INTEGRATING NATIONAL ECONOMIES

International Monetary Arrangements for the 21st Century

Barry Eichengreen

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Integrating National Economies: Promise and Pitfalls

Barry Bosworth (Brookings Institution) and Gur Ofer (Hebrew University)
Reforming Planned Economies in an Integrating World Economy

Ralph C. Bryant (Brookings Institution)
International Coordination of National Stabilization Policies

Susan M. Collins (Brookings Institution/Georgetown University)
Distributive Issues: A Constraint on Global Integration

Richard N. Cooper (Harvard University)
Environment and Resource Policies for the World Economy

Ronald G. Ehrenberg (Cornell University)
Labor Markets and Integrating National Economies

Barry Eichengreen (University of California, Berkeley)
International Monetary Arrangements for the 21st Century

Mitsuhiro Fukao (Bank of Japan)
Financial Integration, Corporate Governance, and the Performance of Multinational Companies

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Developing Nations and the Politics of Global Integration

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Financial Regulation in the Global Economy

Miles Kahler (University of California, San Diego)
International Institutions and the Political Economy of Integration

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Trade Policies and Developing Nations

Robert Z. Lawrence (Harvard University)
Regionalism, Multilateralism, and Deeper Integration

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The Politics of Deeper Integration: National Attitudes and Policies in Japan

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Taxation in an Integrating World

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Regional Integration: The West European Experience

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Foreword

THE 1990s have been turbulent times for the international monetary system. In 1992 a series of speculative crises battered the Exchange Rate Mechanism of the European Monetary System (EMS), forcing Italy and the United Kingdom to withdraw. The Scandinavian countries were forced to abandon the exchange rate pegs that they had established over the course of previous years. In 1993 the crisis spread to other European currencies, forcing Europe to relinquish the narrow bands of the EMS for a much more permissive system. In the summer of 1994, the U.S. dollar depreciated sharply against the Japanese yen, deepening policymakers' dissatisfaction with floating exchange rates among the major currencies. Coming as they did, on the eve of the fiftieth anniversary of the Bretton Woods Agreement, these events did much to rekindle the debate over the future of the international monetary system.

In this book, Barry Eichengreen analyzes international monetary options for the twenty-first century. He argues that it will not be possible for governments to prevent exchange rate movements from exceeding prespecified limits. If this conclusion is correct, it rules out the sustainability of pegged but adjustable exchange rates, crawling pegs, and other regimes in which governments preannounce limits for exchange rate fluctuations. Countries that have traditionally pegged their currencies will be forced to choose between floating exchange rates and monetary unification.

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BRUCE K. MACLAURY
President

September 1994
Washington, D.C.

In truth, the free movement of capital is incompatible with a system of exchange rates that are occasionally changed by consequential amounts and in a predictable direction. . . . These various considerations lead me to conclude that we will need a system of credibly fixed exchange rates. . . . if we are to preserve an open trading and financial system. Exchange rates can be most credibly fixed if they are eliminated altogether, that is, if international transactions take place with a single currency.

Richard Cooper

Preface to the Studies on Integrating National Economies

ECONOMIC interdependence among nations has increased sharply in the past half century. For example, while the value of total production of industrial countries increased at a rate of about 9 percent a year on average between 1964 and 1992, the value of the exports of those nations grew at an average rate of 12 percent, and lending and borrowing across national borders through banks surged upward even more rapidly at 23 percent a year. This international economic interdependence has contributed to significantly improved standards of living for most countries. Continuing international economic integration holds out the promise of further benefits. Yet the increasing sensitivity of national economies to events and policies originating abroad creates dilemmas and pitfalls if national policies and international cooperation are poorly managed.

The Brookings Project on Integrating National Economies, of which this study is a component, focuses on the interplay between two fundamental facts about the world at the end of the twentieth century. First, the world will continue for the foreseeable future to be organized politically into nation-states with sovereign governments. Second, increasing economic integration among nations will continue to erode differences among national economies and undermine the autonomy of national governments. The project explores the opportunities and tensions arising from these two facts.

