

INTERNATIONAL
FINANCIAL
INTEGRATION:
THE POLICY CHALLENGES

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INTERNATIONAL FINANCIAL INTEGRATION: THE POLICY CHALLENGES

A Task Force Report to
The Trilateral Commission

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The Trilateral Commission was formed in 1973 by private citizens of Western Europe, Japan, and North America to foster closer cooperation among these three regions on common problems. It seeks to improve public understanding of such problems, to support proposals for handling them jointly, and to nurture habits and practices of working together among these regions.

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The Trilateral Process

The report which follows is the joint responsibility of the three authors, with Shijuro Ogata serving as principal author. Although only the authors are responsible for the analysis and conclusions, they have been aided in their work by others.

On the Japanese side, several persons met with Shijuro Ogata early in the project to help establish its general lines. On the European side, Horst Schulmann discussed ideas for the report with European members of the Trilateral Commission assembled for the regional meeting in Oslo at the beginning of October 1988. On the North American side, Gerald Bouey, former Governor of the Bank of Canada, provided useful comments along the way. The three authors together, while meeting in Washington, consulted with leading officials at the International Monetary Fund and the U.S. Federal Reserve.

Mr. Ogata took the first steps in shaping the report by preparing in July 1988 a memorandum on main issues. This memorandum was discussed at the authors' meeting in Washington on September 6. Mr. Ogata then prepared an extensive outline, which was discussed at the authors' meeting in Washington on November 17-18. Mr. Schulmann had prepared a brief discussion paper for the European regional meeting in Oslo which became a background paper for the November meeting as well. Mr. Ogata completed the first draft of the report in mid-December 1988. With comments from Mr. Cooper and Mr. Schulmann, Mr. Ogata prepared a somewhat revised draft which the authors discussed in detail during their meeting in Washington on February 4-5, 1989. Further comments were exchanged in the following weeks and a second revised draft completed, which was discussed on April 9 in Paris during the 1989 annual meeting of the Trilateral Commission. Final refinements before publication were completed in June. Charles Heck, North American Director of the Trilateral Commission, provided able editorial support in the later stages.

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INTRODUCTION: THE NEED FOR INTERNATIONAL COLLABORATION

Today the international economic system is dominated by financial factors. Thirty years ago, most foreign exchange transactions were closely related to the transfer of goods and services across national frontiers. Today only some five percent or less of foreign exchange transactions reflect world trade in goods and services.[†] The globalization of financial markets extends beyond foreign exchange to securities of increasing varieties. The leading example among securities is the market for U.S. Treasury paper, which has become a global commodity (and even a medium of exchange). Barring catastrophe, the globalization of financial markets will continue. Trading around the clock and around the world will not only be an enduring feature of the international economic system but will become even more pervasive.

The decision-making processes and regulatory and legislative frameworks in Trilateral countries were created many years ago and are essentially the children of the nation-state. At best, they pay lip service to a marketplace of worldwide dimensions in which firms with different charters and national origins compete with each other continuously all over the world.

The globalization of markets is thus in tension with inherited arrangements for making decisions by national governments—particularly with regard to taxation and regulation of financial activity, which have traditionally been considered quintessentially matters of domestic policy. The growing international mobility of financial capital will reduce the effectiveness of strictly national taxation and regulation, and may distort the international flows of capital away from their economically most useful roles, i.e., to direct surplus national savings to productive investments and to help spread risks.

[†]Foreign exchange settlements in the New York market alone total some \$700 billion *per day*—roughly one-fourth the annual value of world trade.

National control of international capital movements is increasingly impractical. The channels for transferring funds from one center to another are numerous, and effective control would require a major move toward autarky in all international transactions, which would be prohibitively costly to economic well-being. To avoid loss of influence altogether, Trilateral countries must collaborate to reduce the differences in taxation and regulation of financial capital which would otherwise lead to extensive avoidance. Over time, the convergence in tax and regulatory policies will have to be extended to other countries as well.

Loss of national sovereignty is not at issue. Sovereignty remains unambiguously lodged with national governments, each with its own constitutional procedures. At issue rather is the ability of sovereign nations to influence their own destiny. That has always been subject to outside events, but in the economic arena the influence of outside events is increasing rapidly. Nations do not lose sovereignty by reaching agreement with other sovereign nations to reassert some measure of political control over the evolution of economic events.

The stakes are high. While international financial integration brings widespread benefits, these benefits are not automatically realized. International financial integration has not been accompanied by increased stability. Particularly since the early 1980s, both the volatility and misalignment of exchange rates have been pronounced, with deleterious effects on longer-term real economic performance. The higher degree of interdependence has quickened the worldwide transmission of changes in interest rates and securities prices, starkly evident in the stock market crash of October 1987. How is reasonable stability to be maintained in a world of growing financial integration? How can governments jointly re-assert some measure of control over the evolution of exchange and financial markets?

The answers to these questions must be sought not only in exchange and financial markets. As long as the current account imbalances of major countries remain enormous, financial markets will remain uneasy and volatile. If stability is sought superficially without adequately addressing the fundamental causes of underlying imbalances, exchange and financial markets might react in a volatile manner. Volatility itself can be a warning to policymakers (and the public) against the misalignment of national economic policies, correction of which is a necessary part of the process of adjustment. We devote one section of our report to macroeconomic policies of the Trilateral countries. The importance of these policies can hardly be overemphasized.

A basic aim which should guide macroeconomic policy collaboration among our countries is, of course, the attainment of non-inflationary economic growth. In the short term, there may be some trade-off between growth and price stability, but in the longer term, confidence in price stability will contribute to steady economic growth. Another basic aim should be the maintenance and promotion of free movement of goods and services. This report will not focus on trade policy, but the successful outcome of the Uruguay Round of multilateral trade negotiations under the auspices of GATT is of great importance. The trade policies of Trilateral countries, even those adjusting large trade and current account imbalances, should be pursued in ways that impose as little strain as possible on other countries and on the international economic system.

