Financial Market Implications of Trade and Currency Zones

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Recent developments have focused renewed attention on the implications of trade and currency unions. In Europe, the single market is scheduled to be fully operational by the beginning of 1993. By that date, the countries of the European Community (EC) should be virtually free of all formal barriers to the movement of goods, services, labor, and capital. Meanwhile, in North America, the Canada-U.S. Free Trade Agreement is removing tariff barriers to trade in goods and services between the United States and Canada. Negotiations have recently begun for the creation of a North American free trade area which would embrace Mexico, as well as Canada and the United States.

There are also moves toward strengthening currency links, especially in Europe. For more than a decade, the European Monetary System (EMS), through its exchange rate mechanism, has linked participating currencies in a "zone of monetary stability." Now, after a flurry of activity initiated by the Delors Report (1989)[1] two intergovernmental conferences are under way, aimed at concluding draft amendments to the Treaty of Rome that would eventually transform the European Community into a single currency area. Some of the more ambitious proponents of Economic and Monetary Union (EMU) in Europe envisage a move to locked exchange rates and a single monetary authority as early as the late 1990s.

These various trends have led a number of observers to see the

world economy evolving in a tripolar direction, with the United States, Japan, and the European Community serving as the focal point of trade and currency zones of North America, East Asia, and Europe respectively.

This is a considerable simplification of the forces at work, however. For one thing, the three main "zones" in the world economy vary enormously in the tightness of the links among their constituent economies. Europe is on the way to becoming a true economic and monetary union, in which the economies of the EC members will be almost as closely integrated as regions within individual national economies. North America has very close trade links, but has no plans to move forward from the rather informal leadership role occupied by the U.S. dollar. And in East Asia, despite the regional weight of Japan, many of the countries of the region look more toward their trading and other economic links with the United States than to those with Japan.

Another reason why the "tripolar" paradigm can be misleading is that it overlooks the importance of the trend toward greater economic integration at the ***global*** level. The postwar period has seen the dismantling of much of the network of trade barriers that had been built up'during the 1930s and the wartime period. This process has continued in the 1970s and 1980s, albeit at a slower pace and with some backsliding. So the development of closer trading links within the three main areas of the industrialized world, as well as in other smaller regional trading areas, has not been at the expense of trade growth ***between*** trade zones, or with the rest of the world.

Nevertheless', the growing significance of trade and currency zones poses a series of analytic and policy issues that command attention. This paper will attempt to deal with five of them:

(1) Is there an ***inherent dynamic*** in regional economic integration? Does increasing trade among national economies lead naturally to a formal trade zone? And does this process tend to spill over into the financial sphere, with growing links involving currency and financial markets?

(2) Will integration lead to changes infinancial structure? Will institutions and markets become more homogeneous among countries belonging to trade and currency zones? Will transnational financial conglomerates become the norm, or will financial markets remain more segmented, and financial institutions more specialized or localized?

(3) As economies become more closely integrated, how do supervisory and regulatory arrangements need to evolve so as to both promote efficiency and competition in the financial sector and at the same time provide adequate prudential safeguards?

(4) What are the implications of trade and currency zones for monetary and other macroeconomic policies? Do new instruments of control need to be developed to compensate for the autonomy that is lost as a result of economic integration?

(5) What are the implications for the management ofjinancial relations between major economic zones? How is it possible to ensure that greater liberalization within regions is not accompanied by the erection of greater barriers to trade and financial relations with the outside world?

This is rather a long list of questions. Each one of them could be the subject of a paper in itself. The following analysis will do no more, therefore, than touch on a number of the key issues that arise; First, however, it is worth a brief digression to define terms.

A definition of terms

At its least formal, a trade zone could be said to comprise an area within which trading links are closer and more important than they are with the outside world. Trading relations do not need to be formalized for there to be a recognized mutuality of interest in the trading flows that occur. More usually, however, analytical attention is focused on situations where preferential trading arrangements exist between member states in a trade zone. This usually involves understandings that tariffs among members of the preferential trad-

ing area will be levied at reduced or zero rates, and/or that quotas and other nontariff barriers will be waived or applied on a less discriminatory basis. Finally, countries can enter into a ***single market arrangement*** in which goods, services, and factors of production can be exchanged across national boundaries within the union on exactly the same terms as they can be sold domestically. This involves not just the removal of tariffs, but also the elimination of barriers to factor mobility (explicitly excluded in the classical theory of international trade) and the dismantling of administrative barriers that are found in the form of product specifications and labeling requirements, health and safety standards, marketing arrangements, and so on.

Table 1

Increasing Currency Integration	**Increasing Trade Integration**		
	Preferential Trade Zone	Trading Arrangements	Single Market
Currency Zone	Japan (1991)	U.S. (1991)	
Mutual Currency Management		Europe (1991)	Europe (1993)
Single Currency			Europe (2000+?)

In the domain of currency zones, it is similarly possible to distinguish three broad classes of relationship. The least formal may be called a ***currency zone,*** and is characterized by the predominant use of a single currency for invoicing trade within the area, as well as the use of that currency as a standard for the management of other currencies within the zone. Such a situation would not involve any formal rights or obligations among members of the zone. A more formalized set of obligations exists in a currency zone with ***mutual currency management arrangements.*** In such a situation, countries enter into arrangements to maintain the value of their currency in a certain relationship with that of other members of the zone, and to provide and receive the financial resources necessary to meet this obligation. They retain, however, the ultimate responsibility to decide on their internal monetary policy, and have the right to

negotiate changes in the external peg for their currency. Lastly, countries can decide to turn such arrangements into a thorough-going ***currency union,*** in which the countries concerned have, in effect, a single currency with a single monetary authority.

