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Evolving International Trade and Monetary Regimes and Related Policy Issues

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This essay focuses on some aspects of policy issues relating to evolving international trade and monetary regimes, and patterns of national saving and investment balances conducive to better global economic performance.

I. In Quest of New Rules

At an international conference held recently in the United States, a prominent American economist argued that the remarkable rise of living standards in the democratic market economies for more than forty years after World War II owed much to the political, trade, and monetary stability achieved under U.S. leadership (Meltzer, 1991). The rules for political, trade, and monetary stability imposed by the United States as "hegemon" of the postwar, market economies were not ideal, nor was the implementation ideal. But the rules worked so well that the relative positions of the United States and other countries have changed markedly. He then expressed the view that the United States is now less willing to enforce rules for trade and political stability and less able to impose the rules of the trade and monetary system on others. He also observed that fortunately, Japan and Germany have been more committed to monetary stability than the United States, but unfortunately they seem less committed to extending, strengthening, and enforcing rules for trade and political stability when such actions would impose costs on them. He concluded by noting that new rules for trade, defence or police, and price stability are required to ensure a sustained rise in living standards for the market economies in the future at the rates of the past four (or even two) decades.

In a statement before the Committee on Ways and Means of the U.S. House of Representatives in March this year, another distinguished American economist discussed how collective leadership should be exercised beyond the Cold War and the Gulf War (Bergsten, 1991). He first observed that the sharing of the economic and financial burden of the coalition effort in the Gulf was handled as effectively as the military effort. He then argued that "the United States and other members of the military coalition would almost

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

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

In a more multipolar world, with a more even distribution of power, it will be more difficult to secure and implement international consensus for the management of conflicts. The challenge of formulating and working out a set of rules for dividing up responsibilities is daunting. This process will be painful for countries losing their relative positions in decisionmaking. This was clearly evidenced, for example, by difficulties in the negotiations for increasing the quota shares of Japan and Germany in the IMF which had continued for quite a number of years before both of them obtained the second largest shares to the United States. A new situation now evolving in the Soviet Union may greatly influence our task in quest of new rules for dividing up responsibilities.

II. Implications of Evolving Trade and Monetary Regimes

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

The issue of regional trade co-operation has been accentuated with the European Community's programme for internal market integration by the end of 1992 (Shigehara, 1991), and the start of negotiations for a proposed free trade zone for the United States, Canada, and Mexico, building on the U.S.-Canada Free Trade Agreement which went into effect in January 1989. Some approaches to strengthening co-operation both within East Asia and in the Pacific Rim are being pursued, although there are thus far no trade or currency arrangements in place for further regional integration in this area.

Intra-Asian trade has expanded rapidly over the recent years, partly as a result of substantial Japanese investment in other Asian countries, and partly as a result of slow growth in the Americas. But Asia and the Americas are each others' largest trading partners. Both of them have more trade outside than within the regions. These trade

patterns suggest that it would not be in the interest of either Japan or the United States to develop intra-regional trade as a substitute for open, multilateral trade. Europe is more highly integrated than the other regions in terms of intra-regional trade, and has been so for a long time. One can probably argue that the EC typically represents the case of "natural integration." But, it is noteworthy that for the original EC group, intra-trade has tended to stagnate in relative terms since 1970. While the apparent loss of momentum in integration within the EC has been cited by the Commission as a reason for initiating the programme for completing internal market integration by the end of 1992, removing trade barriers with the rest of the world should be a top priority of the EC, if the main competitive pressure — a source of greater economic efficiency — should come from the rest of the world rather than from within the EC, as suggested in a recent study by European economists (Neven and Röller, 1990).

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

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

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

increased use of trade restrictions as an alternative adjustment mechanism, if such a zone covers a wide range of countries including those where institutional factors are such that wage and price flexibility is likely to remain more limited than in the other member countries.