After discussion of macroeconomic policies, the report describes the broad structural adjustments in Trilateral countries that are also essential in reducing imbalances and creating an environment more conducive over time to international financial stability.

Following a discussion of macroeconomic and structural adjustments, two sections address issues directly related to exchange and financial markets. They form the heart of this report. However important macroeconomic policies are in correcting the disequilibria that underlie exchange and financial market instability, they cannot substitute for direct attention to the functioning of these markets.

In the five-year perspective that has informed this report, longer-term proposals for the reform of international institutional arrangements—such as creation of a common central bank for the industrial democracies—are not practical. Several issues relating to existing international institutions are quite relevant, however, and we devote one section to them. It is important to strengthen the International Monetary Fund and the World Bank, and a new issue of Special Drawing Rights (SDRs) is now in order.

The Trilateral countries do not exist in a vacuum, but rather function in a global environment. Three dimensions are especially noteworthy. 1) The current account surpluses of some newly industrialized countries in Asia have become large enough to constitute a significant part of the global imbalances. Their economic policies, particularly their exchange rate and trade policies, have a measurable impact on the world economy; and their stake in international economic cooperation has increased. 2) The heavy indebtedness of a number of major middle-income developing countries acts as a drag on world economic growth as well as on their own growth, impedes the correction of global imbalances, and contributes to international financial instability. Prog-

ress in this policy area is of global importance. 3) Increased regional economic integration in the European Community and North America simultaneously marks a move away from multilateralism and advances economic liberalization in important new areas. The Trilateral countries, principal custodians of the broad multilateral system, must take care that regional progress is not sought at global expense. The first of these three dimensions was addressed in a 1988 report to the Trilateral Commission, and the second in a 1987 report, but all three require at least brief treatment here to round out our report.[†]

A reminder before we proceed: Basic numbers routinely used in formulating economic policy are really quite weak, and in some ways are getting worse. The intellectual efforts that have gone into refining the economic interrelationships among the Trilateral countries have certainly not been matched by efforts to improve the statistical data underlying the sophisticated econometric modelling of the world economy. For example: 1) Conventional statistics for our domestic economies were devised in a time when traditional economic activities—industrial and agricultural production, retail sales, housing construction—were dominant, and do not adequately capture newly growing service activities such as tourism and a variety of professional and technical services. 2) Monetary indicators require constant review. There are enormous ongoing changes in deregulated financial markets; the distinction between transaction and investment balances in monetary aggregates is increasingly eroded; and the internationalization of financial markets raises questions concerning the significance of national money supply measures. 3) The current account balances of different countries present baffling discrepancies when added together, with a recorded global deficit amounting in the mid-1980s to \$40-80 billion. The increasing internationalization of economic activity makes it more difficult to interpret conventional balance of payments statistics based on the resident principle. In sum, traditional statistics need to be reviewed from time to time, and adapted as necessary to the changing character of the world economy. In the meantime, they must be used to inform policymakers—but they should be used with caution.

[†]See Richard Holbrooke, Roderick MacFarquhar, and Kazuo Nukazawa, *East Asia in Transition: Challenges for the Trilateral Countries* (1988) and Martin Feldstein, Hervé de Carmoy, Koei Narusawa, and Paul R. Krugman, *Restoring Growth in the Debt-Laden Third World* (1987).

MACROECONOMIC POLICIES

Large current account surpluses and deficits of major countries aggravate exchange rate and financial market instability. These international imbalances reflect wide disparities between domestic demand and output and between investment and saving. The primary role in the reduction of these imbalances has to be played by macroeconomic policies, which affect not only relative prices and incomes of the countries concerned but also their investment-saving balances.

Some countries have large savings relative to investment opportunities, others the reverse. The United States was a large importer of capital from Europe in the 19th century, as was Canada from Europe and the United States in the 20th century. These capital inflows contributed importantly to the development of North America. So there is nothing wrong, *per se*, with current account imbalances—that is, with one nation making net investments in another. Indeed, such imbalances are a natural state of affairs. Of course, net foreign investment will generate interest and dividend payments, so that at some point the merchandise trade surpluses of countries with surplus savings can be expected to decline, and eventually to become deficits, even when the current account surplus remains large.

When we speak of the need for external adjustment, we do not therefore mean that the current account must be in full balance, but rather that imbalances can be comfortably sustained over time by inflows of capital from abroad seeking profitable investment opportunities, without provoking sharp movements in exchange rates and interest rates and without provoking protectionist reactions (against foreign goods or foreign capital) by the capital-importing country.

Today, for a variety of complex reasons, only partially understood, Japan and parts of Europe have large surplus savings. The natural destination of these savings is those countries that are poised for development, but lack adequate capital. The debt crisis of the 1980s has inhibited the flow of private financial resources from Europe and Japan to most of those developing countries. Instead, these savings have flowed in large amounts to the United States. There is nothing intrinsically wrong with that, if it contributes to U.S. growth. But attractive U.S. yields are due in considerable measure to a large budget deficit,

rather than to exceptional opportunities for real investment. So there is good reason for believing that the debt crisis and large U.S. government borrowing combined are disturbing the natural and desirable flow of capital in the world.

