CHAPTER 7

Whither International Trade and Finance?

THROUGHOUT HISTORY, international trade and finance have been powerful engines of growth for the United States and the world. International trade has benefited all countries; one country does not capture the benefits of open trade at the expense of its trading partners. A key part of the Administration's economic policy has been to work toward more open trade and investment relationships through such initiatives as the North American Free Trade Agreement (NAFTA) and the Uruguay Round of multilateral trade talks under the General Agreement on Tariffs and Trade (GATT). Successful negotiations on NAFTA were completed in 1992, and progress has been made toward an agreement on the long-lasting and complex Uruguay Round. In the area of international finance, the Administration implemented the Brady Plan, which worked to make it easier for developing countries to service commercial bank debt, and the Enterprise for the Americas Initiative (EAI), which supports investment and growth in the Western Hemisphere.

International trade—the voluntary exchange of goods or services across national boundaries—increases the well-being of all participants by promoting economic efficiency in a variety of ways. International trade allows each country to concentrate on its most efficient activities. Trade gives firms access to the large international market, allowing them to increase output and lower their average cost by taking advantage of scale economies. Access to world markets for raw materials, capital goods, and technology improves productivity. Foreign competition forces domestic monopolies or oligopolies to lower prices, and imported goods provide consumers with greater choice. Finally, a liberal trade regime can provide a better climate for investment and innovation, raising the rate of economic growth.

An expansion in opportunities for international trade has effects similar to those of technological improvements: For the same amount of inputs and resources, more output will be produced. On the other hand, like technological change, more open international trade may require economic adjustments. Just as the invention of the transistor shifted production away from vacuum tubes, in-

creased trade causes shifts in resources away from production of commodities that compete with imports and toward production of commodities exported from the country.

Open trade may be especially beneficial to the growth of the developing economies and the former Communist nations that have smaller, less competitive markets and a greater need for investment and capital goods embodying modern technology. By creating new competition, providing domestic producers with access to large international markets, and improving the environment for investment, international trade can make a far greater contribution than direct aid to economic development.

In general, international trade has grown much faster than world production during the last 300 years. Most recently, between 1965 and 1990, inflation-adjusted merchandise exports grew by 439 percent, while world production rose 136 percent. The increase in world trade is, in part, the result of GATT, which was created after World War II to reduce tariffs and remove other nontariff barriers to international trade. In seven rounds of GATT-sponsored multilateral trade negotiations (the Uruguay Round is the eighth), countries have lowered tariff barriers and agreed on codes of conduct for nontariff barriers. Trade among GATT members now accounts for over 80 percent of world trade.

An important counterpart to an integrated global trade system is a well-functioning international financial system for the transfer of bonds, equities, short-term securities, and other assets among nations. The international flow of capital takes various forms: Direct foreign investment is the establishment of a business in a foreign country; portfolio investment is the purchase of financial assets such as corporate bonds or government securities; and direct lending is a similar form of capital inflow where a borrower promises to repay a foreign lender.

The international financial system serves several important functions. It provides traders with access to foreign exchange and credit, expanding the scope for commercial transactions, and allows nations to finance trade imbalances through private capital flows, government borrowing and lending, or changes in reserves. Second, the system of international finance encourages capital to move to countries where it is more productive. Capital inflows can finance domestic investment, and therefore enable a country to invest more than it saves; as a consequence, the country imports more goods and services than it exports (that is, it runs a trade deficit). Finally, international finance allows investors to diversify their portfolios, and thus reduce the risk of losses due to poor economic performance or political upheaval in individual countries.

Trade in currencies represents another facet of international finance. Because international trade typically involves two or more

currencies, a smoothly functioning foreign exchange (or currency) market—the market where currencies are exchanged for one another—is important for efficiency in the international markets for goods, services, and assets. An exchange rate—the price of one currency in terms of another—influences both international capital flows and international trade by affecting the domestic prices of foreign commodities and assets. Between the end of World War II and the early 1970s, exchange rates were pegged—that is, maintained at particular values—in line with an agreement made shortly before the end of World War II, commonly called the Bretton Woods Agreement. Subsequently, exchange-rate regimes with varying degrees of flexibility have evolved. How, and under what circumstances, exchange rates should be allowed to change has become an important issue, especially within the European Community (EC), which reestablished pegged rates among most of its national currencies in the late 1970s. The reluctance to realign exchange rates within the pegged rate system in the face of major disturbances has played a role in the current sluggish growth and recession in a number of countries in Europe. This has adversely affected the EC's trading partners by reducing demand for their exports.

Since World War II, the growth of international trade has been complemented by the rapid expansion of international capital flows. As economies grow and become more integrated with the world economy, they develop occasional trade surpluses or deficits that are financed through capital flows. For example, in the wake of World War II, Europe's reconstruction needs far exceeded its available savings, leading to large trade deficits for Europe and, conversely, substantial U.S. trade surpluses coupled with capital flows from the United States to Europe. Likewise, in the 1960s and 1970s, capital scarcity in many developing countries was reflected in trade deficits and higher expected rates of return to investment that attracted capital from industrialized countries.

In fact, the growth of international capital movements has dwarfed the growth in trade. The stock of international bank loans, for example, has grown from 5 percent of gross domestic product (GDP) of countries in the Organization for Economic Cooperation and Development (OECD) in 1973 to about 20 percent of OECD GDP in 1991. Gross sales and purchases of U.S. long-term securities by foreigners grew from $144 billion in 1978 to $5.6 trillion in 1991, far outstripping the growth of world output and trade over this period. Average daily turnover in U.S. markets for foreign currencies is estimated at about $192 billion in 1992, more than a tenfold increase from $18 billion in 1980.

The growth in international finance is the result not only of the increase in international trade but also of improvements in tech-

nology, financial innovations, and changes in regulatory environments. Technological improvements in communications and computers have made international financial transactions faster, easier, and cheaper, and now provide investors with up-to-the-minute information on financial activity throughout the world. Improved technology has also spurred development of new financial products that require extensive processing of information to construct and price accurately.

The regulatory environment affecting international capital flows has become less restrictive since World War II. During the 1950s, for example, European countries removed laws restricting the exchange of domestic for foreign currency. By the end of 1992, members of the EC had removed almost all their capital controls. The liberalization of restrictions on capital flows provided significant impetus to the development of an integrated global financial market.

As an important example, the removal of external capital restrictions in Europe, along with other U.S. and European tax and regulatory policies, contributed to the creation in the 1950s and 1960s of the Eurodollar markets in which banks outside the United States accept deposits and make loans denominated in dollars. The Eurodollar markets have developed into "Eurocurrency" markets with transactions in other currencies in addition to dollars, and have expanded throughout much of the globe. After the oil shocks of the 1970s, the Eurodollar markets played an important role in taking deposits from oil-producing countries running trade surpluses and lending those funds to oil-consuming nations requiring financing for their trade deficits.

THE EVOLUTION OF EXCHANGE-RATE ARRANGEMENTS

The past half century has been marked by a number of experiments with different exchange-rate arrangements. Under the Bretton Woods system, designed at the end of World War II, currencies of participating nations were pegged to the dollar and only occasionally adjusted. Since this system was abandoned in the early 1970s, the exchange rates of the major industrialized countries have generally "floated" against each other in response to market forces. However, a number of European countries revived the pegged exchange-rate system when they created the European Monetary System (EMS) in 1979. Many developing countries peg their currencies to the dollar or other stable currencies, and this is considered a viable option for some of the economies of Eastern Europe and the former Soviet Union as well.

At the heart of the widespread experimentation with different exchange-rate arrangements is the fact that no one arrangement—be it a pegged-or a floating-rate system—is appropriate to all countries at all times and under all circumstances. Exchange-rate arrangements may be classified according to how rigidly they fix exchange rates between currencies (Box 7–1). At one extreme, several countries (or for that matter, regions within a country) share a single currency, so that there is no actual exchange rate to change. At the other extreme lies a system with freely floating exchange rates, in which currency values are determined exclusively by supply and demand. Pegged exchange rates represent an intermediate case: Governments maintain exchange rates at desired levels, but occasionally change those levels as circumstances change.

Box 7–1.—Exchange-rate arrangements

Single currency arrangements. Two or more countries form a "currency union" to share a single currency. Because there is only one currency, there is no exchange rate between participating nations.

Pegged exchange rates. Governments buy or sell currencies in order to maintain the value of their own currency within a specified band around the pegged rate. The pegged rate itself occasionally can be changed in response to changing circumstances.

Floating exchange rates. With a freely floating exchange rate, governments do not enter the foreign exchange markets to influence exchange rates, which are determined exclusively by market forces. In practice, governments occasionally intervene in foreign exchange markets to buy or sell currencies in order to influence their value; this is known as a "dirty float."

Different exchange-rate arrangements offer different benefits. A pegged exchange rate, if held for extended periods, can reduce the risks of exchange-rate changes to businesses conducting international trade. It can also exert pressure on governments to keep inflation low in order to maintain the value of their currencies. On the other hand, pegging the exchange rate may prevent a country's monetary authorities from responding flexibly to major shifts in economic conditions, and in that regard floating rates or more readily adjusted pegged rates may provide for more appropriate responses. For example, if world demand for one of a country's principal export products drops sharply, perhaps because a cheaper substitute has been developed, it may be helpful to let the value of that country's currency fall in international markets; this will make the country's other products cheaper to foreigners, helping to

maintain demand for its goods and reducing the downward pressure on income and employment that a reduction in exports could cause.

Hence, countries choosing an exchange-rate arrangement face a tradeoff between the stability offered by fixed exchange-rate systems and the greater freedom to set domestic monetary policies that is offered by more flexible exchange-rate arrangements. When the international environment is relatively stable and rates of inflation are similar among countries, pegged exchange-rate systems may work smoothly while inducing governments to control inflation. Conversely, major disturbances such as escalating oil prices, or widely divergent inflation rates among countries, may call for more flexible exchange-rate arrangements that can permit smooth adjustment to these developments.

In practice, the distinction between the stability of one system and the flexibility of the other can be exaggerated. Even in floating-rate systems, central banks often intervene in foreign exchange markets in order to moderate fluctuations in currency values, although such interventions usually have very little impact, and then only for brief durations, unless accompanied by fundamental shifts in monetary policies. Conversely, the risk of exchange-rate fluctuations to importers and exporters could be greater in a pegged-rate system that experiences occasional large and unpredicted devaluations than in a floating-rate system where exchange rates move continuously but by small amounts. Moreover, private markets have developed means of helping traders "hedge" (protect against) such risks. An exporter expecting to receive British pounds in one year can contract now, at a specified "forward" exchange rate, to buy dollars for pounds next year, thereby guaranteeing the dollar value of future receipts. In fact, since World War II, international trade has grown vigorously under both pegged and flexible exchange rates.

Nevertheless, the choice of an exchange-rate arrangement can substantially affect the performance of the economy and, in fact, exchange-rate issues have been very important over the past year. In Europe, the EMS came under severe strain as its members struggled to keep pace with high German interest rates, exacerbating the economic slowdown and prompting Italy and the United Kingdom to float their currencies. Argentina entered the second year of a disinflation program that is based on a pegged exchange rate and reduced budget deficits. The major industrialized countries pledged $6 billion to help Russia stabilize the ruble once appropriate policies are in place.

These developments may have important implications for our own living standards and national security. Slower growth in Europe has reduced demand for U.S. exports and slowed our own

recovery. Strong growth in various Latin American economies, on the other hand, in part based on the stabilization of their currencies, is contributing to their emergence as key trading partners for the United States. Economic stabilization and growth in the former Soviet Union is indispensable to achieving peace and democracy in that part of the world. An understanding of how and why exchange-rate arrangements have evolved since the creation of the Bretton Woods system may shed light on the exchange-rate choices confronting these economies today.

