Policy Responses to Increased Economic Integration

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The increased openness and financial integration of modern economies have important consequences for macroeconomic policy. Policymakers have responded by embracing different approaches to policymaking. This paper briefly describes these alternative policy approaches as well as related empirical evidence. The paper argues that persistent success characterizes two of the three approaches described.

Toward an Open Economy: Evidence and Implications of Integration

The following facts provide evidence that economies are more open and that markets are increasingly integrated:[1] (1) ratios of imports and exports to GNP have significantly increased in countries like the United States (Cooper 1986); (2) the foreign presence in major domestic markets is rising (Frenkel and Goldstein 1991); (3) inflation rates among industrialized countries have converged; (4) interest rate differentials between the costs of domestic and offshore interbank funds have fallen dramatically (Frenkel and Goldstein 1991: 11; Goldstein, Mathieson, and Lane, 1991: 7–11); and (5) covered interest parity holds in many short-term financial markets (Goldstein, Mathieson, and Lane 1991: 7; Frankel 1991). While evidence pertaining to uncovered interest parity and real interest parity is more difficult to interpret, data concerning short-term financial markets seem to suggest that they are highly integrated and returns on longer-term debt

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[1]See for example, Richard Cooper (1986); Jacob Frenkel, Morris Goldstein, and Paul Masson (1990); Stanley Fischer (1988); and William Branson, Jacob Frenkel, and Morris Goldstein (1990).

and equity instruments in various countries have shown increasing tendencies to move together (Goldstein, Mathieson, and Lane 1991: 8–10).

There are two key implications of increased integration: first, as markets broaden, and as specialization proceeds making the economy more complex, the price system becomes more important in coordinating economic activity. It has to allocate resources over a broader realm of activity. Second, integrated economies imply shrinking spheres of autonomy (or influence) for economic policymakers in various countries. Heightened interdependence limits the control and scope for conventional domestic policymakers. Markets increasingly constrain or discipline policymakers. The more integrated the economy, for example, the more quickly divergent policies impact exchange markets or capital flows, thereby constraining policymakers.

Alternative Approaches to Policy in an Integrated Environment

Given the lessened scope for policymakers in the wake of integration, what alternative policy options for managing the domestic economy in this environment are available? What are the appropriate policy frameworks for this environment?

Generally, there are three types of approaches to national economic policymaking in this environment: first, coordinating discretionary macroeconomic policymaking, an approach sometimes associated with the Group of Seven (G-7); second, policy competition among decentralized policymakers, and third, rule-based policy coordination.

Discretionary Macro-Policymaking

Those supporting the first approach, the coordination of discretionary macro-policymaking, believe that since this heightened international interdependence limits the scope for independent policy action, countries must coordinate policy to regain the potency of policymaking. In effect, proponents of this approach see and use policy coordination as a way to circumvent the constraints of exchange markets or capital flows. In their view, policy coordination is identified with coordination of aggregate demand. Aggregate demand is controlled and coordinated by discretionary adjustments of monetary and fiscal policy. The budget deficit is the key fiscal policy instrument for fiscal policy coordination.

Studies that have attempted to quantify the effects of macro-policy coordination have generally found its benefits to be quantitatively

quite small.[2] Thus, little formal evidence supports this type of policy coordination (especially, that variety emphasizing the coordination of fiscal policy). A number of studies have examined attempts to coordinate macroeconomic policy[3] but researchers could only point to a few limited episodes of "successful" macro-policy coordination of this type. At times central authorities found it advantageous temporarily to join coordination efforts, but such coordination did not persist when the self-interests of these authorities conflicted with policy coordination goals. In sum, little, if any, evidence exists of lasting successes of this type of policy coordination, especially for the coordination of fiscal policy. There are a host of reasons why this type of coordination has not worked and cannot work.[4]

Policy Competition

The second approach to policymaking in the current integrated environment is policy competition among decentralized policymakers. According to this approach, capital mobility will induce policymakers of various countries to adopt competitive tax and regulatory policies that attract and keep capital. This will tend to promote harmonization of efficient tax and regulatory policies—a result that is not achieved by the coordinated decisions of centralized tax authorities but through the workings of the competitive process itself. This policy approach is fully compatible with the operation of the price mechanism and fosters regulatory experimentation and innovation as well.

Empirical evidence does exist supporting this policy approach. There are many examples of tax harmonization produced by decentralized tax competition, including the widespread individual and corporate tax reductions and tax reform that took place in the 1980s in both developed and less developed countries, documented, for example, by Michael Boskin and Charles McLure (1990) and Vito Tanzi and A. Lans Bovenberg (1990). These reductions followed neither

[2]See, for example, the review of this empirical literature discussed in David Currie, Gerald Holtham, and Andrew Hallett (1989), especially pp. 25–27. Several of these studies argue that persistent economic shocks and policymaker credibility can appreciably increase the value of coordination. See also David Currie, Paul Levine, and Nic Vidalis (1987); and Gomel, Saccomanni, and Vona (1990: 16–18).