Reducing the U.S. Fiscal Deficit

The largest current account imbalance in absolute terms is the deficit of the United States, which reached \$154 billion in 1987 (\$127 billion in 1988). The ratio of this deficit to the U.S. GNP was 3.4 percent (2.6% in 1988), smaller than the ratio for many other countries, but the absolute amount was extremely large because the United States is the world's largest economy. Given the need to service the continuing growth of the external debt of the United States, the total swing in merchandise trade required to eliminate this current account deficit by 1993 would be roughly \$200 billion. In view of the present capacity and future potential of American industries, and also in the light of the inability of major surplus countries to reduce their surpluses rapidly, it is unrealistic to expect the total elimination of the U.S. current account deficit in the immediate future, even over the next four years. Nevertheless, a clear but gradual decline of the deficit will exert a steadying influence on foreign exchange and financial markets.

One way to reduce the U.S. current account deficit is to depreciate the dollar further in order to stimulate exports and discourage imports. But since the U.S. dollar has already depreciated substantially over the period 1985-88 and the U.S. economy is operating close to full capacity yet is still expanding at a pace faster than its productive capacity, further reliance on exchange rate depreciation alone would be inflationary for the United States and possibly destabilizing for financial markets.

The growth in domestic demand could be curtailed by tightening monetary policy. But higher interest rates would discourage private investment and possibly weaken highly leveraged sectors of the economy. Higher interest rates would also aggravate the budget deficit, because of the large outstanding public debt. Furthermore, higher interest rates would perversely strengthen the dollar in exchange markets and, as a result, would hurt U.S. competitiveness. It would also hurt heavily indebted countries that are still servicing their debts.

By far the best approach under the circumstances is to reduce the fiscal deficit and to promote domestic savings, thereby permitting the shift of domestic resources to exports and export-related investment. Continuous efforts in this direction should be the highest priority of the U.S. Administration. Such an "expenditure shift" is a necessary

condition, under present circumstances, for a continued reduction in the U.S. current account deficit. Whether this will alone be sufficient, or whether some further depreciation of the dollar will also be necessary, it is too early to tell. The dollar's appreciation in the first half of 1989, however, will surely be reversed at some point.

It is often pointed out that the U.S. fiscal deficit is not as large, compared to GNP, as the deficits of many other countries. But the fiscal deficit should be compared with domestic savings. The U.S. fiscal deficit plus the continued borrowing by American consumers and corporations are too large to be financed by American domestic savings. At present, government budget deficits in the United States absorb about 50 percent of net private savings, leaving far too little for domestic investment. It is often argued that the expected accumulation of Social Security surpluses in the coming years will reduce the fiscal deficit and raise the savings of the entire U.S. economy even without additional policy actions. While Social Security surpluses will grow for some years, they will not continue indefinitely for demographic reasons, and in any case this accumulated surplus is being built up to satisfy pension claims in the more distant future and should not be dissipated on current government expenditures.

The Gramm-Rudman-Hollings Act has already set a target of reducing the Federal budget deficit (including Social Security) by \$30-40 billion annually, to zero in 1993. It is important for the U.S. Administration, with the support of the Congress, to take measures as soon as possible to meet this target in substance and not merely in form.

For the time being, the U.S. Administration seems committed not to increase taxes. It is unlikely, however, that a "flexible freeze" on spending will be enough to achieve a sufficient reduction of the deficit. Such a freeze must cover politically sensitive areas such as defense, farm subsidies and Medicare benefits; financial assistance to troubled Savings and Loan Associations will add an additional burden, even if the bulk of it is handled off the budget. If some taxes on consumption—for instance on gasoline and tobacco and alcohol products—are adopted early during the term of the Administration, these would be effective not only as a means of accelerating the process of deficit reduction but also as symbolic assurance to exchange and financial markets that the Administration is really serious about reducing the deficit.

Macroeconomic Policies in Japan and the European Community

Effective U.S. measures to reduce the fiscal deficit and raise domestic savings will slow the growth of U.S. domestic demand and imports.

The U.S. trade deficit has been at least partly due to the continued overdependence of other countries on the large size and relative openness of the U.S. market. To promote the reversal of the large imbalance between the United States and the rest of world, Japan and major countries in Europe should pursue macroeconomic policies which strengthen their domestic economic activities and their capacity to absorb products imported from other countries. A declining trade surplus implies, as a matter of simple arithmetic, that domestic demand grow more rapidly than real GNP.

Domestic demand-led growth is being promoted in Japan. There has been a remarkable rise of imports, particularly of manufactured goods. But Japan's current account surplus is still very large, nearly \$80 billion in 1988. The rise of income from overseas investments makes it difficult to reduce the current account surplus quickly. It can be argued that, as long as the United States and many developing countries continue to be deficient in savings, the excess savings in Japan are helpful to the world economy. It is nonetheless important for Japan to continue to absorb more foreign products through steady domestic demand-led growth and further opening of its own markets, while at the same time improving the ways to recycle its current account surplus to meet urgent financial needs of developing countries.

Similar arguments can be made in connection with some European countries, to differing degrees. Europe is now in the process of greater economic integration through "completing the internal market" by the end of 1992. Whether individual surplus countries such as the Federal Republic should be singled out or the external balance of the entire European Community should be considered as a unified entity depends upon the degree of economic integration, in terms of both actual economic activity and economic policy formulation. So long as macroeconomic policy remains predominantly under national control, as seems likely well beyond 1992, it is appropriate to consider the national payments positions of individual members of the European Community. In any event, the need to strengthen domestic economic activity and to support the growth of world trade will continue to be important both for individual surplus countries and for the European Community as a whole.

Poor Fiscal Policies Force Excessive Reliance on Monetary Policies

In almost all major countries, heavy burdens have been placed on monetary policy not only to influence exchange rate changes but also to adjust domestic demand. For political and institutional reasons, fiscal policy has been framed with too little regard for its international

consequences. In the United States and Canada, where the fiscal deficit needs to be lowered, fiscal actions tend to be delayed, or inadequate if taken, because of fundamental disagreement over the scope and composition of government spending. There is too little public concern about the deficits and, in the United States in particular, a lack of political will to increase taxation.[†] In Japan, where the flexible activation of fiscal stimulus can be justified from time to time, such actions tend to be either postponed or resisted because of bureaucratic apprehension about the possible irreversibility of fiscal stimuli due to structurally weak political leadership.