PEGGED EXCHANGE RATES UNDER THE BRETTON WOODS SYSTEM

The primary objective of the Bretton Woods system was to ensure a stable financial setting for international trade. When the designers of the system met in Bretton Woods, New Hampshire, in 1944, they were eager to avoid repeating the experience of the 1930s. The abandonment at that time of the gold standard, which had fixed the values of national currencies in terms of gold and therefore in terms of one another, was followed by marked swings in exchange rates and a sharp decline in international trade. While increases in tariffs and falling incomes were primarily responsible for the reduction in trade, the chaotic conditions of the interwar period, including the Great Depression, convinced participants at the Bretton Woods Conference of the need to limit market-driven fluctuations in the value of currencies.

At the same time, the Bretton Woods participants recognized that a system of permanently fixed exchange rates, such as the gold standard, could establish too strong a link between domestic economic activity and external developments. In a fixed exchange-rate system, governments or central banks must finance surpluses or deficits in their balance of payments (the difference between international sales and purchases of goods, services, and assets) by buying or selling international reserve currencies or gold. Whenever a central bank buys assets, whether domestic bonds or foreign currencies, it increases the domestic money supply; conversely, the domestic money supply falls when the central bank sells reserves of foreign exchange. These changes in the money supply, in turn, tend automatically to reduce existing payments imbalances. For example, countries with deficits sell reserves, leading to a decline in the money supply, a contraction in aggregate demand and imports, and thereby an automatic reduction in the balance of payments deficit. The opposite occurs when countries with surpluses buy foreign exchange.

Depending on the initial state of the economy, these adjustments may either improve or worsen the domestic situation. For example, in a booming economy with inflationary pressures, the reduction in

the money stock associated with a payments deficit should restrain demand and reduce inflation. If the economy is already weak, however, a payments deficit will lead to further contraction and increases in unemployment. The contraction may become even more pronounced if the country is in danger of running out of international reserves; in this case, it may take strong action to suppress domestic demand further in order to reduce its external deficit and retain the reserves needed to protect its exchange rate.

By contrast, with freely floating exchange rates, the authorities are not committed to a specific rate, and can focus on domestic objectives when setting monetary and fiscal policies. Balance of payments pressures lead to changes in exchange rates that, by changing the prices of exports and imports, lead to a reduction of payments imbalances with less need for domestic adjustment.

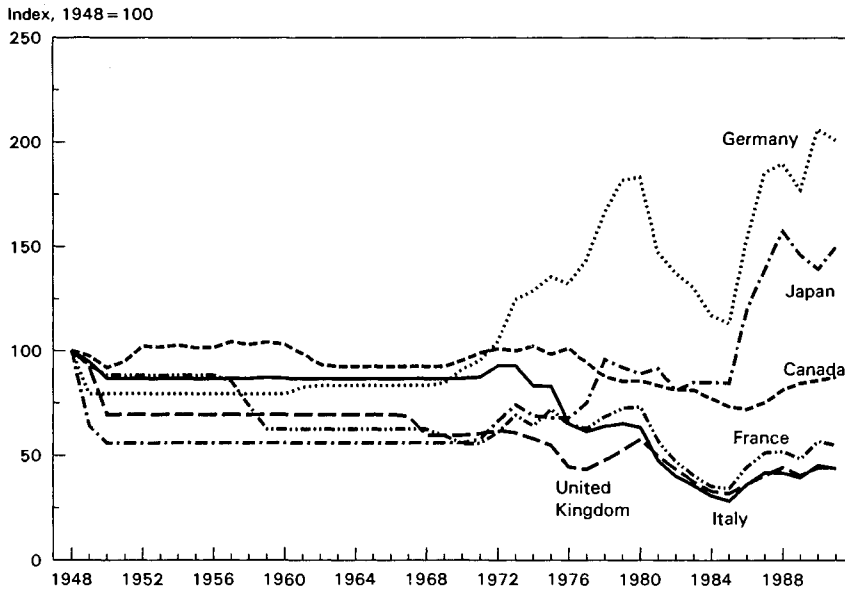
As a compromise between fixed and floating exchange-rate systems, the Bretton Woods system provided for an "adjustable peg." Under this system, each country would peg the price of its currency in terms of the dollar. When temporary balance of payments deficits occurred, countries with limited reserves would be able to borrow from the International Monetary Fund to alleviate the need to contract aggregate demand sharply, giving them time to adjust domestic policies more gradually. In the event of "fundamental disequilibrium" in the balance of payments—a phrase never precisely defined but clearly referring to a situation in which countries are unable to adjust their payments imbalances without severely disturbing the domestic economy—countries were allowed to change their official exchange rates. The United States, in turn, linked the dollar to gold at $35 per ounce.

Economic Performance Under the Bretton Woods System

For most of its quarter-century of existence (1946–71), the Bretton Woods system was relatively successful in securing its twin goals of strong growth in international trade and stable exchange rates. In fact, exchange rates were even more stable than had been anticipated. National authorities, desiring to avoid the loss of prestige and increased speculative pressures associated with devaluations, were increasingly reluctant to change their official parities. After some changes in parities in the late 1940s, exchange rates remained, with a few exceptions, largely unchanged until 1967 (Chart 7-1).

The Bretton Woods era was also marked by a steady growth in output and, after a postwar burst of inflation, by relatively stable prices. Inflation in the seven major industrial economies averaged 3.5 percent between 1950 and 1970, compared with 7.4 percent between 1970 and 1991 (Table 7-1). Annual growth in output averaged 5.4 percent and 2.9 percent, respectively, during the two periods. Some observers attribute the favorable performance of the in-

Chart 7-1 **Exchange Rates of Major Industrialized Countries in Terms of the Dollar**
Exchange rates were considerably more stable during the Bretton Woods era than they have been in the past two decades.



Source: International Monetary Fund.

dustrial economies in the 1950s and 1960s to the pegged exchange-rate system, which may have exerted pressure to pursue responsible macroeconomic policies, moderating the cycles of inflation and recession that became more pronounced after 1971. However, others contend that the successful economic performances of the Bretton Woods period should not be attributed to pegged exchange rates and that the relative stability of prices and of output growth during this period is what enabled exchange rates to remain stable.

TABLE 7-1.—*Output Growth and Inflation in the G7 Countries*

Country	Output Growth		Inflation	
	1950–70	1970–91	1950–70	1970–91
United States	2.8	2.1	2.4	6.2
Japan	9.2	4.4	4.9	5.5
West Germany	6.3	2.5	2.2	3.8
Canada	4.9	3.5	2.5	6.9
United Kingdom	3.6	2.4	3.7	10.0
France	5.3	2.7	4.9	7.8
Italy	5.7	3.0	3.5	11.7
Average	5.4	2.9	3.5	7.4

Note.—Output growth is the average annual growth of GDP/GNP in constant 1985 units of each domestic currency. Inflation is the average annual growth of the CPI.

Source: International Monetary Fund.

The Breakdown of the Bretton Woods System

As the Bretton Woods era progressed, tensions within the exchange-rate system became more pronounced, in part because of the increasing international integration of capital markets. At the beginning of the Bretton Woods era, most countries had controls on the purchase and sale of foreign exchange and on capital flows. Over time, these controls were lifted, and by 1958 most European countries had liberalized transactions in foreign exchange for trade in goods and services. While most countries retained capital controls through the 1960s and beyond, advances in telecommunications and institutional developments such as the Eurodollar market made these controls increasingly easy to evade.

As a result of increased capital mobility, balance of payments deficits that raised the prospect of a currency devaluation tended to trigger speculative capital outflows, forcing governments to take severe restrictive actions or even to devalue their currencies. This tendency substantially limited economic policy choices, since even a moderate shift in a country's balance of payments could lead to a crisis that would be difficult to resolve. Since governments tended to resist devaluations (or in some cases, revaluations) until they had no alternatives, purchases of foreign currency offered near-certain profits to speculators. Strong capital outflows forced the devaluations of the British pound in 1967 and the French franc in 1969. Ironically, growing capital mobility not only increasingly restricted domestic economic policy but also reinforced tendencies to keep exchange rates unchanged. Governments declined to make corrective adjustments in their parities in order to bolster confidence in their currencies.

A second source of heightened tension under the Bretton Woods system was concern about the dollar's role in the international monetary system. During the Bretton Woods period, the dollar became the prime reserve currency, that is, it was used by other countries as a medium of payment for international transactions and as a reserve asset in case of future balance of payments deficits. On the one hand, the dollar's status as a reserve currency meant that the United States could run balance of payments deficits without having to tighten its domestic policies (sometimes referred to as "deficits without tears"), since the countries that were running balance of payments surpluses were willing to accumulate U.S. dollars.

On the other hand, the willingness of other countries to hold dollars as a reserve currency depended in part on their confidence that the dollar would retain its value in terms of gold. Persistent U.S. balance of payments deficits, reflecting capital outflows in excess of U.S. trade surpluses, caused foreign dollar claims on the United States to grow significantly larger than U.S. holdings of

gold during the Bretton Woods period, increasingly throwing into question the ability of the United States to maintain the official price of gold at $35 per ounce. In March 1968, faced with declines in its stock of gold, the United States participated in an international arrangement that allowed the price of gold to float in private markets, although the price was held at $35 per ounce for transactions with foreign central banks. These banks, however, became increasingly reluctant to continue accumulating dollars whose price in terms of gold was declining in private markets.

Reinforcing these concerns was the asymmetrical nature of exchange-rate adjustments under Bretton Woods. Countries running balance of payments deficits often had to devalue when international reserves threatened to run out, while surplus countries generally faced no analogous pressure to revalue. Since changes in exchange rates were made vis-a-vis the dollar, this led to a bias toward devaluation for the system as a whole that caused the dollar itself to become overvalued.

In 1971, record levels of U.S. private capital outflows occurred in response to both expansionary monetary policy aimed at spurring recovery from the 1970 recession, a policy that heightened fears of rising inflation, and further concerns about the dollar provoked by the first U.S. trade deficit in the postwar period. The threat of a depletion of its stock of gold prompted the United States to suspend the convertibility of dollars into gold in August 1971, in the process eliminating a key feature of the Bretton Woods system and encouraging those countries that had not already floated their currencies to do so. An attempt to reconstruct the global pegged exchange-rate system, marked by the Smithsonian Agreement of December 1971, was abandoned by March 1973 in response to continued balance of payments difficulties among a number of participating countries.

THE DOLLAR IN THE FLOATING-RATE ERA

In the 1970s and 1980s exchange rates fluctuated more widely than they had during the Bretton Woods period of the 1950s and 1960s (Table 7-2). Inflation and production in the United States also became more variable since the breakdown of the Bretton Woods system, and this occurred in other industrialized countries as well.

As noted earlier, observers disagree on whether the end of the pegged exchange-rate system was itself responsible for the increased economic volatility. During the 1970s, the world experienced a number of economic shocks, most notably the oil price increases of 1973–74 and 1979–80. These shocks tended to affect each country differently, prompting a variety of policy responses and partially explaining the increased volatility of exchange rates. Moreover, the changes in exchange rates helped economies adjust

TABLE 7-2.—*The Increasing Variability of U.S. Exchange Rates, Output and Inflation*

	Ratio of Variability: 1971-91/1950-70[1]
Exchange rate[2]	13.00
Output[3]	2.58
Inflation[4]	2.25

[1] Ratio of statistical variance of the indicator during the 1971-91 period to its variance during the 1950-70 period.
[2] Monthly deutsche mark/dollar rate.
[3] Deviation from quarterly trend of real GDP (or GNP) in billions of 1982 dollars.
[4] Twelve-month growth rate of the monthly, seasonally adjusted CPI.
Sources: Department of Commerce, Bureau of Economic Analysis; Department of Labor; and International Monetary Fund.

to the shocks (Box 7-2); had exchange rates not been allowed to adjust, many countries would have had to respond to balance of payments difficulties by more sharply reducing aggregate demand.

Box 7-2.—Floating Exchange Rates

Under a floating exchange-rate system, governments allow the market to set the prices of currencies. A central virtue of floating exchange rates is that currency prices eventually adjust to correct international payments imbalances, reducing the need for domestic economic adjustment.