The international economic scene offers examples of all of these types of trade and currency zones. Using the definitions given above, North America has long been a ***trade zone,*** in the sense that trading relations between the United States and Canada have always been much closer than with other trade partners. But North America has for some time been moving in the direction of becoming a ***preferential trading area.*** Agreements such as that related to automobiles were formalizing trading links before the Canada-U.S. Free Trade Agreement came into existence in 1989. It seems unlikely that the United States and Canada will become a full ***single market*** in the foreseeable future, however.[2] Nor is it likely that a formal relationship between the U.S. and Canadian dollars will be established. In the taxonomy developed above, North America is a ***currency zone,*** because of the central importance of the U.S. dollar, and the fact that Canada (along with many other countries in the Western Hemisphere) gives heavy weight in its own monetary management to its exchange rate with the U.S. dollar. But it seems unlikely that Canada and the United States would contemplate reciprocal obligations in the currency sphere, still less that they would move toward the use of a single currency.

Europe presents a picture of gradual movement in the direction of closer integration, both in the trade and in the currency sphere. In the immediate postwar period, it would have been hard to consider Europe as being either a trade or a currency zone. Several European countries (notably France and the United Kingdom) had closer trading links with suppliers and markets in the developing world than they did with their geographical neighbors and competitors in Europe. Reconstruction, and the gradual removal of payments barriers, strengthened trading links. ***Preferential trading arrangements*** were established in the late 1950s with the formation of the European Economic Community (EEC) and the European Free Trade Area (EFTA). Thirty years or so later, the passage of the Single European Act (1986) represented an attempt to move the enlarged EEC for-

ward to the status of a genuine single market. Similarly, the negotiations on Economic and Monetary Union have the goal of going beyond the mutual currency arrangements of the EMS to a full monetary union.

East Asia has much less closely interlinked economies than either Europe or North America. Despite the economic weight of Japan, most economies in the region still depend very heavily on the United States (and to a lesser extent Europe) as markets for their manufactured goods. Nevertheless, supplier-customer relationships between Japan and raw-material producing East Asian countries have always been strong. And they are increasingly being complemented by investment links, as Japanese manufacturing corporations seek to use the relatively cheap labor that is still available in other Asian countries to displace Japanese production of labor-intensive products.

The trade and currency zones of the industrial world will be the principal focus of this paper. Before going on to analyze the questions identified in the introduction, however, it is worth noting that there are several trade and currency zones in the developing world, some of which are of quite long standing. The CFA franc zone, for example, is a fairly highly developed economic union, whose members enjoy preferential trading arrangements and use what is, in effect, a common currency.[3] The Andean Pact countries have cooperated for more than 30 years and tariff-free internal trade is expected by 1992. Other examples of regional trade arrangements include the Caribbean Common Market (Caricom) and Mercosur—the recently-established pact between Brazil, Argentina, Uruguay, and Paraguay which aims at establishing a free trade zone by the end of 1995.

Trade and currency zones in the developing world differ from those among industrial countries in that they generally have the aim of developing trading links among countries whose existing trade relations are rather meager. They often represent an attempt to move away from dependence on trade links with developed countries, and an effort to enlarge the market for infant industries behind protective barriers. Trade zones in the industrial world, however, particularly those in North America and Europe, reflect an attempt to strengthen

further trade linkages that are already strong.

The dynamics of trade and currency zones

The example of the European Community suggests that there is an inherent dynamic to regional economic integration. In Europe, trade linkages became formalized into preferential trade arrangements, and the tariff-free ***common*** market gave way to a demand for a ***single*** market, in which administrative as well as formal barriers to trade would be removed, and where factors of production and services would be as free to cross national boundaries as manufactured goods.

From a financial standpoint, an interesting question is whether the benefits of free trade require parallel progress in the field of capital liberalization and financial market integration. Traditionally, freedom of capital movements has been accorded a lower priority in the process of liberalization than freedom of payments for current transactions. This is reflected in a variety of international pronouncements, from the Articles of Agreement of the International Monetary Fund down to the recommendations now being offered to the formerly centrally planned economies as they embark on the process of economic restructuring and reform.

This advice is perhaps understandable. Trade integration brings more obvious benefits in the international specialization of labor, and the linking of the domestic economy with the international price structure. And freedom of payments to finance trade does not have the potentially disruptive effects on currency relationships of freedom of capital transactions.

There are, however, at least four reasons why the removal of controls on capital flows can be important in improving efficiency and welfare in a trade zone.

First, freedom of capital flows is an important complement to the cross border provision of financial services. While exchange controls remain, banking, investment, and insurance services face barriers in international competition. Together, such services represent

some 5-10 percent of GNP in Organization for Economic Cooperation and Development (OECD) countries, and are an important intermediate input to the production process in the industrial sector. The principles of specialization of function and comparative advantage are no less important in the area of services than they are in trade in manufactured goods.

Second, capital liberalization can promote ***dynamic efficiency*** in the financial services sector. Not only will liberalization lead to the displacement of relatively inefficient by relatively efficient suppliers, it will increase competitive pressure on a continuing basis, and thus promote innovation and productivity improvement.