The resultant excessive reliance on monetary policy has created a number of difficult problems. In the United States, when monetary conditions are tightened to combat inflationary pressures, the rise of nominal and real interest rates there affects other countries. The impact is particularly great on debtor countries in the developing world, which, unlike private borrowers in the United States, do not benefit from the tax deductibility of interest payments. Also, higher interest rates tend to keep the U.S. dollar stronger than it would otherwise be.

In surplus countries such as Japan, easier monetary conditions alone cannot quickly stimulate economic activity but do intensify the adverse impact of excess liquidity. Though monetary policy has been used to adjust interest rate differentials between major countries and to moderate exchange rate changes, the heavy and excessive reliance on monetary policy has increased rather than reduced the volatility of interest rates and exchange rates in recent years.

It is not certain how much lower interest rates would be and how much more stable exchange rates would be with better coordination of fiscal policy, but the following points can be made. First, inflation in any country can be better resisted by early use of both fiscal and monetary policies. Second, although occasional fiscal stimulus may be necessary in surplus countries, the reduction over time of fiscal deficits of major countries is important for reduction of real interest rates, which is beneficial also for developing countries. Third, it is important to take international implications into account in framing fiscal policy. Fourth, desirable fiscal policy actions may nevertheless continue to be delayed or insufficient. Under such circumstances the only way out, regrettably, may again be the use of coordinated monetary policy—certainly better than inaction.

[†]The Canadian Government did announce significant tax increases in its April 1989 Budget Speech, which will increase revenues by roughly one percent of GNP by the 1990-91 fiscal year.

Though it is possible to agree on the general direction for macro-economic policies, it is impossible to establish mechanical, automatic rules among major countries which stipulate certain policy actions under certain specified economic and financial conditions. Possible reasons for imbalances are numerous, and appropriate policy reactions cannot be predetermined. The economic indicators to be watched are numerous and require constant review because of the continuous evolution of economic and financial conditions.

It will continue to be necessary to rely on the discretionary use of policy instruments by national authorities, but it would be helpful in framing national policy over the medium term to have agreement at the international level with regard to economic objectives and the choice of instruments to achieve them. Periodic international review of the state of the world economy and national policy actions is indispensable. Fora for such a review exist, for example the G-7, the OECD and the IMF. The expertise of international organizations should be extensively utilized, both for their continuity and for their objectivity.

STRUCTURAL ADJUSTMENT

The huge current account imbalances within the Trilateral area are not only due to macroeconomic policy choices and national economic cycles that are out of phase. There are "structural" aspects, that will not be overcome quickly and automatically. In the case of the United States, the key is to increase national savings. As we have already discussed, that can be done in part by reducing the Federal budget deficit. In addition, an improvement of international competitiveness is essential. With a large domestic market, it is not easy to strengthen Americans' willingness to export, but with the appropriate tax structure and appropriate exchange rates, the investments of export-oriented manufacturers in the United States will stimulate American exports in general. Though the market-oriented philosophy of the current Administration is not likely to lead to the adoption of an industrial policy to encourage specific sectors or regions, it would be desirable for the Administration to use its influence to generate a national consensus on the need to improve U.S. performance in the international marketplace in a variety of dimensions. In Canada too, a high priority must be to reduce the federal budget deficit, which in relation to GNP is even higher than the U.S. federal budget deficit. It is also important that Canadian industry should take advantage of its access to a much larger market through the free trade agreement with the United States to improve its efficiency and its general international competitiveness.

In Japan, the change from an export-led economy to a more balanced economy has made progress. So far most of the adjustment has taken place in the private corporate sector, particularly in manufacturing, through rationalization, direct investment overseas, and diversification of products and markets. Other sectors, particularly agriculture and distribution, have not made much progress in structural adjustment and continue to pose obstacles to import liberalization. Through competition and deregulation, structural overhaul of these still highly regulated and inefficient sectors should be accelerated.

In Europe, the drive toward greater economic integration by 1992 will offer excellent opportunities to modernize obsolete industries, to stimulate entrepreneurship, and to reduce the rigidity of labor markets. In addition, Europe should reduce agricultural protection and ac-

celerate the movement of resources out of agriculture. Through deregulation and liberalization within Europe, economic vitality will be strengthened.

EXCHANGE MARKET POLICIES

Intervention an Important Tool

Though key exchange rates are determined in the financial markets, the monetary authorities need to be concerned about their level and direction of change. The exchange rate is the single most important price in any market-oriented industrial country. Exchange rates influence investment and marketing decisions of business firms, hence overall demand pressures and future growth in the economy. Exchange rates in open economies also influence movements in the price level, hence inflationary expectations of the public. Finally, short-term volatility in exchange markets can undermine the orderliness of financial markets generally, hence public confidence in how well markets are functioning. As important as macroeconomic policies are to correcting the international disequilibria which underlie exchange rate instability, there is also a case for official intervention in the foreign exchange market. A totally hands-off policy by any major country is detrimental. The experience of 1981-85 illustrates this—the official U.S. declaration of indifference to exchange rates and the policy of total non-intervention in exchange markets was not only unwise but also positively harmful. Though its efficacy should not be exaggerated, exchange market intervention can sometimes be useful to express the concerns and preferences of monetary authorities and to help stabilize exchange markets, especially if conducted in coordination with other countries and on an appropriate scale, and as a supplement to appropriate macroeconomic policies.