When there are tendencies toward a U.S. balance of payments deficit, the receipts of foreign exchange (from the sale of goods and services abroad or from capital inflows) are less than the demand for foreign exchange (to buy foreign goods and services or to invest abroad). As a result, the prices of foreign currencies rise (or equivalently, the dollar depreciates), making foreign products more expensive at home and U.S. products cheaper abroad. Imports fall, exports rise, and the supply and demand for foreign exchange move into balance. An incipient balance of payments surplus—when the supply of foreign exchange exceeds the demand at the current exchange rate—will have the opposite effect, increasing the dollar's value, depressing exports, and again restoring balance.

However, the fluctuations in currency values in the post-Bretton Woods era reflected divergent economic policies and performances as well as international economic shocks. Inflation rates for the United States, Japan, and Germany diverged considerably in the late 1970s, when U.S. policies focused on supporting recovery from the mid-1970s recession and U.S. inflation rose in relation to that of the other two countries (Chart 7-2). The higher inflationary pressures in the United States meant that any attempt to have fixed the value of the dollar during this period would have significantly increased balance of payments difficulties for the United

Box 7-3.—Real Exchange Rates and Real Interest Rates

When rates of inflation differ across countries, it is the *real exchange rate* rather than the *nominal (that is, actual) exchange rate* that matters most to the balance of payments. The real exchange rate takes into account changes in price levels. For example, if Japanese prices doubled while U.S. prices remained unchanged, then for a given nominal yen/dollar exchange rate, the real exchange rate—which measures the purchasing power of the dollar in terms of Japanese goods—would drop by half. A real exchange-rate appreciation signifies that a country's goods and services are becoming more expensive compared with foreign products; a real exchange-rate depreciation indicates that a country's products are becoming cheaper compared with foreign products. When a country's inflation rate differs from inflation rates abroad, its competitive position generally will be stable if its nominal exchange rate adjusts by enough to keep its real exchange rate stable.

Exchange-rate movements are often determined primarily by capital movements, especially in the short run. Capital tends to flow from countries with low real interest rates to those with high real interest rates. The real interest rate is (approximately) the nominal interest rate less the expected rate of inflation. When differences in nominal interest rates merely reflect differences in expected inflation rates—that is, when real interest rates are the same across countries—capital flows are unlikely to occur in response, since exchange rates are likely to change in the future to compensate for different rates of inflation.

An inflow of capital into a country with a high real interest rate will create demand for the domestic currency, causing it to appreciate. Conversely, the currency of a country with a low real interest rate will depreciate as capital migrates out of that country. As a result, monetary and fiscal policies that affect real interest rate differentials will cause movements in the exchange rate (Chart 7-3).

policy had begun to ease in 1984, while attempts to reduce inflation abroad had strengthened, narrowing the gap between U.S. and foreign interest rates. Against this background, in September 1985, the G-5 countries (the United States, Germany, France, Japan, and the United Kingdom) reached the Plaza Accord, agreeing to coordinate policies more closely to lower the dollar's value further. With the dollar still falling in February 1987, six major industrial countries (the G-5 plus Canada) reached agreement, in the Louvre

Accord, to strengthen policy coordination and stabilize the dollar, although it continued to decline until the end of the year. The downward correction of the dollar and stronger growth in the other major countries led to a narrowing of the U.S. trade deficit from its peak of $160 billion in 1987 to $73 billion in 1991.

The widening U.S. trade deficit of the 1980s cannot be attributed solely to the effects of floating exchange rates. Underlying both the appreciation of the dollar and the increase in the trade deficit was the widening gap between saving and investment in the United States. U.S. gross investment averaged 17 percent of GDP in the 1980s, about the same as in the 1970s. However, the gross national saving rate declined from 17 percent in the 1970s to 15.4 percent in the 1980s, reflecting both reductions in household savings rates and the growing Federal deficit. The reduction in national saving meant that a greater share of U.S. investment had to be financed with resources from abroad. Therefore, the trade deficit would have widened with either pegged or floating exchange rates.

THE MOVEMENT TOWARD A SINGLE CURRENCY IN EUROPE

In the Maastricht Treaty of 1991, the members of the European Community agreed to replace their national currencies with a single currency by the year 2000, thereby superseding the present system of pegged exchange rates under the EMS and permanently ruling out exchange-rate changes. Ironically, events in 1992, including the (at least temporary) withdrawal of a number of countries from the exchange rate mechanism of the EMS, underscored the shortcomings of a pegged exchange-rate system in the face of economic disturbances and provided an example of the pressures that can build up if exchange rates are not realigned in a timely way.

Progress toward a single European currency is viewed as complementary to the increasing integration of the European market for goods and services. In 1985, the member states of the EC agreed to remove almost all remaining barriers to the free movement of goods, capital, services, and people by the end of 1992, a step often referred to as "EC 92." A single European currency is expected to reinforce this integration by eliminating both the transactions costs of dealing in different currencies and concerns about exchange-rate fluctuations that could interfere with cross-border business planning. In addition, the move to a single currency is expected to lower interest rates and thereby promote growth in some member countries by eliminating the risk to lenders that the currency might be devalued against others in the system.

Many observers, however, believe that the primary economic benefit of European integration lies in the elimination of barriers to trade. There is uncertainty as to how much additional benefit

will be yielded by the permanent fixing of exchange rates implied by a single currency. By comparison, NAFTA is designed to achieve the benefits of regional free trade, but a currency union among the United States, Mexico, and Canada is not believed to be necessary to achieve these gains.

The European Monetary System

The EMS was created in March 1979, partially as a reaction to the increased exchange-rate volatility that followed the end of the Bretton Woods system. Under the exchange rate mechanism of the EMS, most member countries are required to maintain their exchange rates within 2¼ percent of "central rates" established between their currency and each of the other members' currencies. When an exchange rate between two members' currencies moves 2¼ percent away from its central rate—that is, to the edge of the exchange-rate band—the central banks of both countries are required to intervene to prevent the exchange rate from moving outside the band. Realignments of each country's central rate are permitted. In this sense, the exchange rate mechanism was designed to operate much like the adjustable peg of the Bretton Woods system.

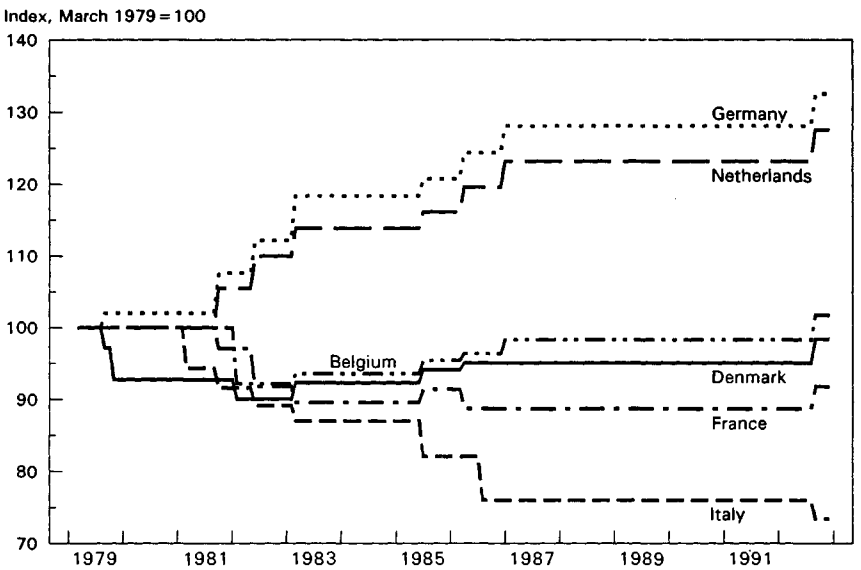
It was initially intended that the central rates would be changed more frequently and in smaller increments than under Bretton Woods; rates would be changed before irresistible pressures built up. While realignments did take place relatively often in the first few years of the EMS, they later became less frequent. Between 1979 and 1987, there were 11 realignments, after which essentially no realignments took place until September 1992 (Chart 7-4).

The difference between the appreciating currencies of Germany and the Netherlands and the most swiftly depreciating currencies, such as those of France and Italy, is accounted for primarily by differences in their macroeconomic performance, particularly inflation (Chart 7-5). The countries with the highest inflation rates had to devalue their currencies frequently in the early years of the EMS in order to maintain the competitiveness of their exports and prevent increases in external deficits.

By the mid-1980s, differences in rates of inflation became smaller as the most inflationary nations brought their rates down toward those of Germany and the Netherlands. Some observers argue that the desire to avoid realignments, in particular because of the loss of credibility and national standing such realignments entailed, was important in leading policymakers in the countries with high inflation to implement strong disinflationary measures. These countries, notably France, concentrated on maintaining stable exchange rates with respect to the deutsche mark, since Germany had for historic reasons established an unwavering commitment to price stability; French inflation declined from over 10 percent at

Chart 7-4 **Central Exchange Rates of Selected EMS Countries**

Following an initial period of frequent realignments, exchange rates among the countries of the EMS became more stable after the mid-1980s.



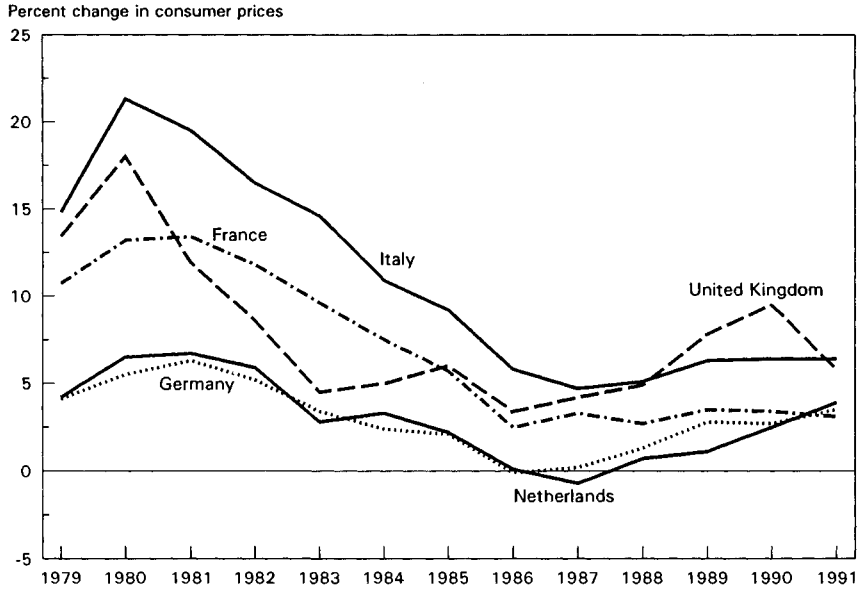
Note: Index is the value of domestic currency relative to the ECU (a weighted average of the currencies of the EMS).

Source: Banque Nationale de Paris.

the start of the 1980s to under 3 percent in 1992. Increasingly, the deutsche mark became the monetary anchor for the EMS.

To the extent that disinflationary policies can be linked to the EMS, this highlights an important rationale for the pegged exchange-rate system: to exert anti-inflationary discipline over domestic policies. An alternative view is that the disinflationary policies of various countries were not motivated by the EMS itself but were part of a more widespread movement to correct the inflationary excesses of the preceding decade. During the 1980s, inflation declined in many countries that did not participate in the pegged-rate system of the EMS, including the United Kingdom (which did not join the exchange rate mechanism of the EMS until 1990) and the United States. This fact suggests that the relative stability of EMS parities in recent years could have been the result, as much as the cause, of a convergence in rates of inflation. By implication, future changes in national priorities concerning inflation and growth, such as those that have occurred recently, would reduce the viability of a pegged exchange-rate system unless the members were willing to make more frequent adjustments to their pegs.

Chart 7-5 **Inflation Rates in Selected EMS Countries**
During the 1980s, inflation rates in EMS countries declined while differences in inflation rates across countries narrowed.