Scholars from a variety of disciplines have produced twenty-one studies for the first phase of the project. Each study examines the heightened competition between national political sovereignty and increased cross-border economic integration. This preface identifies background themes and issues common to all the studies and provides a brief overview of the project as a whole.[1]

Increasing World Economic Integration

Two underlying sets of causes have led nations to become more closely intertwined. First, technological, social, and cultural changes have sharply reduced the effective economic distances among nations. Second, many of the government policies that traditionally inhibited cross-border transactions have been relaxed or even dismantled.

The same improvements in transportation and communications technology that make it much easier and cheaper for companies in New York to ship goods to California, for residents of Strasbourg to visit relatives in Marseilles, and for investors in Hokkaido to buy and sell shares on the Tokyo Stock Exchange facilitate trade, migration, and capital movements spanning nations and continents. The sharply reduced costs of moving goods, money, people, and information underlie the profound economic truth that technology has made the world markedly smaller.

New communications technology has been especially significant for financial activity. Computers, switching devices, and telecommunications satellites have slashed the cost of transmitting information internationally, of confirming transactions, and of paying for transactions. In the 1950s, for example, foreign exchange could be bought and sold only during conventional business hours in the initiating party's time zone. Such transactions can now be carried out instantaneously twenty-four hours a day. Large banks pass the management of their worldwide foreign-exchange positions around the globe from one branch to another, staying continuously ahead of the setting sun.

Such technological innovations have increased the knowledge of potentially profitable international exchanges and of economic opportunities abroad. Those developments, in turn, have changed consumers' and producers' tastes. Foreign goods, foreign vacations, foreign financial investments—virtually anything from other nations—have lost some of their exotic character.

1. A complete list of authors and study titles is included at the beginning of this volume, facing the title page.

Although technological change permits increased contact among nations, it would not have produced such dramatic effects if it had been countermanded by government policies. Governments have traditionally taxed goods moving in international trade, directly restricted imports and subsidized exports, and tried to limit international capital movements. Those policies erected "separation fences" at the borders of nations. From the perspective of private sector agents, separation fences imposed extra costs on cross-border transactions. They reduced trade and, in some cases, eliminated it. During the 1930s governments used such policies with particular zeal, a practice now believed to have deepened and lengthened the Great Depression.

After World War II, most national governments began—sometimes unilaterally, more often collaboratively—to lower their separation fences, to make them more permeable, or sometimes even to tear down parts of them. The multilateral negotiations under the auspices of the General Agreement on Trade and Tariffs (GATT)—for example, the Kennedy Round in the 1960s, the Tokyo Round in the 1970s, and most recently the protracted negotiations of the Uruguay Round, formally signed only in April 1994—stand out as the most prominent examples of fence lowering for trade in goods. Though contentious and marked by many compromises, the GATT negotiations are responsible for sharp reductions in at-the-border restrictions on trade in goods and services. After the mid-1980s a large number of developing countries moved unilaterally to reduce border barriers and to pursue outwardly oriented policies.

The lowering of fences for financial transactions began later and was less dramatic. Nonetheless, by the 1990s government restrictions on capital flows, especially among the industrial countries, were much less important and widespread than at the end of World War II and in the 1950s.

By shrinking the economic distances among nations, changes in technology would have progressively integrated the world economy even in the absence of reductions in governments' separation fences. Reductions in separation fences would have enhanced interdependence even without the technological innovations. Together, these two sets of evolutionary changes have reinforced each other and strikingly transformed the world economy.

Changes in the Government of Nations

Simultaneously with the transformation of the global economy, major changes have occurred in the world's political structure. First, the number of governmental decisionmaking units in the world has expanded markedly and political power has been diffused more broadly among them. Rising nationalism and, in some areas, heightened ethnic tensions have accompanied that increasing political pluralism.