Third, the removal of capital controls is necessary to improve the channeling of resources from savers to investors. For a variety of reasons (demographic, developmental, cyclical, and policy-induced) some countries will be net savers, and others net absorbers of saving, at a given world rate of interest. Capital account restrictions tend to keep national savings bottled up in each national economy, and thereby prevent flows of financial and real resources from economies with a high propensity to save to those with a high propensity to invest.

Fourth, related to the above, the removal of capital controls of investment improves the allocation of a given volume of investment. It can facilitate two-way investment through which enterprises with technological or managerial know-how in a particular sector can diversify abroad, and promotes the spread of best-practice techniques in foreign countries.

Most economists would accept that free capital movements have potential benefits for international resource allocation. These are comparable to the benefits that a national economy derives from a unified capital market and financial system. But capital liberalization also carries one important drawback. It can facilitate large scale speculative capital movements that undermine exchange rate stability. So long as exchange rate stability is felt to be important for the promotion of trade, and so long as trade in goods is thought to be more important than trade in services and international invest-

ment, capital account liberalization is likely to be accorded a secondary priority.

To reconcile this conflict requires arrangements that can contain or absorb speculative currency flows, as the freedom of economic agents to move their financial resources is enlarged. The recent success of the .European Monetary System's exchange rate mechanism (the last substantive realignment was in January 1987) suggests that it is possible to achieve sufficient policy convergence for fixed exchange rate margins to contribute to exchange rate stability, rather than to provide a focus for speculative attack. This occurs when the belief in the authorities' willingness to do what is necessary to defend a parity is such that private economic agents tend to ***buy*** currencies at the bottom of their fluctuation margin (to profit from subsequent appreciation) rather than sell them (to profit from eventual realignment).

The contention that the ERM is ***inherently*** unstable in the absence of capital controls[4] is belied by the experience of the past four and a half years. But it could still be argued that it is ***potentially*** unstable, if exogenous disturbances or endogenous shifts in policy preferences were to call in question the willingness of monetary authorities to sustain the existing parity grid. It is to deal with this potential instability that some observers believe it is necessary to go forward to full monetary union. Once the members of the EC use a single currency, it will become impossible to envisage realignment, and capital flows within the union will perform the same equilibrating function that they do in, say, the United States.

Of course, the arguments for moving to a single currency are not just to avoid the potentially destabilizing effects of capital flows. It has been argued that the continued existence of difficult national currencies will represent "the last nontariff barrier" once the single market is achieved in 1992. In a thorough study of the costs and benefits of moving to a single currency, the EC Commission has argued that there will be a substantial positive welfare effect from reducing uncertainty and eliminating transactions costs.[5] The Commission's estimate of the benefit may be exaggerated,[6] but the potential trade promoting consequences of currency union neverthe-

less have a powerful appeal.

The general conclusion of this section is that there is, indeed, a natural evolution within economic zones whereby trade arrangements lead to a perceived need for capital liberalization, and capital liberalization creates the need for closer cooperation on currency arrangements. It would be wrong to suggest that trade zones in North America and Japan will copy the path that Europe has followed at any time in the foreseeable future. But it is perhaps not fanciful to expect that the issue of how to make capital liberalization compatible with the desired degree of regional exchange rate stability is one that will receive increased attention in the years ahead.

Financial market structure

Another financial issue that is raised by the formation of trade and currency zones is how the structure of financial institutions and markets will respond in a situation of greater economic integration. Historically, financial structures have developed differently in different countries. In North America and Japan, for example, there remains a fairly strict segregation of banking and securities business, the product of the Glass-Steagall Act in the United States and Article 65 in Japan. In much of continental Europe, by contrast, the "universal bank" has been the norm. The United Kingdom occupies an intermediate position.

There are also significant distinctions with respect to geographical diversification. In the United States, branching by banks has traditionally been closely circumscribed, while in Europe, banks have branched freely in their respective national economies.

It has been argued earlier that a natural extension of regional free trade in goods is a free market in services, including banking services. Does this mean that financial structures will tend to converge in the member countries of a single market area? Will large multinational conglomerates tend to absorb smaller institutions? And will a single major financial center exert a centripetal force on financial activity in the whole area?

Concerning the long-run development of institutional structures, it seems inevitable that there will be a tendency to converge on the most efficient and low-cost means of providing financial services. To that extent, market forces are bound to bring about some increase in the homogeneity of financial structures within a currency zone. However, most studies do not suggest that there are major differences in efficiency resulting directly from the different structures.[7] Moreover, customs and traditions take time to change, and established relationships between financial institutions and their customers have the character of "sunk capital." All in all, therefore, it seems unlikely that Europe will see rapid changes in existing financial structures as a direct result of single market legislation..

What is perhaps more likely is that capital markets throughout Europe will become increasingly integrated. Improvements in payments systems will link markets for banking services, and the removal of remaining restrictions on cross border investment will promote harmonization in securities market practices. This will inevitably be a gradual process, however. At present, the main financial centers in Europe are in competition with each other for securities business, and attempts at inter-European collaboration have not so far met with great success. The differences in market practice which have been referred to, reflect long-standing differences in tradition between different centers, which will take some time to dissipate. But exposure to free competition will 'undoubtedly catalyze that process.

Another issue concerns whether the expansion of the market for financial services will eventually lead to a smaller number of larger institutions, as mergers occur to reap economies of scale. Some observers note that the number of banks in the community far exceeds the number of major suppliers in other sectors of economic activity. Just as international trade in goods has led to concentration in steel or chemicals or automobiles, will not the same process lead to mergers in the banking and financial services industries?