Source: International Monetary Fund.

The Maastricht Treaty on Economic and Monetary Union

The Maastricht Treaty of December 1991 is a blueprint for the replacement of the EMS by an Economic and Monetary Union (EMU) with a single currency and a European central bank overseeing a single monetary policy. Under the treaty, progress toward the EMU would take place in stages, with the final stage—when exchange rates are fixed irrevocably—to be initiated by 1999.

High standards for joining the EMU have been established, although there is still debate over how precisely these criteria will be applied. An entering country's inflation rate must not be more than 1.5 percentage points above the average of the three EC countries with the lowest inflation. Its interest rate on long-term government bonds cannot exceed those of the three members with the lowest inflation by more than 2 percentage points. The country's budget deficit must not exceed 3 percent of GDP, and outstanding government debt must not exceed 60 percent of GDP. For at least 2 years, the country's currency must have remained within its EMS band without realignment.

As of 1992, only three countries in the European Community appear to have met all these conditions: Denmark, France, and

Luxembourg. Three—Greece, Italy, and Portugal—met none. The difficulty of meeting these conditions suggests either that they may have to be relaxed, that it may be difficult to meet the 1999 target date, or that some countries may be admitted to the EMU only after they have had additional time to improve their economic performance. The chances of this last possibility, sometimes referred to as a "two-tier" or "two-speed" approach to monetary unification, may have increased because of the recent developments in European exchange markets and politics discussed below.

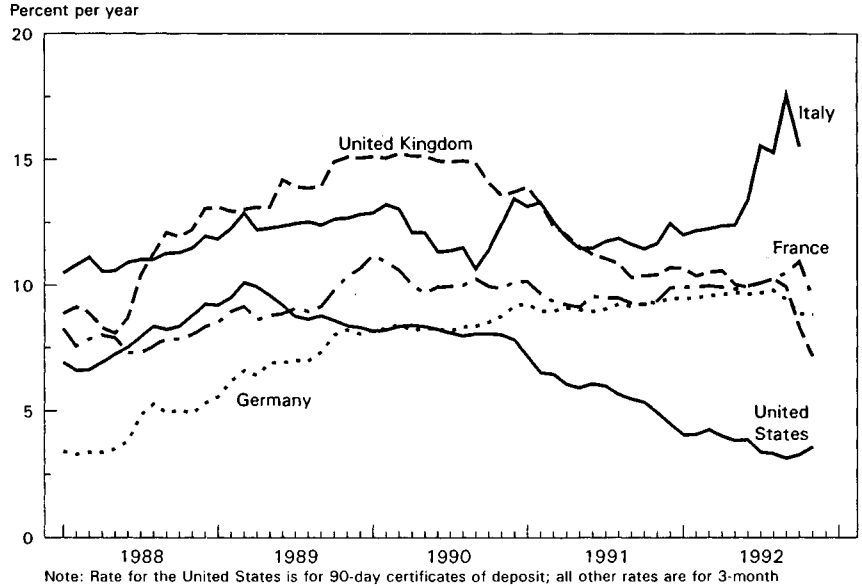
Recent Pitfalls in Progress Toward Monetary Unification

A development that potentially could slow progress toward the EMU is the partial collapse of the EMS in September 1992. A proximate cause of that event was the rise in interest rates and increased difficulty of supporting growth in Europe that accompanied the reunification of Germany in 1990, and that added to tensions within the EMS stemming from concerns over the declining competitiveness of some of its members' economies.

German reunification was a welcome development that helped to mark the end of the Cold War. However, the costs of raising productivity and providing a social "safety net" in the former East Germany sharply increased German government spending. The conversion in 1990 of most East German ostmarks into West German deutsche marks at a rate of 1-to-1 (a very favorable rate of exchange for the East Germans) further increased aggregate demand. An acceleration of German wage increases, largely reflecting attempts to reduce wage disparities between East and West Germany, added to inflationary pressures. In response to increased government expenditures and higher inflation, Germany tightened monetary policy rather than raising taxes enough to offset increased outlays. In consequence, the overall public sector budget deficit increased from 0.8 percent of gross national product, or output, in 1989 to over 6 percent in 1992, while the rise in interest rates that had begun in 1988 continued through 1992 (Chart 7-6).

In order to maintain their exchange rates within their prescribed bands, the other EMS countries were forced to increase their interest rates as well. Countries such as the United Kingdom, where interest rates and inflation had been declining, were prevented from further reducing interest rates. This tightening of monetary policy exacerbated the already existing slowdown in growth. In the United Kingdom, where output had declined to a level more than 4 percent below its previous peak and the unemployment rate had climbed above 10 percent by mid-1992, increasing pressure developed to either realign the pound or drop out of the EMS so that interest rates could be lowered. High interest rates were also weakening Italy's prospects of retaining its EMS parity by boosting in-

Chart 7-6 **Interest Rates in the United States and the Major European Economies**
Germany's interest rates have increased since 1988, leading other EMS countries to increase their interest rates or to lower them less than they might have otherwise.



Note: Rate for the United States is for 90-day certificates of deposit; all other rates are for 3-month interbank loans.
Source: Board of Governors of the Federal Reserve System.

terest payments on its large public debt, thereby increasing its fiscal deficit and posing the threat of higher inflation in the future.

Even without the difficulties posed by Germany's tighter monetary policy, Italy and the United Kingdom had been considered more likely to devalue than many other EMS members. Italy had maintained its nominal exchange rate essentially unchanged since 1987 but its inflation rate persistently exceeded the EMS average. Inflation in the United Kingdom also had exceeded the EMS average; additionally, there was concern that when the United Kingdom entered the EMS's exchange rate mechanism in 1990, it had pegged the pound at too high a level.

As the pressure of matching Germany's interest rates increased the cost of maintaining their nominal parities, both Italy and the United Kingdom began to experience massive capital outflows, eventually prompting them to float their currencies and suspend their participation, at least temporarily, in the exchange rate mechanism of the EMS in September 1992. In addition, selling pressure against the currencies of Ireland, Portugal, and Spain led these countries to re-impose temporarily limited exchange controls that in most cases had been dismantled previously under EC 92

goals. A subsequent episode of speculative pressure prompted the devaluation of the Portuguese and Spanish currencies within the framework of the EMS.

Recent pressure on exchange rates within the EMS has been heightened by a second major development in the past half year, the failure to achieve strong popular support for the Maastricht Treaty. In June 1992, Danish voters rejected ratification of the treaty. In September 1992, a French referendum endorsed the treaty by just 51 percent of the vote. These revelations of popular discontent with the Maastricht Treaty have raised concerns that the treaty may have to be revised or its implementation delayed.

PEGS TO THE DOLLAR AMONG DEVELOPING COUNTRIES

At present, about 27 countries as diverse as Argentina, Hong Kong, and Sudan unilaterally peg their currencies to the dollar. A number of developing countries also link their exchange rates to the currencies of other industrialized nations, particularly France. Notwithstanding the difficulties of maintaining a pegged exchange-rate arrangement, pegs may help to stabilize the economy if combined with appropriate macroeconomic policies.

Pegs to the dollar or other stable currencies offer two important benefits. First, the prices of many developing countries' traded goods are determined mainly in the markets of industrialized countries such as the United States, and so by pegging to the dollar or the currencies of other industrialized nations, these countries can stabilize the domestic currency prices of their exports and imports. This is probably the most important reason why some of the Asian newly industrializing economies have linked their currencies (with varying degrees of flexibility) to the dollar. Additionally, linking to the dollar could help to stabilize trade flows with the United States, their principal trading partner.

Second, and perhaps more important in recent decades, many countries with high inflation have pegged to the dollar in order to exert restraint on domestic policies and reduce inflation. At 3 to 4 percent annually, the U.S. inflation rate is well below inflation rates in the developing world. By making the commitment to stabilize their exchange rates against the dollar, governments hope to convince their citizens that they are willing to adopt the responsible monetary policies necessary to achieve low inflation. Pegging the exchange rate may thereby reduce inflationary expectations, leading to lower interest rates, reduced wage demands, a lessening of the loss of output as a result of disinflation, and a moderation of price pressures. In the 1980s various countries successfully augmented the initial phases of their disinflation programs with pegged exchange rates, including Israel in 1985 and Mexico in 1988.

However, the histories of countries with high inflation are replete with examples of failed disinflation programs based on pegged exchange rates. Typically, such programs fail because the government neglects to reduce budget deficits and continues to print money to finance them. These policies lead to continued inflation and an overvalued currency, causing a deterioration in the balance of payments and prompting capital outflows in anticipation of a subsequent devaluation. The authorities are then forced to devalue their currency, abandoning the linch-pin of the disinflation program. While exchange-rate policies may usefully support a disinflation program, the exchange-rate system is not a substitute for appropriate monetary and fiscal policies. In addition, to encourage economic growth as well as reduce inflation, responsible macroeconomic policies should be complemented with reforms aimed at strengthening the market system, including the removal of price controls, the privatization of state-owned enterprises and elimination of public monopolies, and the reduction of barriers to external trade.

Some countries have experimented with means of strengthening the discipline over domestic policies that pegged exchange rates provide. A currency board arrangement ties the domestic monetary base (bank deposits at the central bank plus currency in circulation), a primary determinant of the money supply, to the foreign exchange holdings of the monetary authority. The monetary base responds mechanically to the balance of payments, since the currency board purchases all foreign exchange offered to it at the official price and sells foreign exchange to all who demand it at that price. This automatically keeps the exchange rate fixed and prevents the government from issuing domestic currency to finance its budget deficit. In Hong Kong, which has linked its money supply to the dollar since 1983, inflation has averaged 7.7 percent annually. Argentina developed a slightly different mechanism, passing a law in 1991 fixing its currency against the dollar and requiring the central bank to hold international reserves at least equal to the monetary base (Box 7-4). This law limits the central bank's ability to finance the fiscal deficit, much as a currency board would, and has led to substantial declines in inflation.

Even when disinflation programs based upon pegged exchange rates succeed, factors such as wage contracts or slow-to-adjust expectations may slow inflation's decline and prevent it from falling quickly to international levels. As a result, currencies often become overvalued during disinflation programs, and countries adopting pegged exchange rates then face the challenge of devaluing their currencies later without reigniting inflationary expectations. For example, Israel and Mexico, as noted above, both initiated relatively successful disinflation programs based on pegged exchange rates

Box 7–4.—Pegged Exchange Rates and Disinflation in Argentina

Between 1982 and 1990, inflation in Argentina averaged almost 1,000 percent annually. Three major disinflation programs based on a pegged exchange rate, announced in 1985, 1988, and 1989, all failed to achieve a lasting reduction in inflation. In each case, continued budget deficits and monetary growth forced a devaluation that set the stage for further inflation. Inflation peaked at 197 percent per month in July 1989.

After March 1990, the government reduced the fiscal deficit while allowing the exchange rate to float. The exchange rate remained relatively stable, even though monthly inflation remained above 10 percent for most of the remainder of 1990. In March 1991, following another plunge in the value of the domestic currency, Argentina passed a law fixing the exchange rate against the dollar and requiring the central bank to hold international reserves exceeding, at that exchange rate, the value of the domestic monetary base. This meant that the central bank would have sufficient reserves to support the exchange rate, even if the entire domestic monetary base were exchanged for dollars. The law prevents the central bank from financing fiscal deficits on an extended basis, since that would cause money growth to exceed the growth of the central bank's international reserves.