[3]See, for example, Ralph Bryant and Edith Hodgkinson (1989: 2); Robert Putnam and C. Randall Henning (1989); Gerald Holtham (1989); Destler and Henning (1989): Wendy Dobson (1991); Yoichi Funabashi (1988); and Gomel, Saccomanni, and Vona (1990).

[4]The lack of success of this type of policy coordination can be attributed to a number of formidable obstacles, including: (1) differing policy objectives among governments; (2) disagreements as to how economies work and interact; (3) political and constitutional constraints on the bargaining process; and (4) important incentives of participants to renege on their agreements.

coordinated plans nor centralized international agreement. Rather, they resulted from pressures of competition unleashed by the mobility of capital and commodities. A similar process has worked within the European Economic Community; a degree of tax harmonization has occurred among European product taxes, capital gains taxes, and corporate income taxes. Europeans are becoming increasingly sympathetic to this approach to harmonizing their tax and regulatory structures (Cnossen 1987: 45, 48–49; Giovannini and Hines 1991: 175–76; and Micossi 1988). Still another example is the degree of tax harmonization that has occurred among states in the United States (Eichengreen 1990). However, some critics argue that, in practice, this process of interaction between governments sometimes produces excessive exchange rate volatility and/or unnecessary capital flows. Two examples might include the process of deregulation in the face of deposit insurance or the performance of exchange rates under flexible rates regimes.

Rule-Based Coordination

The third approach to policymaking in the current integrated environment encompasses the adoption of common policy rules, common standards, or common legal conventions. Establishing through international agreements a certain common framework fosters exchange and improves upon the beneficial workings of the market-price system because credible "rules of the game" are crucial to its performance. The approach may involve bilateral or multilateral agreements establishing rules or removing restrictions to the international mobility of commodities, services, capital, or labor. Such rules would minimize tariffs, nontariff trade barriers, or capital controls. The approach may involve rules fostering uniform laws or common "rules of the game." Examples include harmonious bankruptcy, patent, or contract laws, as well as rules for property rights on clearing and settlement. The approach may also encompass international agreements on common standards. Accounting standards, measurement standards for weight, length, temperature, etc., and disclosure standards are examples of such common standards.

Establishing such common international rules or standards can foster trade and exchange by reducing uncertainty and costs of acquiring information and knowledge about product characteristics. Yet, although it can and will promote the workings of markets and the price system, standardization can be overdone if it prevents regulatory innovation and experimentation, fosters cartel powers and rents of regulators, or prevents competition.

From a rule-oriented perspective an argument may be developed favoring an international monetary standard. A credibly anchored fixed

exchange rate system can serve as a standard of value and a standard of deferred payments. Not only does a well-anchored fixed exchange rate system foster price stability but it also eliminates both the well-known excessive volatility and the overshooting of exchange rates, thereby minimizing the variability and dispersion of many other prices and improving the working of the price system.

There are many examples of successful international standards or common policy rules providing supporting evidence for this type of policy approach. Some even argue that this is the only type of policy coordination that can persist over time.

Examples of Rule-Based Policy Coordination

General Agreement on Tariffs and Trade (GATT). GATT, an example of an international agreement to reduce tariffs, is one of the success stories of the post-World War II era. The coordination of tariff policy under the aegis of GATT is a rule-based form of policy coordination in which countries establish credible rules of the game. GATT, after all, is a set of legal rules. While many problems remain with GATT agreements, most economists agree that this rule-based form of international policy coordination has achieved considerable success.

International Monetary Standards. The international gold standard, or more recently, the Bretton Woods system, provides another example. This agreement established fixed, albeit adjustable, exchange rates, thereby effectively committing participating countries to common coordinated monetary policies and ensuring that price levels moved together. It was based on the dollar (theoretically with a noncirculating gold base). In short, this system involved common rules under which the price system would function effectively. While not without defects, the Bretton Woods system performed remarkably well over an extended period of time compared to post-Bretton Woods monetary arrangements:

- The volatility of both nominal and real exchange rates was substantially smaller under Bretton Woods (McKinnon 1990: 5; Giavazzi and Giovannini 1989: 54). Moreover, no exchange rate overshooting occurred.
- The volatility of commodity prices was significantly lower under Bretton Woods (Chu and Morrison 1984: 10).
- On average, levels and volatility of inflation were significantly lower under Bretton Woods (McKinnon and Robinson 1992: Tables 11.3, 11.4). And inflation in participating countries moved together rather than diverging (McKinnon and Robinson 1992: Figure 11.4).