Recent research suggests that economies of scale in financial services are,significantly smaller than was once thought.[8] The need for size in order to service the borrowing needs of major industrial

clients has diminished as large corporations have increasingly found it cheaper to raise finance in their own name. Banking has become increasingly involved with the provision of ***services,*** rather than ***capital,*** except in the case of small and medium-sized customers. This has diminished the need for size, and put a premium on the flexibility that smaller financial institutions are able to offer.

Diversification also seems less popular than several years ago. Some attempts to develop financial services conglomerates (Sears Roebuck, American Express) have encountered difficulties in the attempt to manage businesses with different characteristics. The prospect of "Chinese walls" separating different aspects of the business of a single financial enterprise also diminishes the potential attractiveness of diversification.

This does not mean, of course, that diversification will not occur. In particular, it seems likely that the repeal or reform of the Glass-Steagall Act and Article 65 will be accompanied by a movement on the part of banks and securities houses into each other's areas of specialization. In Europe, there has been a pronounced trend toward links between banks and insurance companies. But this does not seem likely to be a trend that will transform the nature of financial intermediation within a short period.

What of the issue of geographical concentration? Will the creation of a single financial area in Europe accentuate the trend toward a world of one dominant financial center in each major time zone? Two conflicting tendencies will come into play. On the one hand, there are clearly economies of concentration in financial markets.[9] These will tend to benefit the position of London, as the restrictions and habits that have kept certain activities in continental centers are abolished or die away. On the other hand, certain restrictions have tended to drive business to the more liberal environment and these activities may be repatriated as restrictions are released. Moreover, technology is diminishing the importance of concentration and making it easier to conduct financial business on the basis of screen and telephone. This may weaken the pull of London as a center of ***employment*** in the financial services industry, especially if congestion continues to raise employment costs.

The implications of trade and currency zones for financial market structures are therefore difficult to predict with precision. It has been argued here that major changes are unlikely in the short term, given the absence of major disparities in unit costs, and the inertial forces of existing habits and relationships. Over time, forces of convergence could well become more apparent, but even in the long term, complete homogeneity is not to be expected.

Regulatory and supervisory issues

The extension of free trade to financial services, and the progressive elimination of bamers to capital flows, raises the issue of how to structure regulatory and supervisory controls on an appropriate international basis. The basic rationale of regulation and supervision of the financial system is threefold: first, to assure prudent management of financial institutions, so that the stability of the financial system is safeguarded; second, to ensure that the interests of depositors and investors are protected; and third, to foster competitive efficiency, so that the requirements of users of financial services are adequately met.

These objectives are equally valid when the domain of competition in the provision of financial services is extended to the international level. But the complexity of the issues involved is considerably increased.

Traditionally, the responsibility for the health of financial institutions and markets has lain with the authorities of the country in which financial activity takes place. Institutions that did not meet required standards could be excluded from undertaking business in the country. concerned. This basic approach has been somewhat modified over the years as banks and other financial institutions have become increasingly global in their approach. Understandings among regulators provided that certain elements of supervision should be undertaken by "home country" regulators (that is, those in the country of an institution's head office) while others would continue to be undertaken by the "host" country (the country where business is done). But it was always clear that the host country had the ultimate right to decide which institutions it would permit to

undertake business within its boundaries.

The advent of the single market in Europe will change this situation. The principles of free movement of goods, services, and factors of production mean that individual member states will no longer have the ultimate authority to regulate access to their financial markets.

In the financial services area, the Single Market Act seeks to achieve three broad objectives: *first,* to allow consumers of financial services free access to providers, in whichever member state the latter are located; second, to give properly authorized and supervised providers of services the freedom to offer them on equal terms throughout the European Community; and third, to ensure that financial service providers compete on a "level playing field."

The first of these objectives can be met by the removal of exchange controls. This is already complete in most member countries. The second will be met by the introduction of the principle of "mutual recognition." The principle of mutual recognition has enabled the European Community to avoid time-consuming and unnecessary harmonization of regulatory structures across all member countries. Instead, countries agree to accept the regulatory decisions of other member states as meeting the.requirements for authorization. This approach naturally requires agreement on minimum common standards if it is not to lead to "competition in laxity" and regulatory arbitrage.

The need to agree on minimum common standards is the key practical question in a trade or currency zone where financial services are authorized and regulated on the basis of mutual recognition. All countries have restrictions or regulations about the placement of assets invested on behalf of consumers. There can be no dispute in principle about the need for such restrictions. However, their application in practice can result in a tilting of the playing field against institutions from one or another member country. For example, rules that the assets of insurance companies or pension funds must be invested to a specified minimum extent in instruments issued by governments of their respective home states have an obvious prudential rationale—namely, to protect policyholders from credit

and exchange risk—but interfere with the establishment of a true single market.

The various directives designed to give effect to the single market seek to specify appropriate minimum standards for the European Community as a whole, while leaving member states free to apply nondiscriminatory additional standards, where this is appropriate for the conditions of their particular markets. This means that, for a single institution with branches in different member states,-portfolio constraints relating to capital adequacy and risk concentration are specified centrally, since it is not sensible to think of branches having capital of their own. "Conduct of business" rules, however, which govern such aspects as relations with customers are to be set by host countries, with the important proviso that they must not be disproportionate to the goals they are designed to achieve and thus must not be protectionist in nature.