Intervention can be either sterilized or unsterilized. “Unsterilized” intervention allows the buying or selling of national currency to influence the nation’s money supply, influence which is offset by compensatory action in “sterilized” intervention. The effects of sterilized intervention tend to be relatively short-lived. Usually unsterilized intervention is more effective in moderating exchange rate movements, but since it achieves its impact by contracting or expanding the money supply, it may conflict with other policy objectives. For instance, “unsterilized” buying of national currency to dampen the currency’s

depreciation is useful for both exchange rate stability and domestic price stability if a country is in an inflationary situation, but unsterilized selling of national currency to slow its appreciation may be harmful to domestic price stability if the country is not in a recession.

If necessary, Trilateral monetary authorities can obtain additional foreign currencies for intervention by drawing on the existing swap arrangements between central banks, borrowing from the IMF, selling SDRs to other monetary authorities, or borrowing foreign currencies from markets or directly from the issuing monetary authorities. There are proposals to increase dramatically foreign currency availability to symbolize the readiness and ability of the monetary authorities to intervene massively in case of need. The exchange risk borne by the borrowing country in such operations would impose a certain discipline on its authorities. In the final analysis, however, such arrangements are no substitute for appropriate monetary and fiscal policies. Indeed, if large-scale intervention is not accompanied by other policy measures but only by losses of reserves and rising indebtedness or excessive gains of reserves it can have the perverse effect of reducing confidence in the national currency or in the functioning of the adjustment process.

“Target Zones” Unrealistic in Current Circumstances

As long as international imbalances remain large and major countries have different rates of inflation, there is a need for continued exchange rate flexibility. Under these circumstances, it is difficult, if not impossible, for major countries to agree in advance on a range for exchange rates that can endure for more than a relatively short period of time.

Views differ as to the role foreign exchange rates should play in the adjustment process, and on determination of “equilibrium rates.” Some believe that foreign exchange rates have a vital role in the smooth adjustment of national economies to disturbances to which they will be inevitably subjected from time to time. Others believe that, in a world of high financial integration and an economically alert public, exchange rate changes at best can play only a minor role in facilitating adjustment and at worst will themselves be a major source of disturbance. Even among those who believe that exchange rates have an important role in bringing current account balances closer to a sustainable equilibrium, there is disagreement about the appropriate level of “equilibrium rates.” Some calculate “equilibrium rates” on the basis of likely changes in trade flows, but others believe “equilibrium rates” should reflect purchasing power parities. In practice, all such calculations involve some arbitrary assumptions. Whether they are based

on trade sensitivity or purchasing power parity, these calculated rates can be quite far from market exchange rates and may not be acceptable to the countries concerned.

For all these reasons, it is not realistic to adopt a formal system of "target zones" for the time being, i.e., an exchange rate regime with fixed ranges of fluctuation around agreed fixed but adjustable central rates with certain intervention obligations. It is possible to agree, from time to time and informally, on certain ranges of exchange rates either as interim trading ranges for intervention, or as reference ranges for policy coordination as practiced in the Louvre Accord of February 1987. The announcement of an agreement on reference ranges could strengthen the sense of stability in exchange markets, but a period of calmness in exchange markets after such an informal agreement may foster underestimation of underlying imbalances and thereby discourage further efforts to undertake more durable action toward adjustment.

For some time to come, the most realistic approach toward foreign exchange markets is for the officials of the major countries to agree publicly on the undesirability of major exchange rate movements in what is clearly the wrong direction from the viewpoint of reducing large payments imbalances, and to renew their joint determination to improve their policy coordination whenever exchange rates move in a direction deemed inappropriate. We have a number of precedents for this in the recent past, including one in November 1978 when the U.S. dollar was widely regarded as excessively weak and another in September 1985 when the U.S. dollar was excessively strong by any yardstick.

Lessons from EMS

The experience of the exchange rate mechanism of the European Monetary System provides useful lessons, but the extension of this kind of scheme on a global scale is at least premature for a variety of reasons. The integration of national economies within Europe is far more advanced than in the wider Trilateral area, even before 1992. The EMS has a de facto anchor currency, the German mark. There are also ambitious plans to develop the EMS into a European System of Central Banks as a part of the European Economic and Monetary Union. Furthermore, the European Community has a Common Agricultural Policy, which European farmers and the politicians they elect interpret to require stable exchange rates. Even within the European Community, not all member countries are fully participating in the exchange rate mechanism. Despite the adjustability of central rates, which have

been changed on average about once a year since 1979, many believe that the EMS tends to discourage timely realignments, thereby prolonging current account imbalances within the group and delaying necessary adjustment. While there has been no realignment of EMS currencies since 1987 in spite of divergent current account developments inside Europe, the countries participating in the exchange rate mechanism have sustained the downward convergence of inflation rates which may reflect the "disciplinary effect" of the system on the conduct of monetary and, to a lesser extent, fiscal policies. Until recently, however, the liberalization of capital flows had proceeded further among the major world financial centers (Tokyo, New York, London, Frankfurt) than within Europe, and several EMS countries have yet to dismantle important capital controls. As a result, nominal interest rate differentials may have to become even wider than today among EMS countries if central rate stability is to be maintained as capital controls are removed.

