

Commentary: Global Implications of Trade and Currency Zones

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The paper that Professor Meltzer has prepared for this symposium addresses many important issues concerning the regionalization of the world economy. There is little that I can add by way of criticism. My remarks will basically focus on a few related broad policy issues as Mr. Guffey has asked me to give my own views on them, in addition to comments on Professor **Meltzer's** paper.

Professor Meltzer has argued that the remarkable rise of living standards in the democratic market economies for more than forty years after World War II owes much to the political, trade, and monetary stability achieved under U.S. leadership. The rules for political, trade, and monetary stability imposed by the United States as "hegemon" of the postwar, market economies were not ideal, nor was the implementation ideal. But the rules worked so well that the relative positions of the United States and other countries have changed markedly. Professor Meltzer then notes that the United States is now less willing to enforce rules for trade and political stability and less able to impose the rules of the trade and monetary system on others. He also observes that fortunately, Japan and Germany have been more committed to monetary stability than the United States, but unfortunately they seem less committed to extending, strengthening, and enforcing rules for trade and political stability when such actions would impose costs on them. He concludes by noting that new rules for trade, defense, or police, and price stability are required to ensure a sustained rise in living

standards for the market economies in the future at the rates of the past four (or even two) decades.

In a statement before the Committee on Ways and Means of the U.S. House of Representatives in March this year, Fred **Bergsten** discussed how collective leadership should be exercised beyond the Cold War and the Gulf War. He first observed that the sharing of the economic and financial burden of the coalition effort in the Gulf was handled as effectively as the military effort. He then argued:

"The United States and other members of the military coalition would almost certainly have pursued their military strategy even without external financing so there was a great temptation for other countries to 'free ride'. No compelling formula for sharing the costs was even put forward, let alone debated and agreed by the payers. After the broad policy guidelines were set by the Security Council, the United States (with a few close allies) made all the crucial tactical decisions and the largest non-regional contributors, Japan and Germany, were not even represented in the Security Council. Taxation occurred without full representation."

Our experience in burdensharing for the coalition effort in the Gulf was probably unique. One might wonder if the burdensharing would have been handled in the same way as it was, if the military intervention had continued longer and entailed greater costs both militarily and economically. **Bergsten** argued that, in order to develop an effective system of collective security to deal with future crises both political and economic, decisionmaking must be more closely aligned with burdensharing than at the time of the Gulf crisis.

In a more multipolar world, with a more even distribution of power, it will be **more difficult** to secure and implement international consensus for the management of conflicts. The challenge of formulating and working out a set of rules for dividing up responsibilities is daunting. This process will be painful for countries losing their relative positions in decisionmaking. This was clearly evidenced, for example, by difficulties in the negotiations for increasing the quota shares of Japan and Germany in the International Monetary

Fund (IMF) which had continued for quite a number of years before both of them obtained the second largest shares to the United States.

The expanding number of participants in international trade negotiations, and the growing diversity of their interests, points of view, and technical capabilities, have tended to reduce the efficacy of multilateral fora. Bilateralism and regionalism appear as an increasingly attractive alternative to multilateralism.

The issue of regional trade cooperation has been accentuated with the European Community's (EC) program for internal market integration by the end of 1992, and the start of negotiations for a proposed free trade zone for the United States, Canada, and Mexico, building on the U.S.-Canada Free Trade Agreement which went into effect in January 1989. Some approaches to strengthening cooperation both within East Asia and in the Pacific Rim are being pursued, although there are thus far no trade or currency arrangements in place for further regional integration in this area.

After a review of the broad evolution of intraregional and inter-regional trade patterns which suggests the importance of inter-regional trade, Professor Meltzer argues that it would not be in the interest of either Japan or the United States to develop intraregional trade as a substitute for open, multilateral trade. Europe is more highly integrated than the other regions in terms of intraregional trade, and has been so for a long time. One can probably argue that the EC typically represents the case of "natural integration." But, it is noteworthy that for the original EC group, intratrade has tended to stagnate in relative terms since 1970. While the apparent loss of momentum in integration within the EC has been cited by the European Commission as a reason for initiating the program for completing internal market integration by the end of 1992, removing trade barriers with the rest of the world should be a top priority of the EC, if the main competitive pressure—a source of greater economic efficiency—should come from the rest of the world rather than from within the EC, as suggested in a recent study by European economists.

Trade diversion will be an unavoidable consequence of a free trade

zone. It will take place even if the average level of external protection for the trade zone remains unchanged. A key question for producers outside the zone is the extent to which this trade-diverting effect will be offset by an expansion of extra-zone trade resulting from faster income growth within the zone through its internal integration. The net result for producers in the rest of the world may be influenced not only by the "static" trade effects but also by the long-run "dynamic" effect which a larger, integrated regional market can have on investment and growth. It is because of this that countries outside the trade zone should be concerned about the process of internal industrial reorganization in the enlarged regional market, as well as the course of the external trade policy to be adopted under the regional trade arrangement.

An important question in this respect is how industrial reorganization will proceed within the EC. Greater scale economies will be an essential source of increased efficiency and competitiveness for the industrial sector, but this means that the number of firms must be reduced. There is the risk that long-run efficiency considerations will be subordinated to short-run sociopolitical pressures to reduce conflicts of interest within member countries where losers are likely to be many. Political pressure may mount to offset the competitive threat to domestic losers by protectionist measures against producers outside the region, especially if macroeconomic conditions deteriorate within the region. This points to the importance of good macroeconomic policy management in the process of industrial reorganization.