So far, the "Convertibility Program," as the 1991 initiative was labeled, has been successful. Annual inflation has declined below 20 percent, its lowest level since the early 1970s, while interest rates on deposits, a key indicator of inflationary expectations, have declined to around 10 percent. The interest rate is well below the rate of inflation, but, as asset holders apparently consider a devaluation of the currency to be unlikely in the near future, they are willing to accept rates of return on deposits roughly comparable to those available in international financial markets. The success of the Convertibility Program shows how a pegged exchange rate can help to lower inflationary expectations and accelerate the process of disinflation. However, the program was credible only because it was preceded by nearly a year of budget tightening and because, by requiring international reserves exceeding the monetary base, it made continued budget tightening a necessity. This aspect of the fixed exchange-rate program distinguishes it from its failed predecessors. However, Argentina's inflation remains above international levels, underscoring the continued vulnerability of the stabilization program and the need for continued responsible fiscal and monetary policies.

in the 1980s. Because their inflation rates subsequently remained above international levels, however, both countries have had to adopt more flexible exchange-rate policies. This underscores the need for continued monetary discipline, even after inflation has declined significantly.

EXCHANGE ARRANGEMENT OPTIONS FOR THE FORMER SOVIET UNION

The demise of the Communist regime at the end of 1991 marked the beginning of a new era of hope and opportunity for the people of the former Soviet Union. Over time, market-based reforms promise to raise the standard of living and increase the potential for growth. However, systems of taxation, budgeting, and monetary control that were designed for a command economy have not been adequate to ensure macroeconomic stability in the transition to a market economy. Budget deficits in many of the new independent states (NIS) of the former Soviet Union, as well as subsidies extended by the central bank to state-owned firms, have soared. With the lifting of price controls, inflation has climbed as money is printed to finance these outlays. The plummeting value of the ruble has reduced people's desire to use and hold it. In some instances, this has led to barter trade, contributing to sharp reductions in output and a collapse of trade among the new states of the former Soviet Union.

In developing their monetary and exchange-rate policies, the new states face two distinct but interrelated issues. First, how should the ruble's value be stabilized, in terms both of goods and of other currencies? Second, what type of monetary and exchange-rate arrangement among the states would best support stabilization and continued intra-NIS trade? Additionally, the new states face the challenge of complementing policies to stabilize macroeconomic conditions with structural reforms aimed at establishing and protecting private property rights, encouraging competition and market-determined prices, privatizing state-owned firms, and fostering private entrepreneurship.

Stabilizing the Ruble

Toward the end of 1992, inflation in Russia was running at over 25 percent per month, largely due to the printing of money to cover government outlays and credit extended by the central bank to deficit-ridden industrial firms. As a result, the ruble's value has diminished substantially; it took about 140 rubles to buy one dollar in July 1992, when exchange rates for various transactions were combined into a single floating rate, while it took over 400 rubles to buy a dollar at the end of the year. At the time the single exchange rate was established, the ruble's market value was expected to fluctuate initially because of the unstable macroeconomic situa-

tion but then stabilize as economic reforms progressed, at which time the government planned to peg the exchange rate to the dollar or another "hard" (stable) foreign currency. At the end of 1992, economic reforms had not progressed sufficiently for the exchange rate to be pegged.

To help support the ruble when macroeconomic conditions improve, the G-7 countries announced in April 1992 the creation of a $6 billion currency stabilization fund, conditional on an economic reform program for Russia supported by the International Monetary Fund. Like the $1 billion 1989 stabilization fund for Poland, this fund would be used to support the ruble if its market price declined. The mere existence of this fund could stabilize the ruble by reducing the chances of devaluation and thus the incentive to speculate against it. In fact, the Polish stabilization fund was never drawn upon, although Poland devalued its currency in May 1991 and subsequently has adjusted its value regularly in order to maintain the country's competitiveness in the face of continued inflation.

Successfully stabilizing the ruble would increase the demand for domestic money, helping to reduce inflation; restore the currency's credibility as a medium of transaction, reviving business that had faltered when enterprises resorted to barter; and increase incentives to invest, promoting economic growth. However, pegging the ruble must be combined with appropriate domestic policies. The experience of various developing nations in the 1980s underscores the government's inability to peg the currency without cutting the budget deficit and reducing monetary growth. In the absence of such measures, an additional $6 billion in reserves could do no more than briefly delay a devaluation.

Options for a Monetary Arrangement for the NIS

The difficulties of stabilizing the ruble are compounded by the fact that it is the common currency of most of the new states of the former Soviet Union. While only Russia can create ruble banknotes, the central banks of the other states can create ruble bank deposits, thereby increasing the overall money supply. Additionally, some states—most notably Ukraine before it adopted its separate currency—have issued their own coupons which act as a substitute for ruble banknotes, partially in response to a shortage of such notes; in the first half of 1992, shipments of ruble banknotes from Russia to the other states were insufficient to keep up with increases in the demand for banknotes. Even if Russia were to substantially reduce government spending and subsidies to state enterprises and stop printing money to finance these outlays, money creation by other states could lead to continued inflation. Since each state enjoys the direct benefits of its monetary creation, while the

inflationary costs are spread throughout the NIS, the individual states have strong incentives to create rubles.

The deterioration of trade between the states is another pressing concern. The Communist regime created monopolies for many products throughout the former Soviet Union and located them in the different republics, so the new states are highly dependent on trade with each other. To monitor and control trade imbalances between Russia and the other states, at the start of 1992 Russia required all intra-NIS payments to be channeled through special "correspondent" accounts at the Russian central bank. Processing payments through these accounts has been extremely slow, impeding trade flows and further reducing production and sales throughout the NIS. Moreover, Russia has sought to limit the impact of monetary creation outside Russia by explicitly limiting the credit it will extend to other states through the correspondent accounts.

Various options for an intra-NIS exchange and monetary system that would address these problems have been considered.

Ruble zone. All members would continue to use the Russian ruble as their currency. The central banks of the individual states would agree on rules to limit monetary creation.

A ruble zone, like Europe's EMU, would have most of the features (both positive and negative) of a single-currency system. Ideally, it would both support intra-NIS trade by providing a common credible currency and, through its rules on ruble creation, restrain the states' monetary policies and lead to lower inflation. However, in the absence of a stable and credible ruble, some states may believe that they can do better by adopting their own currencies. Moreover, the lack of political cohesion among these states, as well as their difficult economic circumstances, means that the individual states are more likely than are the EMU members to break the zone's monetary rules or even depart from the zone entirely in order to pursue their own policies. In fact, the Baltic states and Ukraine adopted their own currencies in 1992, dropping out of the de facto ruble zone that has existed since the breakup of the Soviet Union.

Ruble area. In a ruble area, each state would create its own currency and have its own independent central bank (as various states already are doing) but would conduct intra-NIS trade in rubles. This system would be less constraining and possibly more sustainable than a ruble zone, since member states could adjust their exchange rates and follow independent monetary policies. However, unless Russia can sharply reduce its inflation rate and stabilize the ruble exchange rate against Western currencies, the other states may be unwilling to use the ruble.

Payments union. An alternative to using the ruble for intra-NIS transactions would be to use a hard currency such as the dollar or

deutsche mark. Because intra-NIS trade accounts for such a high proportion of economic activity in the NIS, however, each state would need to maintain hard currency reserves in considerable excess of their current holdings. One way to economize on the use of hard currencies would be to create a payments union.

In a payments union, gross payments flows between countries are recorded and net payments calculated; at regular intervals, countries settle their accounts, in whole or in part, in hard currencies. An arrangement of this type, the European Payments Union, was instrumental in supporting intra-European trade after World War II, when initially dollars and other reserve assets were scarce. Additionally, the European Payments Union helped to foster reductions in trade barriers within postwar Europe, and such an institution could play a similar role in the NIS.

THE FUTURE OF EXCHANGE-RATE RELATIONS

International exchange-rate arrangements continue to evolve. Because there are serious tradeoffs between the stability offered by pegged exchange-rate systems and the freedom to respond to shocks offered by more flexible currency arrangements, the most appropriate arrangement may vary over time and across countries. Nonetheless, there are strong advocates for a single global exchange-rate system. Some observers tie many of the current economic difficulties among industrial countries to marked swings in currency values, and advocate a return to a global pegged-rate system, as in the Bretton Woods era, to enhance policy coordination among the industrial countries and foster a more stable international economic environment. Conversely, others argue that slow growth and increased unemployment in Europe have been exacerbated by the commitment to maintaining parities within the EMS, and advocate floating exchange rates free of government intervention.

In fact, implementing a global exchange-rate system would entail serious difficulties. The United States, Germany, and Japan, with their different macroeconomic circumstances and priorities, may find little room for agreement on the common policies needed to sustain a pegged exchange-rate system. Conversely, a global system of floating rates would be unsatisfactory for many of the smaller countries, which would want to continue pegging their currencies to those of the major economies, either to stabilize their trade flows or to help maintain responsible domestic policies.

Under these circumstances, a number of regional exchange-rate blocs could evolve around a few major currencies, which would then float or otherwise move against each other. In the foreseeable future, the dollar will be the most important international currency, but other currencies may become the center of regional blocs. A

single European currency might become the basis of a Europe-centered bloc, while it is possible that the yen could perform a similar role in East Asia.

The development of such currency blocs might occur most naturally in the context of regional trading arrangements. This is most obviously the case in Europe, where the EMU is scheduled to follow the elimination of trade barriers and other obstacles to a single market that is taking place under EC 92. The development of a bloc of nations with currencies linked to the dollar may develop as NAFTA is extended to additional countries in the Western Hemisphere. If trading/currency blocs develop, however, it is essential that they remain outward looking, focusing on the elimination of internal barriers to the movement of goods and capital rather than on raising barriers to the rest of the world.

As regional economic arrangements develop rapidly in Europe and in the Western Hemisphere, it may be time for a systematic evaluation of the options for different exchange-rate arrangements.

SUMMARY

- Pegged exchange-rate arrangements can stabilize the environment for trade and provide incentives to avoid inflationary policies. However, pegged rates can also constrain domestic policies that could offset economic shocks and are likely to be unsustainable when national policies diverge.
- The Bretton Woods system, designed as a compromise between fixed and flexible exchange-rate systems, allowed pegged rates to be adjusted if external pressures became too great. However, the reluctance to adjust either official parities or domestic policies to maintain those parities made the Bretton Woods system increasingly vulnerable to increased capital mobility and divergences in national priorities, leading to its breakdown in the early 1970s.
- The EMS revived pegged exchange rates among a number of European countries in 1979. Recent developments, including German unification, have imposed great strains on the EMS, contributing to a slowdown in output and prompting Italy and the United Kingdom to float their currencies, raising concerns about future progress toward monetary unification.
- By exerting pressure to pursue responsible domestic policies, pegging to stable currencies like the dollar has helped some developing countries reduce their inflation rates. Such an arrangement may also be useful in the former Soviet Union, but it will be effective only if combined with fiscal and monetary restraint.

- Exchange-rate arrangements continue to evolve, and regional currency blocs built around the dollar, a single European currency, and perhaps the yen may develop.

THE CHANGING ROLE OF THE INTERNATIONAL MONETARY FUND

The International Monetary Fund (IMF) was envisaged by its creators at Bretton Woods as the institutional linch-pin of the international monetary system. In recent decades, however, its role in lending to the industrialized countries has diminished substantially, while its relationship with many developing countries has evolved considerably beyond temporary balance of payments financing. This evolution reflects important changes in the international financial system itself.

THE IMF IN THE BRETTON WOODS ERA AND AFTERWARDS

The IMF initially was intended to serve three functions in the Bretton Woods system: overseeing the system of pegged exchange rates, providing temporary financial assistance to countries with balance of payments problems (conditional on their adjusting domestic policies appropriately), and working to eliminate restrictions on transactions in foreign exchange that could limit the growth of international trade. It soon became apparent, however, that the IMF would not be as powerful as might initially have been intended. The resources provided by the United States under the Marshall Plan immediately after World War II largely dwarfed those available from the IMF, reducing the new institution's leverage over national policies. Subsequently, U.S. payments deficits continued to increase global liquidity and reduce dependence on the IMF for funding.