FINANCIAL MARKET POLICIES

Trends in Financial Markets

As we noted at the outset, financial markets are undergoing rapid change. The trends can be summarized as follows:

- *Deregulation.* Interest rates on funding instruments (such as deposits) and on lending and investment instruments are increasingly deregulated and market-determined. Restrictions on financial transactions (such as requirements for collateral) are gradually being lifted. The separation of commercial banking from investment banking or securities business has been blurred, even in countries like the United States and Japan where the existing legislation still prohibits “universal banking.”
- *Internationalization.* Exchange controls have been substantially removed. Financial institutions are increasingly allowed to do business in other countries, while national currencies are used outside the countries of issue and between other countries.
- *Securitization.* Banks’ holding of securities is increasing. Some bank assets are becoming marketable, and borrowing instruments (such as mortgages) are increasingly securitized.
- *Innovation.* New financial techniques of great complexity have been invented, including note issuance facilities, currency and interest rate swaps, futures and options, and forward-rate agreements. They have the effect of increasing off-balance sheet transactions.
- *Globalization and integration.* Through 24-hour screen-based trading all over the world, investors and borrowers are able to engage in cross-border transactions easily and continuously. Financial instruments like U.S. Treasury securities have become global commodities. Payment systems of major countries are highly automated and closely interlinked.

These trends in financial markets, which are not easily reversed, are rooted in a number of factors. Competition among financial institutions has accelerated the application of technological improvements—

in accounting, information processing and telecommunications—to make possible more efficient use of financial resources and globalized financial transactions. The desire to seek greater reward from financial activities has promoted securitization and the circumvention of existing rules and remaining restrictions, and regulatory or tax arbitrage between markets has accelerated the shift of financial transactions to less restricted markets and thereby increased pressures for greater liberalization of the more regulated markets. After the two oil price shocks of the 1970s, the driving forces for economic growth have shifted from capital-intensive heavy manufacturing to more technology-intensive manufacturing and a broad range of service industries, both of which require less physical capital relative to output and hence fewer financial resources. The decline in demand for traditional bank loans has created conditions in which banks and other financial institutions are encouraged to invent new techniques to attract borrowers and to offer new instruments to investors who are more sensitive to financial returns because of slower growth of their incomes from real economic activities. Furthermore, the greater volatility of interest rates and exchange rates in recent years has increased risk exposures of participants in financial transactions, and created incentives to develop new financial instruments which can transform and diversify risks.

The buoyancy in financial markets has eased the strains caused by structural adjustments after the oil price shocks and the drastic changes in real exchange rates. But the disparity in short-term rewards between financial and industrial activities poses potentially serious problems for the longer run. Recently, a growing number of qualified people have been attracted to financial institutions rather than industrial corporations—they move to Wall Street rather than Main Street. The buoyancy of financial activities is likely to detract from the need to raise industrial productivity through applied research and technological innovation.

During the last decade and a half, the sharp changes in oil prices, rates of inflation, interest rates, and exchange rates have, taken together, increased the perceived risk in doing business around the world, and as such have evoked higher risk premiums on financial assets and have encouraged the development of new instruments to manage risk. Trends in financial markets have improved their efficiency through better distribution of financial resources and an apparent diversification of financial risks. The actual effectiveness of new instruments in hedging risks, however, depends on markets functioning smoothly, which in turn depends on a diversity of expectations.

The stock market crash of October 1987 suggests that the systemic risk was larger than any individual participant realized. Moreover, the huge increase in the volume of financial transactions and the complexities of clearing and settling them on time on a global scale can strain the payments system mechanically as well as financially.

In addressing the problems associated with changing financial markets, it is neither desirable nor practical for governments to control individual financial transactions. Now that financial activities have been substantially liberalized and internationalized, any attempt to impose direct controls on financial transactions will lead to an endless competition between loopholes and additional controls.

Common International Framework

Nevertheless, it is necessary to improve the transparency and stability of markets and to provide a common framework for financial service activities in the globalized market. In the first instance, national markets and their linkages should be strengthened through improved clearance, settlement and payment systems and better standardization and dissemination of information. Secondly, market participants should be required to comply with certain internationally agreed rules of conduct—including adequate capital ratios for both banks and non-bank financial institutions, disclosure requirements based on common accounting principles, and common rules against unfair and dishonest practices such as insider trading. Since financial activities are globalized, developments in one market are transmitted very quickly to other major financial centers, and any discrepancy in the degree of prudence among different financial markets could lead to the globalization of imprudent practices. International coordination is extremely important.

As far as banks are concerned, the Basle Supervisors' Committee (a committee of officials concerned with bank supervision, formed in the framework of the Bank for International Settlements and sometimes called the "Cooke Committee" after its previous chairman) has already established capital adequacy guidelines and is studying other prudential aspects of banking. Similar attempts at international coordination should be energetically pursued by securities regulators, securities market committees, and payments system experts in their respective fields. Furthermore, the major central banks should give serious reconsideration to the demands that might be made on them as lenders-of-last-resort given the ongoing changes in the international financial system, such as globalized financial activities and erosion of the distinction between commercial banks and other financial institutions.

Harmonization of Taxation and Regulation

As long as taxes and regulations differ substantially among countries, avoidance of regulation and taxes can take place by shifting financial transactions to nations with lower taxes or weaker regulations. Unless they are willing to lose the financial activity, governments will be forced over time to reduce their taxes and weaken their regulations in order to keep at home or bring home financial transactions that have sought a more favorable foreign locale. If governments wish to avoid competition in regulatory laxity, which after a point will weaken the stability of the financial system, they should address collectively the norms or minimum standards and tax rates around which such harmonization should take place.

As regards access to national markets by foreign institutions, there are two distinct principles in the current debate: "reciprocity," put forward initially by the European Community for banking services, and "national treatment," supported by the United States. Legally as well as in practice, national treatment is more easily adopted, but under this approach institutions from country "A" with tighter restrictions gain more (other things being equal) by establishing themselves in country "B" with fewer restrictions than country "B" institutions entering country "A." One way out of this particular problem would be to accelerate harmonization of national rules, through the Uruguay Round or otherwise, by taking advantage of market pressures created by regulatory arbitrage.