Deposit protection is an awkward issue. Deposit protection schemes vary quite widely in the degree of formal insurance they provide to depositors. At present, deposit protection is a host state responsibility which means that depositors in the same country are not faced with competing deposit insurance arrangements. But logically it should be a home state responsibility, so that the home country supervisor is forced to bear the financial consequences if an institution it supervises fails. This could, however, lead to deposit protection becoming a competitive factor within individual states unless there were a considerable degree of harmonization. Moreover, to the extent that deposit protection is implicitly subsidized (for example, the expectation that a government would not allow a nationalized bank to fail) there is an issue of competitive equality to be faced.

In Europe, agreement has now been reached, in the Second Banking Coordination Directive, on the mutual recognition of banks in all countries of the European Community. Authorization in one country will permit the institution to operate throughout the European Community. The home country will be responsible for supervising the financial soundness of the institution, and will be entitled to monitor compliance with locally established "conduct of

business" rules. Supervisors will, of course, cooperate. with each other through the usual channels in Brussels (the Banking Advisory Committee) and Basle (the EC Central Bank Governors Committee).

Rather less progress has been made in the establishment of common standards for the securities business. Indeed, it seems possible that no agreement may be reached, in which case, there will be no automatic mutual recognition for securities firms.

Why should it be proving more difficult to reach agreement for securities than for banking? Part of the answer may be in the'relative importance of markets as against institutions in different financial activities. In the securities business, ***markets*** are more'important than ***institutions,*** while in banking, it is the other way round. In markets, the interests of consumers are protected by conduct of business rules, whereas for institutions, customers must rely more on portfolio constraints. Conduct of business practices vary significantly from market to market. Some countries favor rules to enforce concentration of trading in a single market, so as to improve liquidity; others believe that markets with different operating techniques should be free to compete with one another. Some favor maximum transparency (that is, immediate publication of all trades); while others would prefer to limit or delay publication, so as not to inhibit large transactions. ***Last,*** some markets operate on a quote-driven system, while others operate on an order-driven 'system.

It is not necessarily inconsistent with the spirit of the single market to allow the .coexistence of different financial markets operating according to different practices. However, the relevant directive (the Investment Services Directive) seeks to achieve agreement on market practices as well as on institutional standards. Failure to agree on the fo'rmer may prevent agreement on the latter. It will be unfortunate if, as a result, investment services companies do not have access to markets throughout the community, especially as, under the terms of the Second Banking Directive and in line with the universal banking model common in Europe, banks are permitted to engage in the full range of securities activities. Competition among providers of financial services would be undermined, to the detriment of consumers' interests.

What conclusions can be drawn about supervision and regulation in a trade and currency zone? *First,* the concept of a single market implies that providers of financial services (whether institutions or markets) should have the right to offer their services throughout the single market area. This implies, ***second,*** a single license, whether this is issued by a central regulatory authority or at the country level with mutual recognition throughout the area. Third, harmonization of market practices is harder, and arguably less important, than the harmonization of capital standards for credit institutions. Since there are different views about the optimal organizational framework for securities markets, a case can be allowed for allowing different structures to coexist and compete.

Monetary policy in a trade and currency zone

Perhaps the most significant aspect of monetary integration lies in the constraints that it imposes on monetary policy. It is a well known theoretical proposition that, of the three policy objectives — stability of exchange rates, freedom of capital movements, and independence of monetary policy--only two can be achieved continuously. When countries pursue independent monetary policies, differential inflation rates will lead to a trend movement in the equilibrium nominal exchange rates. This movement will quickly be perceived by speculators who, in the absence of capital controls, will undertake capital movements in anticipation of the exchange rate movement. Stable exchange rates will therefore be undermined.

For many years, a solution was sought by making compromises in each of the three objectives listed above. Under both the Bretton Woods system and the ERM, for example, exchange rate stability is an important objective, but parity changes are allowed when situations of "fundamental disequilibrium" occur.[10] Capital movements have generally been allowed when they are in support of direct investment flows or other welfare-enhancing transactions, but have been restricted to the kxtent necessary to prevent a fixed exchange rate being overwhelmed by short-term speculative flows.' And domestic monetary policy has typically not been completely independent. It has been formulated in the light of external constraints, though with the choice of exactly how to respond to these constraints

remaining in the hands of national authorities.

Despite this broad characterization, there have clearly been shifts over time in the priority accorded to each of the three objectives. In the Bretton Woods system, fixed exchange rates were seen to be of key importance, and the main objective of monetary policy was to ensure the sustainability of established parities. Capital controls were also important in helping maintain parities, while domestic economic balance was regarded as the task of fiscal policy.[11] By the early 1970s, the benefits of fixed exchange rates were increasingly questioned—at least if that meant fixed ***nominal*** exchange rates which had to be defended by the use of monetary and intervention policy. Greater priority was accorded to the right of each country to pursue its own stabilization policy, with the exchange rate being the residual, or "shock-absorber" in the system. Capital controls had a limited role to play, although some saw them as useful in dampening speculative excesses.

Those who favored monetary independence for national authorities did so because they assumed that this would increase the freedom of maneuver for stability-oriented policies.[12] They also expected that the common pursuit of stability-oriented policies would, in a world of exchange rate flexibility, ultimately lead to greater, not less stability in ***real*** exchange rate relationships.[13]

Experience has not borne out the hopes entertained for flexible exchange rates. Real and nominal exchange rates have been highly volatile, both in the short and medium term. And the record on inflation, despite a considerable improvement in the early and mid-1980s, has left much to be desired. (See Charts 1 and 2.)