The move to floating exchange rates in the 1970s further reduced the need to draw on IMF resources, since governments no longer had to defend pegged exchange rates. The floating-rate system also transformed what initially had been envisaged as one of the IMF's key functions, the oversight of currency parities, although the IMF Articles of Agreement were amended in 1978 to authorize the institution to "exercise firm surveillance over the exchange-rate policies of members." Finally, the growing international integration of capital markets provided the industrialized countries with alternatives to the IMF. In particular, after the oil price increases of the 1970s, additional funds became available in the Eurodollar markets as the oil-exporting countries invested their surplus dollars. The last IMF loans to major industrial countries in support of adjust-

ment programs were made to Italy and the United Kingdom in 1976.

Conversely, the oil shocks increased the financing needs of the oil-importing developing countries. While some of these countries were able to obtain commercial bank loans, this source of funding evaporated with the debt crisis of the early 1980s, when excessive accumulations of debt and rising global interest rates made it difficult for developing countries to repay their existing loans. In the 1970s and 1980s, the developing countries came to depend increasingly on the IMF for financing. The proportion of IMF credit outstanding extended to developing countries rose from an average of 58 percent in the 1950s to 65 percent in the 1970s and 100 percent in the 1980s.

LONG-TERM FINANCING, THE IMF, AND THE WORLD BANK

With the shift in focus from developed to developing countries have come other changes in the role of the IMF. First, the IMF has evolved from a type of credit union whose members took turns as temporary borrowers and lenders to a financial intermediary between developed and developing countries. A second and related development is that the current recipients of IMF loans typically do not suffer from purely transitory payments imbalances, but from longer term payments difficulties associated with sustained structural imbalances and poor macroeconomic policies. As a result, some countries have undergone prolonged sequences of IMF programs, many of them never fully implemented. Increasingly, observers have recognized that solving the payments problems of some countries may require long-term programs of structural adjustment such as those supported by the IMF's Extended Fund Facility, which was created in 1974.

The Extended Fund Facility, and particularly the structural adjustment facilities developed for low-income countries in the 1980s, is similar in time frame and objectives to the Structural Adjustment Loan program initiated by the World Bank in 1980. The World Bank, created along with the IMF at the 1944 Bretton Woods Conference, is an investment bank that traditionally has sustained much longer financing relationships with its members than has the IMF. The World Bank initially focused on financing specific projects such as roads, dams, power stations, agriculture, and education, but its activities subsequently evolved to include support for broader programs of structural reform such as the Structural Adjustment Loan program. As a result, the activities of the World Bank and the IMF increasingly have begun to parallel each other.

The ongoing efforts to assist the former Communist economies provide a good example of the convergence of roles between the IMF and the World Bank. While many of these economies certainly require financial assistance to meet their balance of payments deficits, their major problems are long term and linked to the need to develop strong market-oriented economies and credible macroeconomic policies. The IMF is an important conduit of technical assistance in the areas of macroeconomic analysis and exchange-rate policy, although its advice has at times been quite controversial. At the same time, the World Bank has been active in assisting these countries to privatize state-owned enterprises, restructure their financial sectors, and liberalize prices.

Despite the increasing similarity of their activities, the institutions clearly differ in their areas of focus: The IMF has a comparative advantage in macroeconomic policy analysis, and the World Bank is better qualified to provide assistance in the design of specific projects and sectoral reform programs. Because progress toward macroeconomic stabilization and microeconomic reforms are mutually dependent, close coordination between the IMF and World Bank is essential. Discussions on the division of responsibility between the IMF and the World Bank led in 1989 to an agreement reaffirming the IMF's focus on macroeconomic and balance of payments issues and the World Bank's primary role in microeconomic and structural issues. It also strengthened the process of collaboration and coordination between the two institutions. However, the evolution of the roles of the IMF and the World Bank will continue to be important to the world economy in the coming years.

SUMMARY

- The move to flexible exchange rates in the 1970s and the increasing integration of global capital markets has reduced the IMF's role in providing financing for the industrialized nations. The focus of the IMF has shifted toward providing technical assistance and recurrent financing to the developing countries, bringing its activities closer to those of the World Bank.

THE NORTH AMERICAN FREE TRADE AGREEMENT

The United States, Canada, and Mexico reached an agreement on NAFTA in August 1992. NAFTA will create a free-trade area with more than 360 million consumers and over $6 trillion in annual output, linking the United States to its first- and third-largest trading partners (Box 7-5). NAFTA will stimulate growth, promote investment in North America, enhance the ability of North

American producers to compete, and raise the standard of living of all three countries. NAFTA will also speed up technological progress and provide innovating companies with a larger market. Many economic studies show that NAFTA will lead to higher wages, lower prices, and higher economic growth rates.

NAFTA will also reinforce the market reforms already under way in Mexico. In recent years, Mexico has opened its markets and implemented sweeping economic reforms. In 1986 Mexico joined GATT and began unilaterally to lower its tariffs and other trade barriers. In mid-1985, for example, the production-weighted tariff in Mexico was 23.5 percent, but by 1988 it was only 11 percent. Mexico's reforms have raised its economic growth rate, making it an important export market for the United States. As economic opportunities in Mexico improve, Mexican workers have fewer incentives to migrate to the United States.

A stable and prosperous Mexico is important to the United States, from both an economic and a geopolitical standpoint. The United States shares a border roughly 2,000 miles long with Mexico. In addition, the United States and Mexico are linked by centuries-old ties of family and culture. NAFTA will help the two countries forge a lasting relationship based on open trade and cooperation.

Existing duties on most goods will be either eliminated when the agreement enters into effect or phased out in 5 or 10 years (for certain sensitive items, up to 15 years). Approximately 60 percent of U.S. industrial and agricultural exports to Mexico will be eligible for duty-free treatment within 5 years. NAFTA will also eliminate quotas along with import licenses unless they are essential for such purposes as protecting human health.

In addition to dismantling trade barriers in industrial goods, NAFTA also includes agreements in services, investment, intellectual property rights, agriculture, and the strengthening of trade rules. There are also side agreements on labor provisions and protection of the environment.

TRADE IN SERVICES AND INVESTMENT

Under NAFTA, the three countries extend both national treatment and most-favored-nation treatment in services to each other. Each NAFTA country must treat service providers from other NAFTA countries no less favorably than it treats its own service providers and no less favorably than it treats service providers from non-NAFTA countries. In addition, a NAFTA country may not require that a service provider of another NAFTA country establish or maintain a residence as a condition for providing the service.

Box 7-5.—Free-Trade Areas and Customs Unions

In a free-trade area such as NAFTA, substantially all barriers to trade among the member countries are eliminated, while each participant maintains its own individual trade barriers with nonmembers. In contrast, a customs union such as the European Community not only eliminates internal barriers among members, but also establishes a common external tariff on imports from nonmembers.

Producers from outside a free-trade area have an incentive to ship products through the low-tariff member and then reship it duty free to a high-tariff member. The problem of transshipment arises whenever tariffs with nonmembers differ among members in a free-trade area.

The standard method of dealing with the transshipment problem is to confine duty-free benefits to products originating within the free-trade area. This practice requires that rules of origin be established to determine those products that fall into this category. NAFTA bases its general rules on changes in tariff classification. A product is classified as originating within North America if imported parts or materials have been transformed enough to shift the product to a different tariff classification. There are also specific rules of origin for products such as textiles, automobiles, and computers.

The transshipment problem does not arise in a customs union, since all members have the same external tariff. Under NAFTA, the external tariff will be the same for some products, likewise eliminating the transshipment problem. For example, the external tariffs of the member countries will eventually be harmonized and set at zero for certain computer products.

NAFTA eliminates discriminatory restrictions on U.S. sales to and investments in the Mexican telecommunications market. Specifically, NAFTA gives U.S. providers of voice mail and packet-switched services nondiscriminatory access to the Mexican public telephone network and eliminates all investment restrictions in this sector by July 1995.

In financial services, Mexico's closed markets will be opened, allowing U.S. and Canadian banks and securities firms to establish wholly owned subsidiaries. In insurance, firms with existing joint ventures will be permitted to obtain 100 percent ownership by 1996, and new entrants can obtain a majority stake in Mexican firms by 1998. By the year 2000, most equity and market share restrictions will be eliminated.

For investment, NAFTA will in most cases require that investors of the parties be treated the same as domestic investors. For all industries, the agreement will eliminate a variety of performance requirements such as minimum export levels and preferences for domestic sourcing. NAFTA investors will be able to convert local currency into foreign currency at the prevailing market exchange rate for transactions associated with an investment. Each NAFTA country will ensure that such foreign currency may be freely transferred among NAFTA countries. No NAFTA country may directly or indirectly expropriate the investments of NAFTA investors, except for a public purpose and in accordance with law.

INTELLECTUAL PROPERTY RIGHTS

NAFTA protects inventions by requiring each country to provide product and process patents for virtually all types of inventions, including pharmaceuticals and agricultural chemicals. Copyrights of computer programs and databases, as well as rental rights for computer programs and sound recordings are also protected—sound recordings for at least 50 years. Service marks and trade secrets are also covered, along with integrated circuits both directly and as components of other products.

AGRICULTURAL TRADE

Over a period of 15 years, NAFTA will virtually eliminate barriers to trade in agricultural commodities between the United States and Mexico. About 50 percent of the agricultural trade between the two countries will be free of all trade barriers as soon as the agreement takes effect. For remaining products, the phaseout will take between 5 and 15 years. For most tariffs imposed by the United States, the phaseout will simply involve an annual reduction in the tariff rate.

The phaseout for remaining nontariff barriers such as quotas is more complicated. Initially, they will be replaced by tariff-rate quotas that allow products to be imported in limited quantities at a low (or zero) tariff rate and impose high tariffs for quantities above the limit. The tariff-rate quotas will be phased out over a 10- to 15-year period by increasing the quantity limit and/or reducing the tariff applied to imports above the limit.

Liberalization of agricultural trade between the United States and Canada continues as agreed to in the United States-Canada Free-Trade Agreement, under which existing tariffs on all agricultural commodities will be eliminated by 1998, while nontariff barriers for dairy products, poultry, eggs, and sugar will remain. In a separate agreement under NAFTA, Canada and Mexico agree to eliminate tariffs on bilateral agricultural trade between the two countries, exempting dairy products, poultry, eggs, and sugar. The

three NAFTA countries also agree to move toward domestic agricultural policies that are more conducive to free international trade and to work toward eliminating export subsidies for agricultural products.

NAFTA is expected to lead to substantial increases in agricultural trade between the United States and Mexico. For example, as a direct result of NAFTA, U.S. wheat and corn exports to Mexico are expected to grow by about 40 and 50 percent, respectively, and Mexican exports of some fresh vegetables to the United States are expected to increase.

SAFEGUARDS AND OTHER TRADE RULES

During the transition period, if increases in imports from a partner country cause or threaten to cause serious injury to a domestic industry, a NAFTA country may take a safeguard action that either temporarily suspends the agreed duty elimination or re-establishes the pre-NAFTA duty. If a NAFTA country undertakes a global or multilateral safeguard action, each NAFTA partner must be excluded unless its exports account for a substantial share of the total imports and they contribute importantly to the serious injury or the threat of serious injury.

In reviewing antidumping and countervailing duty determinations, binational panels will substitute for domestic judicial review. Under antidumping laws, duties may be imposed when a foreign firm is found to be dumping—exporting its product at a price that is below either the selling price in its home market or the cost of production. Countervailing duty law allows the imposition of duties on imports that are subsidized by foreign governments. Both the importing and the exporting countries can request a review. A panel must apply the domestic law of the importing country in reviewing the disputed determination. NAFTA preserves the right of each country to retain its own antidumping and countervailing duty laws. The panel's decisions will be binding.

Dispute resolution can involve several stages. First, a country may request consultations. If the consultations fail, it may call a meeting of the Trade Commission, which will include Ministers designated by each country. If the issue remains unresolved, a panel is convened to make findings of facts and determinations according to NAFTA. Upon receiving the panel's reports, the disputing countries are to agree on the resolution of the dispute. If a panel finds that a complaint is justified but the countries cannot reach an agreement, the complaining country may suspend equivalent benefits.