INTERNATIONAL INSTITUTIONS

For the foreseeable future, decisions concerning economic policy will be taken and implemented by national governments. Nevertheless, international institutions can be extremely helpful in all of the policy areas discussed above. They can provide objective analysis of the current situation and present constructive proposals for policy actions. They can admonish countries that have deviated from agreed rules or courses of action. It is helpful that representatives of key economic organizations (such as the IMF) participate in limited membership fora of major countries (such as the G-7).

The IMF and the World Bank play critical but differentiated roles in providing financial support to many countries around the world. A general capital increase of the World Bank has been agreed but has yet to be fully subscribed. To function effectively, the IMF will need a significant increase of quotas sooner rather than later. It is important over time for voting rights in these institutions to reflect relative international economic weight. This requires periodic revisions of historically established shares for specific countries or specific groups of countries as their roles change in the world economy. In the current negotiations about IMF quotas, Japan's share should be increased while, for example, the shares of the United States, the United Kingdom, and developing countries as a group should be lowered.

Serious consideration should be given to a new allocation of Special Drawing Rights (SDRs). The SDR was created to meet global reserve needs.[†] After allocations totalling SDR 21.4 billion through 1981, new issues have been suspended because a few major countries have opposed them on the grounds that global reserves are sufficient and only badly distributed. Although the ratio of official reserves to total imports is not low, the current amount of official reserves may not be adequate compared with the magnitude of capital flows and turnover in exchange markets. Though official borrowing from international

[†]This international reserve unit for central banks was created in the form of "special drawing rights" on the International Monetary Fund, which is the issuing institution. The value of the SDR is now a weighted composite of five currencies—the British pound, the French franc, the German mark, the Japanese yen, and the U.S. dollar. At the beginning of 1989, one SDR had the value of 1.35 U.S. dollars

markets or other sources is generally easier than it was 20 years ago, a great number of countries have difficulty in tapping these markets. Borrowed funds tend to be readily available when they are least needed, and to dry up when they are most needed.

A new allocation of SDRs could offset some of the contractionary forces which a reduction of the U.S. fiscal deficit will create. The United States could use newly allocated SDRs to purchase foreign currencies required for exchange market intervention, and other major countries could accumulate reserves in SDRs rather than U.S. dollars. Debtor countries could use their allocations as collateral for new borrowings or debt exchanges.

GLOBAL CONTEXT

The Trilateral countries function in a global context, and the policy challenges associated with international financial integration need to be addressed in a global framework. Three challenges are particularly notable: greater involvement in international economic cooperation of newly industrialized countries in Asia, progress in addressing the heavy indebtedness of many developing countries, and assuring that regional progress is not sought at global expense.

Newly Industrialized Economies

A number of newly industrialized countries in Asia have been successful in achieving high rates of export-led growth with remarkable price stability, and offer a model for other developing countries. They are "graduating" from the stage of economic development which justifies preferential treatment. Their current account surpluses have become a part of the global imbalances underlying exchange and financial market instability, and their economic policies, particularly their exchange rate and trade policies, have a measurable impact on the world economy.

Because of the growing importance of these economies, it has become crucial to find an appropriate way to involve them in the international adjustment process. Certain aspects of the economic policies of these countries, particularly their slowness in adjusting exchange rates and reducing trade barriers, have been publicly criticized by officials of certain major countries. This public criticism, whatever its substantive merit, is likely to create ill feelings in the countries being criticized. It is more desirable to invite their representatives to international fora in order to exchange information and engage in policy discussion. Deeper involvement in international economic cooperation is the best way to encourage a sense of international responsibility.

Depending upon their economic performance and the degree of their political liberalization, some of these countries should be invited to participate in various international organizations. Specifically, we believe the the Republic of Korea should be considered for member-

ship in the OECD, as recommended in a 1988 Trilateral report.[†] Efforts should be pursued to admit Taiwan to the GATT, which can be done, as in the case of Hong Kong, without prejudice to the delicate question of sovereignty.

Developing Country Debt

Most developing countries should remain net importers of capital for many years to come in view of their present stage of development. These countries do not represent a monolithic group. There are, first of all, the low-income countries, mostly in sub-Saharan Africa, where poverty is rampant; these countries are largely dependent on foreign aid to supplement their meager domestic savings. Next are those middle-income countries in Asia, North Africa and Southern Europe which have successfully weathered the storms of the '80s; these countries will continue to have little difficulty in meeting the bulk of their capital import requirements from private sources. Finally, there is a group of middle-income countries, concentrated but not exclusively in Latin America, which have encountered severe debt servicing problems in the 1980s and whose access to private capital flows is presently curtailed. Although many of these countries have undertaken substantial efforts to reduce their external deficits, they have not yet regained full access to capital markets. The external debt of these countries no longer poses as much of a threat to the stability of the international financial system as it did in 1982, but their situation remains a challenge for the international financial community. In many of these countries growth is stagnating and living standards are falling. It is clear that renewed efforts by both debtor countries and creditor countries are required to change this unsatisfactory situation.

The performance of these troubled middle-income countries is first and foremost a function of their own policies, and these countries must restore the confidence of both domestic and foreign investors. There is no other way they can achieve durable growth. This means that they will have to continue with the reform efforts underway in many countries, open up their economies, repatriate flight capital and provide incentives—rather than disincentives—for foreign direct investment. A necessary condition for restoring confidence is establishment of effective control over government expenditure and taxation, which in turn will help to reduce high inflation and improve resource allocation.

[†]Holbrooke, MacFarquhar, Nukazawa, *East Asia in Transition*, pp. 23-25, 52-53.

Economic efficiency needs also to be promoted by realistic exchange rates, more leeway for the private sector, and financial sector reform. Measures to curb rapid population growth are no less essential.