The history of membership in international organizations documents the sharp growth in the number of independent states. For example, only 44 nations participated in the Bretton Woods conference of July 1944, which gave birth to the International Monetary Fund. But by the end of 1970, the IMF had 118 member nations. The number of members grew to 150 by the mid-1980s and to 178 by December 1993. Much of this growth reflects the collapse of colonial empires. Although many nations today are small and carry little individual weight in the global economy, their combined influence is considerable and their interests cannot be ignored as easily as they were in the past.

A second political trend, less visible but equally important, has been the gradual loss of the political and economic hegemony of the United States. Immediately after World War II, the United States by itself accounted for more than one-third of world production. By the early 1990s the U.S. share had fallen to about one-fifth. Concurrently, the political and economic influence of the European colonial powers continued to wane, and the economic significance of nations outside Europe and North America, such as Japan, Korea, Indonesia, China, Brazil, and Mexico, increased. A world in which economic power and influence are widely diffused has displaced a world in which one or a few nations effectively dominated international decisionmaking.

Turmoil and the prospect of fundamental change in the formerly centrally planned economies compose a third factor causing radical changes in world politics. During the era of central planning, governments in those nations tried to limit external influences on their economies. Now leaders in the formerly planned economies are trying to adopt reforms modeled on Western capitalist principles. To the extent that these efforts succeed, those nations will increase their economic involvement with the rest of the world. Political and economic alignments among the Western industrialized nations will be forced to adapt.

Governments and scholars have begun to assess these three trends, but their far-reaching ramifications will not be clear for decades.

Dilemmas for National Policies

Cross-border economic integration and national political sovereignty have increasingly come into conflict, leading to a growing mismatch between the economic and political structures of the world. The effective domains of economic markets have come to coincide less and less with national governmental jurisdictions.

When the separation fences at nations' borders were high, governments and citizens could sharply distinguish "international" from "domestic" policies. International policies dealt with at-the-border barriers, such as tariffs and quotas, or responded to events occurring abroad. In contrast, domestic policies were concerned with everything behind the nation's borders, such as competition and antitrust rules, corporate governance, product standards, worker safety, regulation and supervision of financial institutions, environmental protection, tax codes, and the government's budget. Domestic policies were regarded as matters about which nations were sovereign, to be determined by the preferences of the nation's citizens and its political institutions, without regard for effects on other nations.

As separation fences have been lowered and technological innovations have shrunk economic distances, a multitude of formerly neglected differences among nations' domestic policies have become exposed to international scrutiny. National governments and international negotiations must thus increasingly deal with "deeper"—behind-the-border—integration. For example, if country A permits companies to emit air and water pollutants whereas country B does not, companies that use pollution-generating methods of production will find it cheaper to produce in country A. Companies in country B that compete internationally with companies in country A are likely to complain that foreign competitors enjoy unfair advantages and to press for international pollution standards.

Deeper integration requires analysis of the economic and the political aspects of virtually all nonborder policies and practices. Such issues have already figured prominently in negotiations over the evolution of the European Community, over the Uruguay Round of GATT negotiations, over the North American Free Trade Agreement (NAFTA), and over the bilateral economic relationships between Japan and the United States. Future debates about behind-the-border policies will occur with increasing frequency and prove at least as complex and contentious as the past negotiations regarding at-the-border restrictions.

Tensions about deeper integration arise from three broad sources: cross-border spillovers, diminished national autonomy, and challenges to political sovereignty.

Cross-Border Spillovers

Some activities in one nation produce consequences that spill across borders and affect other nations. Illustrations of these spillovers abound. Given the impact of modern technology of banking and securities markets in creating interconnected networks, lax rules in one nation erode the ability of all other nations to enforce banking and securities rules and to deal with fraudulent transactions. Given the rapid diffusion of knowledge, science and technology policies in one nation generate knowledge that other nations can use without full payment. Labor market policies become matters of concern to other nations because workers migrate in search of work; policies in one nation can trigger migration that floods or starves labor markets elsewhere. When one nation dumps pollutants into the air or water that other nations breathe or drink, the matter goes beyond the unitary concern of the polluting nation and becomes a matter for international negotiation. Indeed, the hydrocarbons that are emitted into the atmosphere when individual nations burn coal for generating electricity contribute to global warming and are thereby a matter of concern for the entire world.