- The levels of volatility on both short- and long-term interest rates were lower under Bretton Woods (McKinnon 1990: 6, 8–9; McKinnon and Robinson 1992: Table 11.2).

The European Monetary System. Another example, the European Monetary System (EMS), performed well (until recently) because it had a stable German anchor. During the 10-year-period, 1979–89, for example:

- Both real and nominal exchange rate variability fell (Russo and Tullio 1988: 48; Guitain 1988: 11).
- Inflation rates converged and the dispersion of inflation fell (Russo and Tullio 1988: 48).
- Both short-term and long-term rates converged (Russo and Tullio 1988: 50).
- Devaluations became more infrequent.
- The system imposed discipline on various monetary authorities.

In short, for a decade, the EMS provided another example of a successful, rules-based coordination of monetary policy that worked to improve the performance of the price system.

The U.S. Constitution. The U.S. Constitution is another example of the successful adoption of common policy rules. Recognizing the many problems under the Articles of Confederation, state representatives met in Philadelphia in 1787 and agreed to a number of formal policy rules laid out in the Constitution (McDonald 1985: 154–57). In effect, these representatives agreed to coordinate important elements of economic policymaking. The Constitution created the largest free-trade area in the world at the time (McDonald 1985: 260; McDonald 1982: 58). In addition to eliminating restrictions to the mobility of capital, labor, and commodities across states, it established important property rights, standards, and a common currency area. These "rules of the game" fostered exchange and allowed the market-price system to coordinate economic activity.

More specifically, the Constitution established uniform property rights in the form of uniform bankruptcy, contract and patent laws (Article 1, Section 8), as well as uniform legal tender codes (Article 1, Section 8). It created congressional power to establish uniform standards of weights and measures (Article 1, Section 8) and standards by which to regulate the value of money (Article 1, Section 8). Furthermore, it prohibited states from coining money, effectively creating a common currency area. And it prohibited protectionist trade legislation among states, interstate barriers to trade (Article 1, Section 9), and "locally preferred" regulation of commerce.

Other International Standards. Other examples of the adoption of common international policy rules or standards are the establishment of Greenwich Meantime, the metric system, the Morse Code, uniform maritime rules of the road, international public health agreements, and others. Thus, numerous examples exist of the successful adoption of common policy rules that have persisted over extended periods of time.

Conclusion

The evidence suggests that lasting, persistent success in coordinating market activity in an open economy cannot be achieved through discretionary policymaking (especially of the coordination of deficit-based fiscal policies). Virtually the only examples of persistent successful policy coordination or harmonization are what I described here as the policy competition approach and the common rules approach. Both approaches are fully compatible with the workings of the price system. Consequently, as the world becomes more integrated, these may be the only truly viable policy alternatives.

A pertinent question remains, however. In particular, when is it more appropriate to opt for an international standards or common rules approach and when is it better to foster policy competition? From the very brief and cursory look at the evidence, the answer seems to be that competitive policymaking appears to work in the areas of tax and regulatory issues. Common standards or rules appear to work for trade agreements, for international monetary standards and in certain other areas where standards are appropriate.

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The Future of Universal Banking

Georg Rich and Christian Walter

Universal banks have long played a leading role in Germany, Switzerland, and other Continental European countries. The principal financial institutions in these countries typically are universal banks offering the entire array of banking services. Continental European banks are engaged in deposit taking, real estate and other forms of lending, foreign exchange trading, as well as underwriting, securities trading, and portfolio management. In the Anglo-Saxon countries and in Japan, by contrast, commercial and investment banking tend to be separated. In recent years, though, most of these countries have lowered the barriers between commercial and investment banking, but they have refrained from adopting the Continental European system of universal banking. In the United States, in particular, the resistance to softening the separation of banking activities, as enshrined in the Glass-Steagall Act, continues to be stiff.

The purpose of this paper is to analyze the German and Swiss experience with regard to universal banking. We attempt to show to what extent that experience supports or refutes the arguments against universal banking frequently voiced in the Anglo-Saxon world. Since we are most familiar with the Swiss banking system, we rely heavily on our own experience. Based on this analysis, we draw various conclusions about the future of universal banking.

The remainder of the paper is divided into four parts. First, we discuss the salient characteristics of the German and Swiss banking systems, and attempt to rectify various misconceptions about universal banking. Second, we contrast the history of German and Swiss banking legislation with that of the United States. Third, we consider the

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