In East Asia, diversity in the stage of economic and financial development as well as historical and cultural background in individual countries, and the absence of institutional arrangements for economic integration, will limit the development of an EC-type of monetary integration. Currencies of most of East Asian economies other than Japan are not completely convertible for capital transactions, and the Japanese capital market is not used as actively by private economic agents in these Asian economies as by those in the OECD area. While the absolute value of Japan's direct investment going to Asian countries tripled between 1983 and 1989, and accounts for a substantial portion of total direct investment inflows into these countries, the share of Japan's total direct investment accounted for by Asian countries declined by half during the same period from about 28 percent to 14 percent. A recent IMF study (Tavlas and Ozeki, 1991) reveals that the yen's share in the official reserve holdings of Asian countries rose to about 18 percent in the late 1980s, but a far greater share (56 percent) was held in U.S. dollars, and a significant portion (15 percent) in Deutsche mark.

The economic gains from the free movement of capital will be greater when it is achieved on a global basis than when it is limited to regional transactions. The possibility of lowering the real cost of capital to firms in deficit countries will be greater when they have access to borrowing opportunities in surplus countries outside a trade zone as well as those within it.

Japan should strengthen efforts to make its capital market more efficient and more readily accessible to foreign investors and borrowers alike on an *erga omnes* principle, by further financial liberalization and increasing the transparency of its market. Within the EC, the presence of foreign banks, those of the United States and Japan, in particular, and the possibility of their broader entry into EC financial markets should contribute to the gains from financial integration by increasing competition for financial services. At the same time, European banks should be encouraged to compete more vigorously in the United States, Japan, and the rest of the world. Given their power to conduct universal banking, they should also be encouraged to operate more actively as intermediaries in order to facilitate the flow of nonbank capital, in particular, direct-investment capital, to places within and outside the EC where risk-adjusted rates of return on investment are comparatively high. By adopting a global perspective, European banks would also enlarge the benefits accruing to European savers.

Moreover, major trading partners including Japan should strengthen collective efforts to measure and reduce the *effective* degree of trade protection. It is well known that data on average tariffs alone do not measure the effective degree of trade protection, because of growing resort to nontariff measures, such as voluntary export restraints,

import quotas, local content requirements, and subsidies to domestic industries. Such collective efforts should include a thorough and objective assessment of the view expressed in the United States and Europe that administrative impediments and restricted business practice in Japan make its domestic market practically inaccessible to foreign firms — the view often used as justification for erecting and maintaining barriers against Japanese products. Over the past years, the OECD has made a major contribution to the quantification of the degree of agricultural protection. Beginning this fiscal year, EC member states are asked to provide the Commission with fuller information on industrial subsidies in various forms, and the OECD has been attempting to collect data on such subsidies from all member countries. More generally, the G-7 leaders who met at the Houston Summit last year encouraged the OECD to strengthen its surveillance of structural reforms in individual member countries and review procedures and to find ways of making its work more effective (Shigehara, 1991).

As structural reform proceeds, trade conflicts arising from greater multipolarity and interdependence should weaken. In the context of non-inflationary growth, it should be easier to absorb changes in competitive advantage which characterize a dynamic economy. Nevertheless, powerful pressure groups will continue to seek protection from international competition. The future of the multilateral trading system will depend on the resistance of trade policy to such sectional interests. In any democratic society, policy making will be influenced by the reaction of the electorate. Consumer organizations must be mobilized in opposing protectionist measures which would reduce their welfare. Economists must play an important role in this regard by offering a thorough and objective assessment of the costs and benefits of protection.

III. Desirable Patterns of National Saving and Investment Balances

Trade conflicts occur not only as sectoral issues. They sometimes reflect macroeconomic imbalances among countries. Indeed, during the 1980s when trade conflicts intensified, large current account imbalances persisted among major industrialized countries.

This provoked heated discussion regarding desirable patterns of national saving and investment balances in these countries and their implications for international policy coordination. When a country's national saving exceeds investment, its current account of the balance of payments is in surplus. When this saving / investment relationship is reversed, with saving less than investment, the current account is in deficit. A situation where national saving is larger than investment can be called either a saving excess or an investment shortfall. Which of these is the more relevant perspective? And what sorts of economic policies should be adopted in response? These questions cannot be answered without judgement about desired levels of saving and investment.