THE ENVIRONMENT AND LABOR

The three countries are committed to implementing the agreement in a manner consistent with environmental protection. The agreement requires that international environmental agreements regarding endangered species, ozone-depleting substances, and hazardous wastes take precedence over NAFTA provisions. NAFTA countries recognize that it is inappropriate to encourage investment by relaxing domestic health, safety, or environmental measures.

The agreement affirms the right of each country to choose what it considers appropriate measures to protect human, animal, or plant life, health and the environment. In February 1992, the Governments of the United States and Mexico announced the integrated U.S.-Mexico Environmental Border Plan, a multiyear program to improve protection of human health and natural ecosystems along the border. The United States and Mexico will spend well over $1 billion during the next several years to implement the plan's first stage. In September 1992 a new U.S.-Mexico bilateral agreement on environmental cooperation was initialed. The agreement establishes a joint committee which will meet at least annually to oversee joint work programs and to assess environmental issues, which may include enforcement, pesticides, waste management, responses to chemical emergencies, and pollution.

In the area of labor adjustment assistance, the Administration announced in August 1992 a new comprehensive worker adjustment program—Advancing Skills through Education and Training Services. This program will nearly triple the resources now available for all worker adjustment by providing $2 billion annually, of which at least $335 million is specifically reserved for workers affected by NAFTA.

The U.S. and Mexican labor ministries have been implementing a 1991 memorandum of understanding addressing issues ranging from worker rights to child labor. In September 1992 the United States and Mexico signed a new agreement establishing a Consultative Commission chaired by the U.S. and Mexican Secretaries of Labor that will provide a permanent forum for promoting the rights and interests of workers in both countries. It will manage new and ongoing cooperative labor activities directed at enhancing workplace health and safety and enforcement, among other things.

OTHER REGIONAL AND BILATERAL TRADE DEVELOPMENTS

In addition to NAFTA, there have been several important recent developments in trade, including the Enterprise for the Americas Initiative (EAI), the market access agreement with China, and the Airbus accord.

Enterprise for the Americas Initiative

The agreement for a free-trade area in North America is only the beginning. The EAI, proposed by the Administration in June 1990, addresses trade, debt, and investment issues in a comprehensive manner. The trade and investment aspects of EAI aim to open up markets and increase investment flows throughout the hemisphere. The ultimate objective is to create a free-trade area stretching from Alaska to Argentina. The United States has signed trade and investment framework agreements with a majority of countries in Latin America and the Caribbean, which establish principles governing mutual commercial relationships. They also set up trade and investment councils, which provide an important mechanism for discussing trade and investment liberalization, and protecting intellectual property rights.

Market Access Agreement With China

The market access agreement with China signed in October 1992 will provide greater export opportunities for the United States. China has committed to removing import restrictions, such as import licensing requirements and quotas, from hundreds of products. This agreement commits China to substantially liberalize its import administration and to make reforms that would lay the foundations for a more prosperous China and a closer trade relationship between the two countries.

Among many commitments in the agreement, China's decision to make its trade regime transparent is of long-term importance and it moves China toward compliance with GATT rules. No later than October 10, 1993, China will, among other things, publish regularly and promptly all relevant trade laws and regulations. China has also agreed to remove 75 percent of all nontariff import restrictions within 2 years. In addition, China will reduce tariffs on many of the 90 categories of commodities for which tariffs have been raised since 1988.

The Airbus Agreement

In July 1992, the United States and the European Community signed a bilateral agreement limiting government subsidies and other forms of support for large civilian aircraft programs. This agreement is a step forward in limiting trade conflicts in an important industry. It prohibits all future production subsidies. Funds advanced by governments for aircraft development will be limited to 33 percent of total development costs. The agreement also establishes terms and conditions for repayment of development funds advanced by governments. Efforts are now underway to negotiate a multilateral agreement limiting aircraft subsidies.

SUMMARY

- The Administration has successfully negotiated an agreement with Mexico and Canada that will open up markets for trade and investment in North America.
- NAFTA will eliminate most barriers to trade among Canada, Mexico, and the United States; open markets in banking, insurance, and telecommunication among them; ensure nondiscriminatory treatment for NAFTA investors within the three countries; protect intellectual property rights among NAFTA countries; and provide dispute settlement mechanisms. There are also side agreements on environmental protection and labor provisions.
- NAFTA will reinforce the market-based economic reforms under way in Mexico. As the Mexican economy grows, it will continue to provide the United States with a valuable market for exports. The EAI addresses trade, debt, and investment issues throughout the hemisphere.
- The market access agreement with China will provide U.S. firms with increased access to the growing Chinese market and move China toward compliance with GATT rules. The Airbus agreement provides limits on subsidies to the civilian aircraft industry in the United States and the European Community.

THE URUGUAY ROUND

The Uruguay Round of multilateral trade talks aims not only to lower tariffs on merchandise trade but also to integrate into GATT areas of trade and investment that have not been subject to effective GATT disciplines. These areas include agriculture, textiles, trade in services, investment, and intellectual property rights. The Uruguay Round has also made progress in reforming GATT rules, especially safeguards and other trade rules and dispute settlement procedures. A breakthrough in the agricultural negotiations in November 1992 has improved prospects for a successful completion of the round, but some issues remain to be settled.

The potential rewards for success in the Uruguay Round negotiations are great, as are the potential costs of failure. Failure to conclude the Uruguay Round successfully would not only deny us the benefits of faster growth, it could also lead to a backsliding toward greater barriers to, and contraction in, international trade, and a resulting drag on living standards in the United States and around the world.

AGRICULTURE

Throughout the Uruguay Round negotiations, the most difficult issue has been agriculture. The Uruguay Round agenda for agricul-

334-230 O—92——11 (QL3)

ture includes transforming nontariff trade barriers into tariffs as well as reducing tariffs, domestic support of agriculture, and export subsidies. Agreement has been difficult to reach on all of these issues, especially on how much to reduce domestic support of agriculture and subsidies of agricultural exports. The lengthy and contentious negotiations on agriculture illustrate how domestic political interests may conflict with trade liberalization. Box 7-6 describes another such example.

Virtually every developed country in the world subsidizes agricultural products. In 1986, at the beginning of the Uruguay Round, government programs accounted for almost 80 percent of the value of agricultural products in Japan, over 40 percent in the EC, and over 30 percent in the United States. (The 1988 *Report* discusses this in more detail.)

These subsidies interfere with world trade by increasing the degree to which countries are self-sufficient in food production. In many instances, the subsidy raises domestic prices for farm products above world prices and necessitates quotas or tariffs to keep out lower-priced imported agricultural products. The subsidies can even increase domestic production to such an extent that the country builds up surpluses that are disposed of on world markets. Countries whose agricultural production costs are relatively high can compete against countries whose production costs are low only by directly or indirectly subsidizing exports. Because this practice limits export markets for countries whose production costs are at or near world price levels, some of these countries may react by adopting subsidies of their own.

The Uruguay Round negotiations began with the general intention of liberalizing agricultural trade. The initial U.S. proposal in 1987 was that all subsidies—direct and indirect, domestic and export—that distort agricultural trade should be gradually but totally eliminated over a 10-year period. This proposal was not accepted by other countries however, and negotiations continued for several years without a successful resolution. In 1991, the GATT Director General attempted to move the negotiations forward by proposing a draft text that continued to serve as the basis for negotiations throughout 1992. The current draft negotiating text, often referred to as the "Dunkel Text," called for reductions in (but not elimination of) internal agricultural supports and export subsidies. In addition, all nontariff barriers would be converted to tariffs and old and new tariffs would be reduced by an average of 36 percent. Finally, countries would be required to open their agricultural markets to international competition, so that exporting countries would have at least a minimum level of access to a country's market. Although the current draft negotiating text is less ambitious than the United States and some other countries had hoped

Box 7–6.—The Oilseeds Dispute

In December 1987, U.S. farmers complained that exports of soybeans and other oilseeds to the EC were being unfairly restricted by a program that encouraged the production of oilseeds in the EC. In the 1960–61 Dillon Round of GATT negotiations, the EC had agreed to make a concession to oilseeds exporters by setting its oilseeds tariff at zero. At that time individual EC countries had no widespread system of supports for domestic oilseed production. By the early 1980s, the EC had adopted an oilseeds support program that increased domestic supply, reduced growth in demand for imported oilseeds, and, according to international trade law, "impaired the value of the concession."

The U.S. Government instituted an investigation to determine the validity of this complaint. As the investigation proceeded, the United States asked GATT to establish an expert panel and issue an opinion. In December 1989, the expert panel agreed that the U.S. complaint was justified and recommended that the EC end or modify its oilseeds program to remove the impairment. In October 1991, the EC approved substantial modifications in the oilseeds program. However, the GATT panel studied the modifications and found, in March 1992, that they were not sufficient to bring the EC into conformity with its GATT obligations.

In accordance with Section 301 of the Trade Act of 1974, the U.S. Government threatened to impose tariffs on $1 billion worth of imports from the EC if the EC did not take appropriate actions. Intense negotiations between the United States and the EC continued throughout the summer and fall of 1992, but no solution could be found that would fully compensate U.S. oilseed farmers for their lost market.

On November 5, the United States announced that it would impose a 200 percent tariff on over $300 million of EC exports, primarily white wine, starting on December 5. The United States deliberately announced a retaliation for only part of the damage caused to its trade by the EC policies in order to leave the door open for further negotiations while making clear its intention to insist on its rights under GATT.

Later in November, the United States and the EC reached an agreement in principle resolving the oilseeds dispute. Among other things, the EC agreed to reduce the area on which oilseeds will be grown by reducing program payments if plantings exceed specified area limits. With the agreement in place, the U.S. withdrew its threat to retaliate.

for, it nevertheless represents a significant step. For the first time domestic agricultural policies would be submitted to effective GATT discipline and support levels and export subsidies would be reduced.

In the meantime, some countries have taken steps to reduce their agricultural subsidies, largely because the subsidies are becoming so costly. The United States moved toward a more market-oriented agricultural policy with the 1985 and 1990 farm bills and budget legislation. Government outlays for agricultural support fell from almost $26 billion in 1986 to about $10 billion in 1991. The changes brought about by these laws put the internal support targets of the current draft negotiating text within easy reach for the United States.

In the EC, however, the cost of agricultural subsidies continued to escalate (Table 7-3). In the spring of 1992 the EC adopted a new set of internal agricultural policies, called Common Agricultural Policy (CAP) reform, which represented a major departure from previous policy. The old method of supporting crop farmers by keeping farm prices above world levels was phased down, and a new method of directly subsidizing farm incomes was adopted. CAP reform represents significant progress, but still falls short of the standards in the current draft GATT negotiating text.

TABLE 7-3.—*Common Agricultural Policy Expenditures, EC agricultural trade, and EC self-sufficiency for selected commodities: 1975-1990*

[Millions of dollars]

	1975	1980	1985	1990
Total expenditures[1] [2]	5,612	15,739	15,125	33,676
per capita (dollars)	22	60	55	103
Export subsidies[2] [3]	1,457	7,922	5,125	9,830
EC agricultural exports[4]	11,648	27,580	25,067	44,800
EC agricultural imports[4]	29,684	51,258	39,874	71,200
Degree of self-sufficiency[5]				
Wheat	101	117	124	127
Beef	99	104	106	100
Fresh vegetables	95	99	107	106

[1] Data for 1975 and 1980 refer to EC-9; for 1985 to EC-10; for 1990 to EC-12.
[2] CAP spending refers to Guarantee Section expenditures.
[3] Export subsidies are expenditures for export refunds.
[4] Trade data are for EC-12 and exclude intra-EC trade.
[5] Self-sufficiency is the ratio of domestic consumption to production. For 1975 and 1980, values refer to marketing years ending in those years. Values for 1985 are from marketing year 1985/86, except for beef which is from 1986/87. The 1990 values for wheat, beef and vegetables are from 1989/90, 1989, and 1987/88 respectively.