It is partly this experience that led the European Community to search for arrangements to help create a "zone of monetary stability." The objective is both to create a conducive environment for regional economic integration, and to provide a credible exchange rate "anchor" for domestic monetary policy. Although the empirical literature has generally failed to discover much of an effect of exchange rate volatility on trade, much of the investigation has focused on the effects of short-term exchange rate movements.[14]

Chart 1
Exchange Rate Volatility

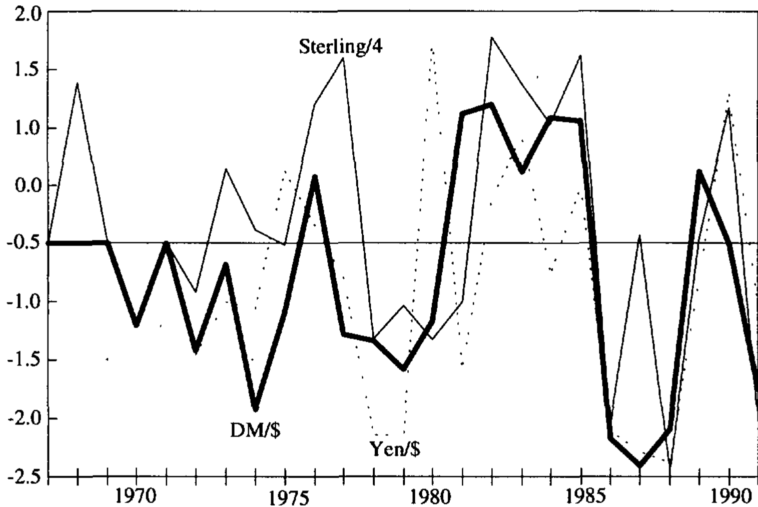
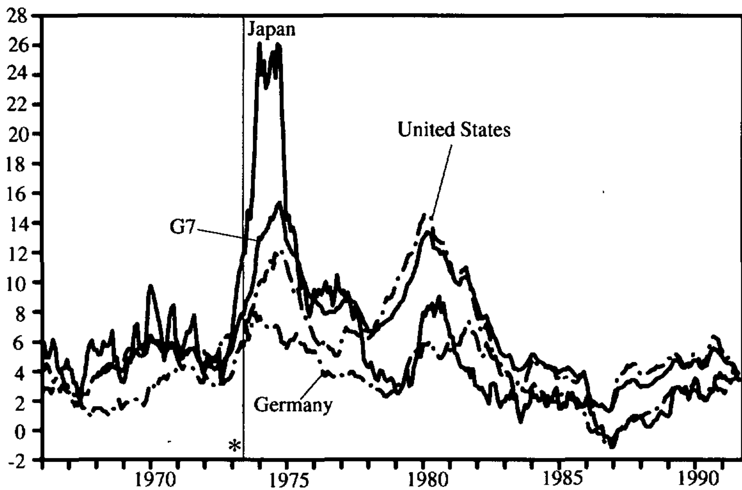


Chart 2
Consumer Price Inflation



*Denotes move to floating exchange rates

When longer-term swings in competitiveness are considered, economic intuition suggests that such volatility must have adverse resource allocation effects, even if these prove hard to capture using standard econometric techniques.

Europe is now in a situation, therefore, in which exchange rate stability and capital liberalization are avowed priorities. What does this mean for the formulation of national monetary policies?

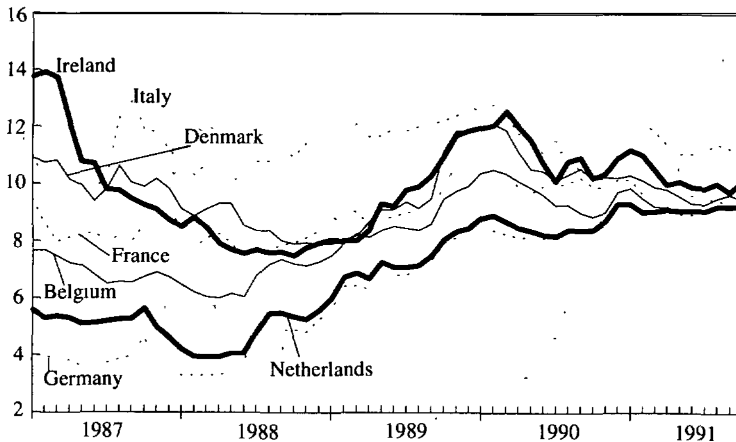
The existence of the European exchange rate mechanism (ERM) means that costs and price trends must be consistent among ERM members if realignments are to be avoided. In the shorter term, growing confidence in the ERM parity grid means interest rates, too, will tend to converge. However, there remains scope for interest rate divergences, which is provided by two factors: first, the existence of exchange rate bands, which even with full credibility of parities would allow interest rates to diverge cyclically among participating countries; and ***second,*** the existence of residual uncertainty concerning the possibility of realignment, which means that some countries have to pay a "premium" over the interest rates prevailing in the anchor country.

Interestingly, interest rate divergences in Europe, which used to be explainable mainly in terms of the "premium" paid by inflation-prone currencies, are now increasingly the result of cyclical divergences in economic conditions. Chart **3** shows that the spread of short-term interest rates among currencies participating in the ERM has narrowed considerably over the period since the realignment of January 1987.