If debtor countries are to implement the kind of policy changes required, the process needs to be supported by the creditors. Generally speaking, there is a need for more official and private funds, non-inflationary growth, lower interest rates, and more open markets in the industrial countries if the strategy is to succeed. With regard to official funds, a new effort must be made to increase foreign aid (which continues to hover around 0.35% of GNP of the OECD countries) as well as other official flows (e.g., from export credit agencies), to increase the grant element of those flows (with special consideration to the poorest countries), and to augment the resources of the international financial institutions. With regard to private flows, there is an urgent need to improve the international environment. The shortage of world savings means that middle-income countries have to compete not only amongst themselves for private funds but also against sovereign borrowers among the industrial countries. The reduction of the fiscal deficits of the United States and other major countries would permit a greater part of the world's private savings to flow to the middle-income countries. With limited budgetary outlays, industrial countries could also strengthen official insurance schemes for trade finance and investment, provide debt relief through the Paris Club, enhance private lending through co-financing with the multilateral development banks and other devices, and grant commercial banks a regulatory, accounting and tax environment that is conducive to new lending and voluntary debt reduction. It bears repeating that creditor countries must continue to strive for non-inflationary growth and remove trade barriers facing debtor countries if the strategy is to succeed.

Recently, the G-7 countries have modified the existing debt management strategy and put more emphasis on debt and debt service reduction as a means to solve the problems of the heavily indebted middle-income countries. There is agreement that the IMF and the World Bank will provide some funds for this purpose. In addition, the government of Japan has pledged resources of its own. Leaving aside the question whether the funds that are presently available will be sufficient to bring about a significant amount of voluntary bank debt and debt service reduction, it is important to realize that debt reduction is not an end in itself. Historically, successful development has required substantial inflows of private foreign capital. Examples are the United States in the 19th century and Australia and Canada in the 20th

century. Therefore, debt and debt service reduction alone will not restore sustained growth and voluntary access to the capital markets.

Dangers of Regionalism

Europe is heading for greater economic integration by 1992, and the U.S.-Canada Free Trade Agreement came into effect at the beginning of 1989, with a ten-year transition period. These regional arrangements are designed to enlarge the size of markets by eliminating internal barriers against movements of goods, services, capital and labor and by harmonizing some regulations among participating countries. Both of these developments involve a step away from global economic arrangements, but both also involve substantial liberalization of areas that hitherto have not been the subject of global arrangements, notably services, investments, and professional activity. In this respect they provide some guidance and experience for future multilateral agreements.

It is important that this type of regional liberalization not increase barriers to transactions with non-participating countries. If regional integration in Europe should proceed in an inward-looking way with higher barriers against outside countries, and if the Uruguay Round of the GATT should fail, there would be a danger of triggering inward-looking regionalism elsewhere. There is already vague talk of strengthened regional arrangements between particular Trilateral countries or areas and their developing country neighbors. Bilateral agreements, particularly so-called voluntary export restraints, seem to be on the rise. A proliferation of regional and bilateral arrangements could lead to the revival of bloc thinking characteristic of the 1930s. It is extremely important to avoid such a development, which would be bad politics as well as bad economics. To this end, the Uruguay Round should be concluded successfully.

AFTERWORD

A March 21, 1921, letter from Benjamin Strong, Governor of the Federal Reserve Bank of New York, to Montagu Norman, Governor of the Bank of England, included the following:

I have always taken the position that both you and we had three possible courses in our relations with each other. One was to deal wholly independently with our respective problems, without any relations, and in complete ignorance of what the other was doing...; another might be to pursue a wholly selfish policy, each disregarding completely the interests of the other, and possibly pursuing a policy antagonistic to the other; and the third might be to adopt a policy of complete understanding, and exchange of information and views, and to cooperate where our respective interests made it possible. How can there be any choice between these three, nor any ground of complaint, so long as we are right and not afraid of our critics.[†]

In the present world much more than in 1921, no country can thrive and grow by isolating itself from the rest of the world. Inept policies are likely to invite severe reactions from exchange and financial markets. National sovereignty in this age of global interdependence should be interpreted as the ability of individual countries to face up to this reality, to agree with other sovereign countries to adopt mutually compatible policies, and to implement such agreements.

International cooperation can take many forms, formal and informal. One is for major countries to exchange information and views on the current situation but determine policies individually. Such “consultation” can be relatively easily arranged but, judging from the experience of past years, will not consistently avoid the adoption by different countries of policies which pull in contrary directions. Only after severe reactions from markets are policies changed. A more desirable approach is to “coordinate” national policies of major countries from the outset.

[†]Quoted in E. Gerald Corrigan, “Strengthening International Economic Policy Coordination,” *Federal Reserve Bank of New York Quarterly Review* (Autumn 1988), p. 5.

Active collaboration does not always imply that governments take positive action. It may sometimes be just as important for governments to agree that there should be no interference with market forces as to agree to intervene. In a related vein, active collaboration is not synonymous with attempts to “fine-tune” the world economy, in the sense of manipulating policy measures frequently to try to assure a steady growth in demand. We do not advocate such “fine-tuning.” On the contrary, there is a premium on actions that provide a medium-term framework for both private business and public authorities in an increasingly global economy.

International cooperation requires a leader, to “chair” the effort with an expansive view of self-interest and some financial resources. The United States played that role on international financial issues during much of the post-war period, but now is less willing to do so. Japan and the European Community are stepping forward, but not yet effectively. Collective leadership, central to the purpose of the Trilateral Commission, is hard to fashion.

The keys to better international coordination include the strength of political will of national leaders to overcome nationalistic sentiment and regional and sectoral interests and the depth of understanding by the general public of the implications of global interdependence. It is extremely important to build up informed public opinion in all Trilateral countries, including influential citizens who are not usually exposed to international debates—a task in which the Trilateral Commission also has an important role.