Among industrialized countries, the United States began to experience a persistently

large current account deficit during the 1980s. If we examine the ratio of national investment, net of depreciation, to GNP, we find that this ratio for the United States did not decline appreciably during the 1980s from the levels of the 1960s and the 1970s. But its national saving ratio showed a substantial decline. During the 1980s, a drop in the saving ratio also occurred in countries such as Japan, Germany and the Netherlands which showed large current account surpluses. In these countries, the decline in the ratio of net national investment to GNP exceeded the decline in the saving ratio.

Over the past two decades, the average saving ratio for industrialized countries declined appreciably, and considerable attention has recently been paid to the adequacy of saving in these countries (Dean, *et al.*, 1990). My own view on the need for saving promotion in industrialized countries is based on the following understanding of underlying economic issues.

The first issue to be addressed is appropriate levels of global saving and investment. During the latter half of the 1980s, along with economic expansion, capacity utilization rates rose, and inflationary pressures began to emerge in most industrialized countries. To sustain economic expansion without a resurgence of inflation, it is of crucial importance to increase capital stocks in these countries. Hence the need for a higher level of saving to secure resources for investment. Moreover, if we take into account the need for resource transfer to the developing nations and to the economies of central and eastern Europe which are undergoing major transformation, it is clearly desirable for industrialized countries as a group to aim at a saving rate higher than the level required to finance investment within this group.

The second issue I would like to address is the respective roles of industrialized countries in current account surplus and those in deficit in the expansion of global saving. While industrialized countries as a whole are in the process of population ageing, the effect on saving will be felt at somewhat different times in individual countries. Japan is undergoing the process of population ageing at the fastest pace among OECD nations. A number of recent studies suggest that the projected demographic changes will reduce Japan's savings rate substantially from around the start of the next century (Auerbach, *et al.*, 1989). A policy implication of this projection is that Japan should aim at a higher national savings ratio during the present decade, mainly by higher government savings through an increase in consumption tax, and it should devote most of incremental savings to higher domestic investment in social infrastructure and housing for use by the present and future generations. But a portion of such savings might better be channelled to developing countries in the forms of direct investment and lending to them directly or through multilateral institutions. Repayment of such lending should start after the lapse of a long grace period of say 15 years or more. A recent study based on a multi-country model at the IMF concludes that a projected sharp decline in Japan's saving rate due largely to demographic changes will bring about a substantial change in its external position in the first few decades of the next century (Marsson and Tryon, 1990). It can be

hoped that presently developing countries will, by that time, have grown into mature economies and will be in a better position for starting the repayment of external debt. The working of this mechanism for *international*, and at the same time *intergenerational*, transfers of savings with technological assistance would be beneficial both to Japan and to the developing countries which will continue to have a relatively larger share of younger people in their populations.

The projected trends in Japan's saving rate and external position imply that continued current account surplus over this decade should not be viewed as a problem in itself in a world of efficient international capital flows. It would be very unfortunate to Japan and to the rest of the world, if Japan's current external payments position were used as an excuse for increasing trade barriers against Japanese products.

Until recently, in discussing the need for more saving in countries running current account deficit, arguments have often centered around the sustainability of their external deficit financing. In the past when the flow of capital from surplus countries to deficit countries was limited, not only by the presence of risk inherent in overseas investment but also by constraints on the availability of the private sector funds to be invested abroad, there was thought to be limit to the extent to which deficit countries could obtain funds from overseas through the private channel (Feldstein and Horioka, 1980). But over the course of the 1980s, along with the further liberalization of capital flows in industrial countries and globalization of financial markets, cross-border capital transactions have become increasingly common and the opportunities have increased for the saving of an industrialized country to become the source of funding for investments in other industrialized countries, at a low transaction cost (Feldstein and Bacchetta,1989).

