces even further the significance of national borders to firms producing within a free trade area and thus helps to promote the integration of all the regions of the area into a single, efficient economic system.

At the present time, the member countries of the European Community are in the process of negotiating economic and monetary union. Achievement of a single European internal market and a single European currency offers the benefits I have just described, but entails some costs as well. It will require significant institutional changes and political compromises as well as some loss of economic flexibility as whatever scope remains for adjustment of member countries' nominal exchange rates is eliminated. The transition from the present system to full monetary union is likely to be difficult, and the decision of when to lock in existing exchange rates may be crucial. Implementation of European economic and monetary union may add to the complexity of expanding EC membership in the future.

The proposed changes associated with European economic and monetary union are far-reaching. While their effects will be felt primarily within Europe, no doubt there will be impacts on all exchange rates and international financial markets in general. Similarly, the achievement of a free trade area in goods and services, including financial services, within North America can be expected to have some impact on financial markets elsewhere.

The past decade has witnessed significant changes in global financial markets as deregulation in many countries and technological advances in information processing and communication have made it possible for financial markets throughout the world to become more closely integrated. The lowering of barriers to competition within proposed trade and currency zones should accelerate that process for the countries within the zones and may well influence the course of developments outside these zones. The balance of competition between banks and other financial institutions and markets, the range of financial services and products available to consumers, the nature of the risks borne by financial intermediaries, the pace of innovation, and the efficiency with which financial intermediation in general is done may all be affected by the increased competition in financial markets that is expected to result from the formation of a free trade area.

The emergence of trade and currency zones poses additional challenges for the ways in which we regulate financial markets. Small regulatory differences between countries within the zone might well tip the balance of competition in favor of one country's firms relative to those of the other. Regulatory inconsistencies across the members of the zone might well be exploited by firms and result in undesired outcomes in terms of the nature and the distribution of risk borne by financial institutions. It would appear that the move toward trade and currency zones needs to be complemented by efforts to achieve greater coordination of supervision and regulation of national financial markets.

In what ways do trade and currency zones have an influence on macroeconomic policies? Their fundamental contribution is to counter any tendency that might be present for policy choices—whether trade policy, exchange rate policy, or monetary and fiscal policy—to be made at the expense of one's neighbor by making neighboring economies so interdependent that such a policy would be self-defeating. At the same time, however, the trade and/or currency zones define a new border—and thus a new "neighbor." It is essential that those responsible for policy choices do not allow the emergence of trade and currency zones to foster a climate of policy choices for the benefit of "insiders" at the expense of "outsiders."

Trade and currency zones raise issues of policy implementation as well. Clearly the scope for independent monetary policy is lost, but to what extent do other macroeconomic policy instruments within the region need to be coordinated? Is some degree of tax harmonization needed to assure a "level playing field" for all economic entities in the zone? Does currency union require limits on national budget policy choices? Is the effectiveness of fiscal policy on the part of one government altered by increased "spillovers" to the partner economies within the zone? Should monetary policy in the low-inflation member of the zone function as an anchor for monetary policy in the other members? Will changes in the structure of financial intermediation affect the transmission of monetary policy, and, if so, how? Our experience with trade and currency zones is still limited. As a consequence, experience will not be a sufficient guide to answer these questions unambiguously.

The range of issues before us is quite broad. We seek answers from the abstract world of economic models and from the ongoing experience gained in the cases of European economic and monetary union and the North American free trade area that are already being planned. We need to address these questions from the perspective of industrial countries and from that of countries still in the process of industrializing. Insights into the economic implications we can expect from trade and currency zones should guide us in choosing appropriate macroeconomic policies now and in the future—whether we are "inside" or "outside" a zone. I recognize that we are not likely to reach complete insight or agreement on these issues in our discussions during the next two days, but I expect the exchange of views, both within the formal sessions and outside of them, to be both stimulating and informative.