This has led to a so-called "paradox" whereby high inflation countries tend to be strong within the ERM. This is not really a paradox, but rather a reflection of the increasing credibility of the ERM parity grid. If markets do not expect a realignment, then the higher interest rates needed to combat inflation in countries with excess demand will tend to make their currencies appreciate.

Still, notwithstanding the scope for intercountry variations in monetary conditions, there is little doubt that Europe is gradually

Chart 3
ERM Short-Term Interest Rates[1]



[1]Rates are three month euro-market rates

moving toward a single monetary policy. Since this trend, perhaps in attenuated form, could well occur in other trade and currency zones, it is of interest to consider the manner in which European monetary policy has been framed.

For much of the 1980s, the ERM was a ***hegemonic*** system, in which the monetary environment was established by the Bundesbank.[15] This was beneficial for the other members of the European Community because of the anti-inflationary orientation of German monetary policy, and the credibility of the Bundesbank. Adherence to the ERM enabled other countries to "borrow" some of the Bundesbank's credibility, and thus to achieve a reduction in domestic inflation at lower cost than might otherwise have been the case.

Despite these successes, however, a hegemonic system has certain disadvantages. ***First,*** in purely political terms, it is difficult to justify such a role for an institution of one country in a multinational community. ***Second,*** despite the successful record of the Bundesbank

thus far, it cannot be guaranteed that this record will continue in the future. ***Third,*** the monetary policy suitable for Germany will not necessarily be.appropriate at all times for the European Community at large. This is more likely to be an issue when adequate price stability has been restored and combating inflation is no longer an adequate focus, in itself, for the European Community's monetary policy. ***Fourth,*** if a single currency managed by a newly created institution is to emerge in the future, the continued dominance of the Bundesbank will not allow experience to be gained of communitywide monetary management..

For these reasons, attention has been given to the question of how responsibility for monetary policy can be shared more widely. The Delors Committee concluded, correctly, that ultimate responsibility for monetary management of each currency must be unambiguous. Nevertheless, within this constraint, European central bank governors have increased their cooperation through their regular monthly meetings in Basle. As capital controls have been dismantled and the stability of the ERM has been reinforced, currency substitution has made the growth of ***national*** monetary aggregates a less reliable guide to policy. The central bank governors have therefore begun to study the use of communitywide indicators as a guide to analyzing policy interactions at the European Community level.

So long as Europe retains twelve separate currencies, none of this will detract from the ultimate responsibility of each national monetary authority to manage its own currency. This situation will change, of course, as soon as the twelve currencies are formally and irrevocably locked. From that time onward, there will be no national monetary autonomy, and all monetary powers will be transferred to an EC institution.

Relations between currency and trade zones

The analysis in this paper so far has been concerned mainly with the financial market implications of trade and currency zones for institutions and markets ***within*** each zone. But questions also arise of how to manage relations ***between*** zones. Three sets of issues can be distinguished:

(1) how to ensure that regional economic integration is made compatible with increasing ***global*** integration and the promotion of a liberal world trading order,

(2) how to preserve equitable market access for institutions coming from outside a particular trade zone, and

.(3) how to promote macroeconomic policy coordination aimed at providing the best global environment for stable noninflationary growth.

There is no reason why the development of closer trading and financial links within an economic zone should involve the erection of higher barriers against institutions from nonmember countries. Spokesmen for the European Community, for example, have been at pains to emphasize that the creation of the single market is not intended to lead to "Fortress Europe."[16] Still, it would be naive to deny that trade zones can lead to trade diversion as well as trade creation. Moreover, if there is a given quantum of political "capital" which politicians are prepared to expend to promote freer trade, the more that is spent in supporting regional trade and currency zones, the less there is left over for use in global negotiations.

It is important, therefore, for all governments to be aware of this danger, and for continuous efforts to be devoted to ensuring that the multilateral discussions of the Uruguay Round are a success. From an economic standpoint, regional free trade is a second-best to global 'free trade.

The issue of ***market access*** in the financial services sector is one which will increasingly involve negotiations between trade zones. In Europe, questions of financial market access had been, naturally enough, the province of national governments. National authorities had undertaken bilateral discussions with their counterpart authorities in the United States, Canada, and Japan. With the advent of the single market, and the inclusion of financial services within the framework of the Uruguay Round, negotiations on market access will increasingly fall within the competence of the European Community taken as a whole, and in practice, become the province of the

EC Commission.

There are two broad approaches to reciprocal market access. ***"Mirror image"*** treatment involves the negotiation of identical conditions of establishment for financial institutions in different markets; ***"National treatment"*** involves the nondiscriminatory treatment of all financial institutions in each national market, but without requiring that each market necessarily offer the same privileges and regulations as its competitors.

Mirror image reciprocity is obviously a considerably more restrictive requirement than national treatment. There is now general agreement that issues of reciprocal market access should be based mainly on the principle of national treatment. This principle is a useful basis for financial relations, but it is not always sufficient to ensure a "level playing field in competition between domestic and foreign financial institutions. For example, if a foreign financial institution is required to establish a subsidiary rather than a branch, this could be held to be inequitable since it does not take account of the availability of head office capital to domestic institutions conducting the. same business. In a similar vein, the ,imposition of interest rate ceilings may hamper the ability of. foreign banks to compete, if they do not have access to the retail deposit base available to indigenous banks. In other words, the playing field must be level de facto, as well as de jure.