It is within this context that the view has gained ground that the current account deficit of the United States, which provides the world's key currency, should not in itself be a major cause for the instability of the dollar. Even if the United States continues to run an annual current account deficit of the order of $100 billion and other industrial countries' claims against the United States increase along with this, the portion of their portfolios accounted for by claims against the United States will not increase provided domestic financial assets in these industrialized countries continue to rise at the pace they have to date. Consequently, even from a long-term perspective, there seems to be little danger of the current account deficit of that magnitude by itself leading to increased risk premium on dollar assets and the instability of the dollar. It can also be argued that insofar as funds borrowed from abroad is used by the United States to finance investment in physical and human resources that will lead to enhanced international competitiveness, and if the expected rate of return on U.S. investments among market participants remains at a relatively high level, confidence in the dollar is not likely to decline.

The key point of arguments related to the external deficit of the United States at the present time is not so much the issue of the market's absorptive capacity of additional dollar balances resulting from the current level of its deficit, but whether it is really

desirable from the point of view of the global allocation of resources that a leading industrialized countries such as the United States should continue to absorb a portion of the savings of other industrialized countries by tolerating a large fiscal deficit and a low household saving rate. Global resource allocation will improve, if the U.S. current account turns into surplus through budget deficit cuts while Japan and Germany continue to run some reasonable amounts of surpluses over this decade, and if their surplus funds are channelled, in the way I explained earlier, mainly to developing countries and central and eastern European countries moving towards the market economies.

Another issue to be addressed is the implication of increased saving for economic growth. In standard neoclassical growth theory, the production function is based on constant returns to scale. So a one-time increase in the saving rate will bring about an increase in capital stock and the level of production but will not lead to a sustained increase in the economic growth rate. In the neoclassical model, the rate of economic growth in the medium- and long-term is determined by the rate of growth in population and the speed of technological progress, both of which are exogenous to the model.

Recently, however, a "new" theory of economic growth has attracted attention among economists (Romer, 1986; Lucas, 1988). Under this theory based on increasing returns to scale, it has been demonstrated that if additional investment is undertaken along with an increase in the saving rate, there is a possibility that the economic growth rate will show a permanent rise. In this new growth model, the speed of technological progress, which has a major influence on the medium- and long-term economic growth rate, is determined endogenously by investment. The new theory has not been sufficiently tested, and it is too early at this stage to draw definite conclusions from the existing empirical results. Nevertheless, this theory provides important new insights into the macroeconomic significance of saving and warrants close attention.

So far, I have discussed the importance of increasing saving in industrialized countries. As my last topic, I would like to make some brief comments on policies for increasing saving. Domestic saving consists of two components classified by source, namely private and government savings. Private sector saving is determined autonomously by households and businesses through the market mechanism. Naturally, in making their decisions, entities in the private sector take into account past, present, and expected future government policies. Within the context of this decisionmaking process, an important role of the government in expanding private saving is to correct any distortions of private saving behaviour that may be caused by the tax system. A growing number of empirical studies (Auerbach and Kotlikoff, 1987) have reached the conclusion that if taxation of saving is effectively reduced by lowering income taxes and raising taxes on consumption with no change in the overall level of taxation, this can have a positive effect on capital investment and output activities in the long run.

Tax exemptions for interest payments on various types of borrowings have been in effect in a number of industrialized nations for some time. This has facilitated the

purchase of resort houses and consumer durable goods through borrowing rather than saving. This trend has been amplified as financial deregulation has progressed and competition has intensified among financial institutions to expand mortgage and other types of consumer loans. Since reversing the process of deregulation is undesirable, consideration should be given to revision of tax policies that tend to reduce private saving.

These policies for raising private saving would not suffice to bring about a significant increase in the aggregate level of national saving. Government actions to increase its own saving is therefore of particular importance. There is a line of argument, the so-called neutrality proposition, that holds that since an increase in government saving or a reduction in the fiscal deficit will lead to a future reduction in the tax burden, economic entities with rational expectations will reduce their saving by an amount equal to what they would have saved in anticipation of future tax increases. Nevertheless, empirical studies have shown this line of argument to be inappropriate in most cases. In Japan, fiscal consolidation should be pursued through a reduction in inefficient subsidies and other current expenditures as well as an increase in private consumption tax to finance public investment at home and abroad. Indeed, aiming for a reduction in the fiscal deficit and contributing to an increase in national saving continues to be an important fiscal policy objective of the 1990s for most of industrialized countries including those in Europe as well as the United States and Japan.

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