The tensions associated with cross-border spillovers can be especially vexing when national policies generate outcomes alleged to be competitively inequitable, as in the example in which country A permits companies to emit pollutants and country B does not. Or consider a situation in which country C requires commodities, whether produced at home or abroad, to meet certain design standards, justified for safety reasons. Foreign competitors may find it too expensive to meet these standards. In that event, the standards in C act very much like tariffs or quotas, effectively narrowing or even eliminating foreign competition for domestic producers. Citing examples of this sort, producers or governments in individual nations often complain that business is not conducted on a "level playing field." Typically, the complaining nation proposes that *other* nations adjust their policies to moderate or remove the competitive inequities.

Arguments for creating a level playing field are troublesome at best. International trade occurs precisely because of differences among nations—in resource endowments, labor skills, and consumer tastes. Nations specialize in producing goods and services in which they are relatively most efficient. In a fundamental sense, cross-border trade is valuable because the playing field is *not* level.

When David Ricardo first developed the theory of comparative advantage, he focused on differences among nations owing to climate or technology. But Ricardo could as easily have ascribed the productive differences to differing "social climates" as to physical or technological climates. Taking all "climatic" differences as given, the theory of comparative advantage argues that free trade among nations will maximize global welfare.

Taken to its logical extreme, the notion of leveling the playing field implies that nations should become homogeneous in all major respects. But that recommendation is unrealistic and even pernicious. Suppose country A decides that it is too poor to afford the costs of a clean environment, and will thus permit the production of goods that pollute local air and water supplies. Or suppose it concludes that it cannot afford stringent protections for worker safety. Country A will then argue that it is inappropriate for other nations to impute to country A the value they themselves place on a clean environment and safety standards (just as it would be inappropriate to impute the A valuations to the environment of other nations). The core of the idea of political sovereignty is to permit national residents to order their lives and property in accord with their own preferences.

Which perspective about differences among nations in behind-the-border policies is more compelling? Is country A merely exercising its national preferences and appropriately exploiting its comparative advantage in goods that are dirty or dangerous to produce? Or does a legitimate international problem exist that justifies pressure from other nations urging country A to accept changes in its policies (thus curbing its national sovereignty)? When national governments negotiate resolutions to such questions—trying to agree whether individual nations are legitimately exercising sovereign choices or, alternatively, engaging in behavior that is unfair or damaging to other nations—the dialogue is invariably contentious because the resolutions depend on the typically complex circumstances of the international spillovers and on the relative weights accorded to the interests of particular individuals and particular nations.

Diminished National Autonomy

As cross-border economic integration increases, governments experience greater difficulties in trying to control events within their borders. Those difficulties, summarized by the term *diminished autonomy*, are the second set of reasons why tensions arise from the competition between political sovereignty and economic integration.

For example, nations adjust monetary and fiscal policies to influence domestic inflation and employment. In setting these policies, smaller countries have always been somewhat constrained by foreign economic events and policies. Today, however, all nations are constrained, often severely. More than in the past, therefore, nations may be better able to achieve their economic goals if they work together collaboratively in adjusting their macroeconomic policies.

Diminished autonomy and cross-border spillovers can sometimes be allowed to persist without explicit international cooperation to deal with them. States in the United States adopt their own tax systems and set policies for assistance to poor single people without any formal cooperation or limitation. Market pressures operate to force a degree of de facto cooperation. If one state taxes corporations too heavily, it knows business will move elsewhere. (Those familiar with older debates about "fiscal federalism" within the United States and other nations will recognize the similarity between those issues and the emerging international debates about deeper integration of national economies.) Analogously, differences among nations in regulations, standards, policies, institutions, and even social and cultural preferences create economic incentives for a kind of arbitrage that erodes or eliminates the differences. Such pressures involve not only the conventional arbitrage that exploits price differentials (buying at one point in geographic space or time and selling at another) but also