Lastly, as the global weight of the three main trade and currency zones increases, and as the financial links between the zones become closer, the question arises of how ***macroeconomic interactions*** among the zones should be managed.

The large and prolonged appreciation of the U.S. dollar in the early 1980s, and its substantial depreciation thereafter, show that currency relationships can undergo substantial medium-term swings in the absence of policies to limit or avoid them. These swings have resulted from policy changes that shift relative savings/investment balances in individual countries. Since swings in exchange rates have major effects on economic growth and inflation, as well as on the virulence of inflationary pressures, it is natural that consideration

should be given as to how to limit them.

There are two broad approaches to avoiding the damaging consequences of medium-term exchange rate swings. One involves the establishment of some form of "target zones" for key exchange rates. The expectation is that the policies required for a country to keep its currency within the target zone will help correct savings/investment imbalances, and thus make economic fundamentals consistent with the established target zone. The other approach involves an attempt to deal with macroeconomic imbalances directly through a process of multilateral surveillance and peer pressure.

There are two crucial drawbacks to a process of international policy coordination based on target zones. The first is that it is not easy to identify what is an "equilibrium" exchange rate, around which a target zone would be set. The second is that there can be no guarantee that the policies used to maintain an exchange rate within a target zone will, in fact, be the appropriate ones. For example, if a currency is appreciating because of a loose fiscal/tight monetary policy mix, the desirable solution is to tighten fiscal policy. But the exchange rate constraint could equally be satisfied by an easing of monetary policy—a solution that would tend to exacerbate the original demand/supply imbalances.

If exchange rate rules are impractical as a way of organizing relations among the major economic regions, other means of policy coordination have to be found.' Thus far, this has been in the form of the "G-7 process," which involves continuous consultation among the seven major industrial countries on matters of joint policy interest. Although the G-7 process has its defenders, it also has acknowledged shortcomings.[17] These range from the political objections to the exclusivity of the group, to the more technical complaint that there is no satisfactory model of international economic relationships underlying the coordination process. It is obviously unsatisfactory that policy coordination should rest on such an incomplete structure, yet it is not easy to see how it could be developed and formalized..

Conclusions

This paper has argued that the growing economic linkages within trade and currency zones have important implications for financial markets. These implications have to be considered along with the impact of technical innovations that are already exerting pressures for the globalization of financial relations.

The intensification of trade relations, whether regionally or globally, leads to increased pressure to reduce tariffs and then to reduce remaining barriers to trade. Freer trade in goods in turn creates pressures for financial liberalization. This is necessary both to complete the process of trade liberalization, and to lay the basis for a more effective international use of savings and investment.

Capital liberalization accelerates the integration of financial markets and thereby raises issues of prudential and regulatory control, as well as those of macroeconomic policy coordination, to a different level. Policymakers within a trade or currency zone face two sets of questions: how to coordinate regulatory and macroeconomic policy *within* the zone, so as to maximize the benefits of market integration; and how to manage relations with other countries and zones, so as to preserve a liberal and mutually beneficial world trade environment.

There can be little doubt that the emergence of trade and currency zones is having a profound effect on financial markets. It is to be hoped that they are only part of a wider picture of liberalization, in which the benefits from global economic integration will come to exceed those from integration on a regional basis.

Endnotes

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[1]Delors Report, "Report on Economic and Monetary Union in the European Community," EC Commission, April 1989.

[2]Even the United States is not a true single market in this respect. Different regulations at state level (for example, with respect to car emissions) mean that the same product cannot be sold without modification throughout the union. Moreover, in the financial sector, banks are limited in their interstate activities, and insurance services are regulated at state level.

[3]IMF, "A Review of CFA franc arrangements," SM/90/136, July 9, 1990.

[4]See Alan A Walters, "Britain's Economic Renaissance."

[5]EC Commission, "One Market, One Money," European Economy, 1990.

[6]"Exchange Rate Volatility and World Trade," IMF Occasional Paper No. 28, 1984.

[7]Comparative work on bank margins, such as Revell J., "Costs and Margins in Banking: An International Comparison," 1980, as well as analysis of more recent OECD data on the same subject reveal few systematic differences between bank margins and bank profitability in countries with universal banks, as compared with those that separate commercial and investment banking. Such divisions as occurred could be related to factors such as the division of banking business between retail and wholesale, and competitiveness of the financial system.

[8]"Competition in Banking," OECD, Paris 1989.

[9]See E. Philip Davis, BE Discussion paper No. 51, and Grilli (1989).

[10]"Fundamental disequilibrium" has never been formally defined, but is usually taken to mean a situation in which a sustainable current account position cannot be achieved without unacceptable consequences for domestic economic activity.

[11]Williamson.

[12]Walters, *op. cit.*

[13]Friedman, 'The Case for Flexible Exchange Rates."

[14]"Exchange Rate Volatility and World Trade," IMF Occasional Paper No. 28, 1984.

[15]See Francesco Giavazzi and Alberto Giovannini, "Models of the EMS: Is Europe a Greater Deutsche Mark Area?' in Ralph C. and Richard Poxtes (eds.) ***Global Macroeconomics: Policy Conflict and Cooperation,*** IEA and CEPR, 1987.

[16]Sir Leon Brittan: A speech to Bankers Association for Foreign Trade, June 5, 1989.

[17]See Wendy Dobson, "Economic Policy Coordination: Requiem or Prologue," IIE, April 1991, for a discussion of the strengths and weaknesses of G-7 coordination.