Adoption of a common currency within a trade zone could foster regional economic integration. It could increase wage and price flexibility if the central body for monetary policy decisionmaking gains the credibility of its commitment to price stability, as the experience of a "hard currency" option in smaller countries neighboring Germany has typically shown. But, we must recall that during the gold standard period, resort to trade policy was frequently made as an adjustment mechanism alternative to exchange rate changes. Too early attempts to introduce a common currency in a trade zone may lead to increased use of trade restrictions as an alternative adjustment mechanism, if such a zone covers a wide range of

countries including those where institutional factors are such that wage and price flexibility is likely to remain more limited than in the other member countries.

In East Asia, diversity in the stage of economic and financial development as well as historical and cultural background in individual countries, and the absence of institutional **arrangements** for economic integration, will limit the development of an EC-type of monetary integration. Currencies of most of East Asian economies other than Japan are not completely convertible for capital transactions, and the Japanese capital market is not used as actively by private economic agents in these Asian economies as by those in the Organization for Economic Cooperation and Development (OECD) area. While the absolute value of Japan's direct investment that goes to Asian countries tripled between 1983 and 1989, and accounts for a substantial portion of total direct investment inflows into these countries, the share of Japan's total direct investment that Asian countries account for declined by half during the same period from about 28 percent to 14 percent. A recent IMF study reveals that the yen's share in the official reserve holdings of Asian countries rose to about 18 percent in the late **1980s**, but a far greater share (56 percent) was held in U.S. dollars, and a significant portion (15 percent) in deutsche marks.

The economic gains from the free movement of capital will be greater when it is achieved on a global basis than when it is limited to regional transactions. The possibility of lowering the real cost of capital to firms in deficit countries will be greater when they have access to borrowing opportunities in surplus countries outside a trade zone as well as those within it. My own view is that it would be wrong for the surplus countries to take deliberate policy action to reduce their presently high national savings. Japan is undergoing the process of population aging at the fastest pace among OECD nations. A number of studies suggest that the projected demographic changes will reduce Japan's savings rate substantially from around the start of the next century. A policy implication of this projection would be that Japan should aim at a higher national savings ratio during the present decade, mainly by higher government savings through an increase in consumption tax, and it should devote most of **inremen-**

tal savings to higher domestic investment in social infrastructure and housing for use by the present and future generations. But a portion of such savings might better be channelled to developing countries in the forms of direct investment and lending to them directly or through multilateral institutions. Repayment of such lending should start after the lapse of a long grace period of, say, 15 years or more. A recent study based on a multicountry model at the IMF concludes that a projected sharp decline in Japan's saving rate due largely to demographic changes will bring about a substantial change in its external position in the first decades of the next century. It can be hoped that presently developing countries will, by that time, have grown into mature economies and will be in a better position for starting the repayment of external debt. The working of this mechanism for international, and at the same time intergenerational, transfers of savings with technological assistance would be beneficial both to Japan and other industrialized countries with rapidly aging populations and to the developing countries which will continue to have a relatively larger share of younger people in their populations.

Japan should also strengthen efforts to make its capital market more efficient and more readily accessible to foreign investors and borrowers on an *erga omnes* principle, by further financial liberalization and increasing the transparency of its market. While maintenance of noninflationary growth generated basically by domestic demand and further opening of the remaining restricted areas to the outside world constitute Japan's major international responsibilities, the projected trends in its saving rate and external position imply that Japan's continued current account surplus over this decade should not be viewed as a problem in itself in a world of efficient international capital flows. It would be very unfortunate for Japan and for the rest of the world, if Japan's current external payments position were used as an excuse for increasing trade barriers against Japanese products. In passing, I would add a comment on Professor Meltzer's argument that creditor nations such as Japan and Germany cannot be paid, unless the debtor nations such as the United States have current account surpluses through their net exports to the creditors over time. I would say that global resource allocation will improve, if the U.S. current account turns into surplus

through budget deficit cuts while Japan and Germany continue to run some reasonable amounts of surpluses over this decade, and if their surplus funds are channelled, in the way I explained earlier, mainly to developing countries and Central and Eastern European countries moving toward market economies.

At the same time, major trading partners should strengthen collective efforts to measure and reduce the *effective* degree of trade protection. It is well known that data on average tariffs alone do not measure the effective degree of trade protection, because of growing resort to nontariff measures, such as voluntary export restraints, import quotas, local content requirements, and subsidies to domestic industries. Such collective efforts should include a thorough and objective assessment of the view expressed in the United States and Europe that administrative impediments and restricted business practice in Japan make its domestic market practically inaccessible to foreign firms—the view often used as justification for erecting and maintaining barriers against Japanese products. Over the past years, the OECD has made a major contribution to the quantification of the degree of agricultural protection. Beginning this fiscal year, EC member states are asked to provide the European Commission with fuller information on industrial subsidies in various forms, and the OECD has been attempting to collect data on such subsidies from all member countries. More generally, the G-7 leaders who met at the Houston Summit last year encouraged the OECD to strengthen its surveillance of structural reforms in individual member countries, to review procedures, and to find ways of making its work more effective.

As structural reform proceeds, trade conflicts arising from greater multipolarity and interdependence should weaken. In the context of noninflationary growth, it should be easier to absorb changes in competitive advantage which characterize a dynamic economy. Nevertheless, powerful pressure groups will continue to seek protection from international competition. The future of the multilateral trading system will depend on the resistance of trade policy to such sectional interests. In any democratic society, policymaking will be influenced by the reaction of the electorate. Consumer organizations must be mobilized in opposing protectionist measures which would

reduce their welfare. Economists must play an important role in this regard by offering a thorough and objective assessment of the costs and benefits of protection.

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