Commentary: Financial Market Implications of Trade and Currency Zones

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In order to present my views on Andrew Crockett's excellent paper, I will divide my comments into two sections:

(1) How trade and currency zones affect regional economic integrations: monetary and other macroeconomic policies, and management of financial relations between major economic zones and

(2) how such zones affect the financial and institutional structure and the supervision and regulation of that structure.

Mr. Crockett argues that there is an inherent dynamic in regional economic integration, with increasing trade leading toward formal trade zones, pressure for capital liberalization, and closer cooperation on currency arrangements. His 'discussion of the forces pushing Europe toward monetary integration is persuasive in supporting his thesis.

Interestingly, the same forces that he describes in the European context have been visible in the global context of *G-7* currency arrangements. as well. As Mr. Crockett notes, the "tripolar" paradigm can be misleading by overlooking the importance of the trend toward global integration that has continued even as regional ties became closer. The development of closer trading links within the three main areas of the industrialized world over the last twenty

years has spurred liberalization of international capital flows and rapid movement toward a unified global capital market.

But the move toward a unified global market also carried the drawback of promoting speculative capital flows and exchange rate instability, as witnessed in the spectacular rise and fall of the dollar in the 1980s. Concerns about the potentially damaging effects of exchange rate instability on trade and investment prompted closer cooperation on currency arrangements between the major nations, starting with the Baker-Miyazawa accord in 1986 and evolving into the Louvre Accord framework for currency management that has been (more or less) in place since February 1987. Although the commitment toward "target zone" management of dollar-yen and dollar-deutsche mark has been far less formalized than European currency arrangements, it illustrates the same set of forces at the global level that Mr. Crockett describes at the regional level.

That said, a key question that remains unanswered is whether the concern about currency stability that prompted the Louvre Accord is justified. According to research cited by Mr. Crockett, growth in world trade does not appear to have been unduly hampered by large currency movements among the main industrialized nations in the 1980s, nor is it clear that overall levels of capital investment suffered. In addition, it can be argued that the move to stabilize exchange rates carried the undesirable side effect of exporting higher inflation from the United States to Japan and Germany as their central banks, in effect, helped the United States monetize its deficits. Since considerable disagreement about the desired degree of global exchange rate stability remains, it can be expected that the same issues Mr. Crockett has raised about capital liberalization and exchange rate stability at the regional level will continue to be of great importance at the global level as well.

Mr. Crockett describes clearly the economic logic behind the proposition that movement toward fixed currency and free capital flows within a trading bloc will require the abandonment of national monetary autonomy. In the context of Europe's movement toward monetary integration; he describes the need to develop new instruments of control and new institutions to compensate for the loss of

monetary autonomy involved in the move toward economic and monetary integration. Obstacles to establishing a Eurofed that is not simply an extension of the Bundesbank are discussed as well as the need to establish European Communitywide indicators as a guide to setting policy at the cornmunitywide level.

This point strikes at the heart of the Brussels versus Westminster argument that causes so much consternation in the United Kingdom. A fixed currency zone in Europe has clearly removed (to differing degrees) the ability of national governments to implement monetary policy. This disenfranchisement has been greatest for those nations that have the tightest currency links within the exchange rate mechanism (ERM) (Netherlands, Belgium, and to a lesser degree, France and Denmark) and who have had to almost fully replicate German monetary policy changes in the past. Fiscal policy control has not been ceded so quickly but the ability of national governments to adopt contrasting fiscal stances is still limited by ERM constraints. However, in the future, it is expected that rules on fiscal policy may be imposed on aberrant national governments in order to safeguard Economic and Monetary Union.

What might be usefully added to the analysis is some discussion of the impact of a move toward monetary integration on domestic fiscal policy as well. Recent work by Giavazzi and Spaventa ("The New EMS," Center for Economic Policy Research, Discussion Paper No. 369) points out that, with the abandonment of the use of monetary policy for domestic stabilization, EC members may have to make more flexible and determined use of fiscal policy for that purpose. Unfortunately, the track record of state and local governments in the United States is not encouraging on this score. They are already in the position that EC member states will be in when they lose autonomy over monetary affairs, and appear to use state-level fiscal policy in a pro-cyclical manner—that is, raising spending when the economy is doing well and cutting it when the economy weakens.

Mr. Crockett's warning that trade zones can lead to trade diversion as well as trade creation is well-taken, as is his observation that the more political "capital" that is expended to promote regional trade and currency zones, the less there is left over for use in global

negotiations. I concur that governments need to be aware of this danger and continue to work toward a successful conclusion of the multilateral discussions of the Uruguay Round.

His observation that there is no satisfactory model of international economic relationships underlying the G-7's coordination process may be accurate, but it is worth noting that there is a successful example of a large, geographically and economically diverse region that has maintained monetary unity and free internal capital movement. It is the United States. If Europe can provide a model of how nations with diverse political systems, cultures, and languages can achieve economic integration comparable to that in the United States — without resorting to a "Fortress Europe" approach toward its relations with the rest of the world — then broader visions of global free trade and closer economic integration will, in time, become possible.