Sources: Department of Agriculture and Commission of the European Communities.

In November 1992 the United States and the EC reached an agreement on the major elements that had blocked progress in the multilateral negotiations in Geneva. Under the agricultural agreement, aggregate internal subsidies would be reduced by 20 percent, and export subsidies would be reduced by 36 percent in value and 21 percent in volume over 6 years. To complete the Uruguay Round, this agreement between the United States and the EC must be agreed to by other parties to the negotiations, and multilateral

agreements on remaining agricultural and nonagricultural issues must be reached.

TEXTILES AND OTHER IMPORTANT ISSUES

For decades, international trade in textiles and apparel products has effectively been exempted from GATT rules. Instead, agreements have been established under the Multi-Fiber Arrangement to limit textile and apparel exports from developing to developed countries. These limits cost American consumers an estimated $11 billion in 1987. Under the current draft negotiating text for GATT, 51 percent of the volume of textile products covered by the Multi-Fiber Arrangement would be free of quotas in 10 years. After 10 years, quotas would be eliminated and textiles would be reintegrated into general GATT rules. All countries, including developing countries, would cut their trade barriers in textiles significantly.

A successful Uruguay Round will also yield GATT rules governing trade and investment in services such as telecommunication and financial services. Negotiations have led to agreements on some trade-related investment measures. For example, the current text prohibits requirements that foreign firms use a predetermined amount of locally produced goods. A successful round could also provide protection for intellectual property rights such as patents, copyrights, and trademarks.

The current draft negotiating text prohibits voluntary export restraints and other similar measures often used as safeguards outside GATT rules. It sets specific time limits on the dispute settlement panels and provides for automatic adoption of their reports. (Further details of the current draft negotiating text may be found in the 1992 *Report*).

SUMMARY

- The Uruguay Round aims at extending and tightening multilateral trade and investment rules in areas such as agriculture, textiles, services, investment, and intellectual property rights. Substantial progress has been made, but final agreement has not been reached.
- The most difficult area in the Uruguay Round has been agriculture. Negotiations continue in order to multilateralize the U.S.-E.C. breakthrough in agriculture and other areas.

REGIONAL INTEGRATION AND MULTILATERALISM

Regional integration such as NAFTA can further promote free trade. The administration's objective is to expand open and transparent trade worldwide. Government policies should be aimed at

opening rather than closing markets. Multilateral, regional, and bilateral trade agreements are instruments to realize such an objective. Multilateral integration is the most important, with regional integration and bilateral agreements fulfilling a complementary role. GATT permits the creation of free-trade areas and customs unions under two main conditions. Trade barriers must be eliminated on substantially all trade within the region. In addition, regional integration must not result in duties and regulations for outside countries that are more restrictive than original barriers. These conditions make it more likely that regional integrations will have an overall liberalizing impact, and will not promote trade within the region at the expense of trade with outside countries.

Regional integration and multilateral efforts to reduce worldwide trade barriers have often gone hand in hand. For example, despite controversies, the integration of the European Community in the 1950s and the 1960s was accompanied by the Dillon Rounds and the Kennedy Rounds of multilateral liberalization. Furthermore, for countries that are left out of the regional groupings, there may be added incentives to accelerate the process of multilateral liberalization to ensure that the benefits of freer trade will not be confined to members of regional agreements. Regional integration can also help countries identify issues that are outside the scope of GATT and later resolve them in a multilateral setting. For instance, the issues of extending and strengthening GATT rules to services, investment, and intellectual property rights have been successfully negotiated in NAFTA, providing useful experience for negotiating the same topics in the Uruguay Round.

Though economic integration consistent with GATT will generally promote greater well-being for all participants, some economic objections can be raised against regional trade arrangements. Primary among these is trade diversion, which occurs when member countries switch from importing from a low-cost nonmember country to importing from a higher cost member country because the countries outside the area do not benefit from the tariff cuts among the members. Trade diversion distorts the trading pattern and hurts countries outside the trading area.

The amount of trade diversion can be minimized if regional integration brings together countries that are already trading intensively with each other such as Canada, Mexico, and the United States through NAFTA and the European economies through the European Community.

SUMMARY

- Regional integration promotes trade within the free-trade area. Trade may be diverted away from efficient producers in nonmember countries. Regional free-trade associations can mini-

mize potential risks by remaining within GATT guidelines. The risk of trade diversion is less when a free-trade area is made up of countries that already trade intensively with each other.

TRADE POLICY AGENDA FOR THE FUTURE

The ratification of NAFTA and the satisfactory conclusion of the Uruguay Round are the two immediate trade priorities. Next will be the successful implementation of NAFTA and the round. While GATT has contributed significantly to a more open and harmonious world trading system, new areas in trade will arise as the world economy evolves. The international community will face several important trade issues in the not-too-distant future.

INTERNATIONAL TRADE AND COMPETITION POLICY

Within nations, governments have antitrust laws to enforce competition and prevent predatory practices by large firms. When more than one country is involved, however, policies promoting competition become more complex. Faced with unfair competition from abroad, firms generally do not have the option of antitrust actions, and often turn to antidumping actions instead. Some critics have observed that—unlike domestic antitrust enforcement which generally lowers prices—antidumping actions raise prices. One solution is to make competition policies more compatible among nations, and enforceable across borders.

NAFTA contains provisions that the three countries will cooperate on issues of competition law enforcement and other antitrust issues. It also imposes rules on federal monopolies and on any designated privately owned monopoly. Each country must ensure that the monopolies do not engage in anticompetitive practices, including dealings with an enterprise with common ownership operating in a different country. A trilateral committee will be set up to consider the relationship between competition laws and trade in the NAFTA countries.

Competition policy in the EC is a special case. Firms in member states of the EC cannot initiate antidumping actions against firms from other member states, because competition policy is a community-wide issue. Antidumping actions can only be taken against firms from nonmember countries.

Given the increasing linkages between international trade and antitrust policies, there probably will be more attention paid to this area. Multilateral efforts can resolve potential frictions and help achieve economic efficiency and trade liberalization supported by nondiscriminatory, transparent trade and competition rules.

TRADE RULES FOR HIGH-TECHNOLOGY INDUSTRIES

Increasingly, trade disputes involve government support for high-technology industries. Some have expressed concern that unless the United States provides preferential treatment, subsidies, and/or trade restrictions to help high-technology industries, some of these industries may not survive domestically. Economists generally doubt the merits of government intervention in industries unless market failures are clearly identified. If there are market failures they are likely to occur at the early stage of research and development. At the generic and pre-competitive stage of research and development, the fruits of research may be hard to capture. But even when the benefits of research cannot be fully appropriated by the market, this does not mean that the government should automatically step in. The economic benefits of government-sponsored research must also be weighed against their costs. The role of government-sponsored research in our economy must be considered in light of two standards: Appropriability and the balance of costs and benefits.

If the U.S. Government had a policy of choosing specific technology for massive government subsidy in the past quarter century, it is quite possible that we would have supported the supersonic passenger airplane and the development of a high-definition television technology that soon proved to be obsolete. Neither of these projects—which attracted strong support at the time—would have represented a good investment. For example, the development of high-definition television has already cost the Japanese government more than $700 million, with little prospect of recovering the investment. As for the supersonic aircraft, the British and the French Governments paid for the development of the Concorde. The results have been a commercial disaster. Concordes are extremely expensive to run and only a few Concordes have been sold. It is sometimes argued that the chances of failure can be lessened by having choices made by a governmental technical group, divorced from political pressures. There is no reason to believe, however, that a governmental group would be better at making correct choices than private individuals putting their own capital at risk. Moreover, it is naive to believe that the spending of large sums by the government can be kept free of the political process. Nor is it self-evident that this would be desirable in a democratic system.

In spite of the difficulties in picking "winners," a number of governments are likely to continue active participation in research and development activities, which could lead to an international competitive race to subsidize high technology. To limit this danger, bilateral and multilateral mechanisms may be needed to identify what types of support may be legitimate. In the aircraft industry, for example, the United States and the EC recently agreed to limit

development subsidies and prohibit future production subsidies. This agreement demonstrates how nations can cooperate on questions of government support.

TRADE AND THE ENVIRONMENT

Trade and environmental issues have become intertwined in recent years. Some accuse GATT of being hostile to the environment, while others argue that some environmental policies are only disguised protectionism. Generally, economists view international trade as an effective means of promoting economic growth and a higher standard of living. By improving the allocation of resources and access to the world market, trade will provide more resources and better technology to clean up the environment. In addition, as nations grow richer through open trade and the overall quality of life improves, people will prefer and demand a cleaner and better environment.

From an economic standpoint, environmental problems may require government action when prices do not reflect environmental costs. But, even if these environmental problems exist, trade restraints are usually not the best policy. If the environmental problem is limited to one country, domestic policies should be employed. Where pollution or other environmental problems spill across borders, however, international rules and cooperation will be necessary.

There are three main international environmental conventions that affect trade. The Montreal Protocol seeks to reverse the depletion of the upper atmosphere ozone layer caused by the release of chlorofluorocarbons and other chemicals. The protocol establishes binding commitments to reduce the production and consumption of controlled substances according to a strict time schedule. The protocol also requires certain types of trade restrictions imposed against nonparties to support its objectives. The Convention on Trade in Endangered Species of Fauna and Flora aims to protect endangered species of wildlife by restricting and monitoring their trade. The Basel Convention controls the transboundary movement of hazardous wastes from one party to another. Both exporting and importing countries are obligated to prohibit a transboundary movement if there is reason to believe that the wastes will not be managed in an environmentally sound manner.

Founders of GATT could not have foreseen the present importance of environmental problems. Clarification of environmental policies, perhaps through GATT, may be desirable to ameliorate environmental problems without unnecessary disruption of trade.

SUMMARY

- The international community may soon have to confront several emerging trade issues, including the relationship between trade and competition policy, a code of conduct for government support of high-technology industries, and the clarification of trade and environmental issues.

CONCLUSION

Open trade provides important economic benefits: more vigorous competition; greater incentives for innovation; a larger variety of goods; and a more efficient allocation of resources. This implies that trade will lead to a higher standard of living and higher economic growth. International trade is mutually beneficial—it benefits all countries involved. International trade has grown rapidly since World War II, in part because of the success of GATT in removing trade barriers. The benefits of freer trade can be obtained by regional as well as multilateral agreements. In 1992, the three North American countries successfully completed negotiations for NAFTA, which will remove most trade and investment barriers among the three signatories and strengthen ongoing Mexican market reforms. On the multilateral front, though progress has been made in the complex Uruguay Round, no final agreement has been reached.

Freer capital flows provide strong support for the continued growth of global trade and output by facilitating trade, allocating capital to its most efficient uses, and enabling people to diversify their portfolios. Flows of international capital promise to play an important role in supporting investment and growth in many developing and former Communist countries that are reforming their economies.

Several exchange-rate arrangements have been used since the Bretton Woods Conference almost 50 years ago. The Bretton Woods system allowed the pegged rate to be adjusted when external pressures on a currency became too intense. But it was abandoned because of the reluctance to adjust official parities or to adjust domestic policies to defend these parities, the inability of the United States to adjust its exchange rate, and greater capital mobility. More recently, the EMS revived the pegged exchange-rate system among many European countries. But events of the past year have strained that system as EMS member countries were forced to match increases in German interest rates, contributing to an economic slowdown and leading Italy and the United Kingdom to float their currencies. Some developing countries have sought to lower inflation by pegging their currencies to a stable currency, but a

pegged exchange-rate policy must be combined with reasonable domestic fiscal and monetary policies.

As the world economy evolves, international institutions such as GATT and the IMF face new challenges. Following the collapse of the Bretton Woods system, the primary focus of the IMF has shifted toward providing technical assistance and recurrent financing to the developing countries and the transitional economies of Eastern Europe and the former Soviet Union. With GATT, there are several emerging trade issues to be confronted including the relationship between trade and competition policy, government support in high-technology industries, and international trade and the environment.