Mr. Crockett then poses a series of questions as to the effect of zones on the financial and institutional structure:

(1) Does this mean that financial structures will tend to converge in the member countries of a single market area?

(2) Will large multinational conglomerates tend to absorb smaller institutions?

(3) Will a single major financial center exert a centripetal force on financial activity in the whole area?

I agree with his view that it is unlikely Europe will see rapid changes in the existing financial structures as a direct and immediate result of single market legislation. The longer term, however, depends on what happens in the rest of the world. There will be some changes which will be the result of further improvements in technology and the commercial logic arguing for consolidation. But, as he notes, the most likely area for change is the capital markets system which is rapidly becoming more integrated throughout Europe and throughout the world. Free competition will clearly act as a catalyst in the European capital markets and whereas it is true that the

European financial centers are in competition, they are clearly dominated by London. This will continue since London has the critical mass of people, technology, and the like unless the British authorities take actions which will drive market participants away. On the other hand, it is logical to conclude that considerable growth. in capital markets will be outside London in centers such as Paris and Frankfurt which are making an attempt to attract capital market activities: Hence, the European capital markets will grow on an absolute basis, as will London, but on a relative basis, growth outside London should be greater.

With respect to diversification,' I agree with Mr. Crockett on his fundamental points. Obviously, the repeal of Glass-Steagall and Article 65 will be accompanied by a considerable diversification activity on the part of banks in the United States and Japan. But these actions will be on the margin; they will not transform the financial institutions over the short run.

On a global basis over time, I believe that large multinational conglomerates will tend to absorb smaller institutions. Put another way, rationalization of the international financial structures will follow domestic restructuring which is now happening in the EC; ABN/AMRO, Hispano Americano/Central, bank mergers in Italy, and a multiplicity of cross-shareholding arrangements; in the United States, Bank of America/Security Pacific, Manufacturers Hanover/Chemical, C&S/Sovran; and in Japan, where we have already witnessed two major bank mergers.

Over the next decade, the financial structure will evolve into a two-tiered system, global institutions and global markets, plus discreet regional and national markets served by regional and national institutions. To some degree this has been going on for years, and as the journalists say, "more to come."

Financial scandals are this summer's songs. In the United States, Salomon has shocked the markets as it confessed to improper behavior in the U.S. Treasury market. The Japanese are awash in scandals involving large financial institutions where securities houses have been involved in customer paybacks and the ramping of

shares, fraudulent loans in the banking system, and assorted crimes and misdemeanors. In Frankfurt, illegal insider trading activities have been uncovered. And the shock waves of the criminal manipulation of BCCI continue to reverberate.

These scandals follow on the savings and loans mess in the United States, the fall of Drexel Burnham, and the excesses of the junk bond era; the Blue Arrow and Guinness affairs in London; and other problems within the world's financial system.

In the case of Salomon, was the dispersal of supervisory responsibility between the Treasury, the New York Fed, and the Securities and Exchange Commission a recipe for ineffective oversight? On an international scale, is the lack of a consolidated supervisory overview of BCCI the reason why its condition went undetected? In Japan, is the obverse true—namely, the concentration of basic supervisory powers within the MOF which has viewed Japanese financial institutions as an instrument 'of national policy, rather than the object of policy?

As Mr. Crockett correctly notes, the basic rationale for supervision is

—to assure prudent management of financial institutions;

—to assure that the interests of depositors and investors are protected; and

—to foster competitive efficiency.

He points out that the regulation of international banking, with all its flaws, is more advanced than the regulation of international securities markets. He further adds that in banking, institutions are more important, whereas in the securities business, markets are more important than institutions. Yet we live in an age where banking and securities activities are coming closer together.

International banking regulation has come a long way since Herstatt. The Bank for International Settlements Committee on

banking supervision — the Cooke Committee, now to be chaired by Jerry Corrigan of the New York Fed—has made meaningful progress on many fronts, such as capital adequacy. Yet much remains to be done,. Mr. Crockett points out, as an example, the competitive complications of deposit insurance arrangements between host and home countries, unless the schemes are harmonized. Banking has become international; supervising it has not!

The key issues are:

(1) How is systemic risk best limited?

(2) Should branches of foreign banks be treated the same way as subsidiaries?

(3) Under whose rules should deposits be insured?

(4) Should there be an agreed way to resolve competing international claims on the assets of a failed bank (BCCI)?

These issues and more are discussed in the Group of Thirty's Occasional Paper-International Trade in Banking Services: A *Conceptual* Framework — authored by Sydney J. Key, an economist with the Board of Governors of the Federal Reserve System, and Hal S. Scott, a professor at Harvard, which lays out a framework for strengthening the regulatory system. They have provided a "Banking Matrix" using three sets of regulation — Home Country, Host Country, and Harmonized Rule—that underlie the often confusing principals of national treatment, mutual recognition, and effective market access.

What must be achieved over time is an international supervisory system of harmonized standards. This is easier to apply to credit institutions than to market practice. If the trend toward further integration of credit institutions with capital market activities continues and since markets are more difficult to harmonize than banks — then I believe that more and more market harmonization will be directed through the institutions that operate in those markets. In the final analysis, we need to pay more attention to capital market activities and the supervision thereof than we do at the present time.