

Commentary: Macroeconomic Policy Implications of Trade and Currency Zones

Tommaso Padoa-Schioppa

In recent years **there has** been a significant increase in the number and size of country groupings being formed and leading to formal and informal trading agreements. Today, most industrialized nations are involved in such groupings. The European Community (EC) embarked on the 1992 Internal Market Program in 1986 and is now heading toward Economic and Monetary Union (EMU). Other landmarks in the process are the **U.S.-Canada** Free Trade Agreement and the Australia-New **Zealand** Closer Economic Relations Agreement.

The movement continues. Discussions are under way in Europe, between the EC and the member countries of the European Free Trade Agreement (EFTA) with a view to creating a European Economic Space; the transition of Central and Eastern Europe toward a market system is stimulating interest in a reorganization of trade relationships between them to replace the now obsolete Com-econ; and **proposals have** been put forward to negotiate free trade agreements between the EC and EFTA countries on the one hand and the Eastern European countries on the other. Outside Europe, an extension of the **U.S.-Canada** free trade agreement to include Mexico is being discussed; the U.S. "Enterprise for the Americas Initiative," launched last year, envisages other free trade areas in the hemisphere; a common market agreement was recently **signed** by the Southern Cone countries of Latin America; and, finally, the

informal Asian Pacific Economic Cooperation Process could evolve into a more formal regional arrangement.

These developments pose a number of problems for both economists and policymakers. Economists discover that traditional trade theory was based on an excessively simplistic picture of both the world and the structure of a modern economy. Policymakers have to make concrete choices in the bilateral, regional, and global fora of trade negotiations.

In this paper I will touch on only a few of the many issues raised by trade and currency zones. I shall focus on their internal and external macroeconomic policy implications, but shall first spend some words on definitions and concepts as I think that much of the current debate on these issues is obfuscated by terminological confusion. I shall conclude with a general point on reconciling a "zone" approach with a "global" approach.

My remarks will be considerably influenced by the EC example, which is undoubtedly the most significant experience in this century of the progressive deepening of the organization of a multicountry economy. Right now, the EC is deeply involved in negotiating a treaty that would transform its own zone into an Economic and Monetary Union, so that some of the points made today and yesterday seem to be slightly out of date in the light of the important political—though not yet **legal**—commitments that have been entered into on the EC level.

Definitions and concepts

A certain vagueness in defining the subject of the debate may contribute to the success of the debate itself—some vagueness, but not too much. Different persons express different views, but these views may refer to different subjects rather than to the same subject. In our case the vagueness concerns the very topic of the conference, namely what we mean by trade zones and currency zones.

In yesterday's discussion the only element defining a zone was considered to be geographical extension (number of countries involved),

possibly corrected by the proximity factor mentioned by Paul Krugman. I think that at least two other elements are crucial: the economic content of the zone's arrangements and the legal and institutional structure of the zone. As to the economic content, it makes a great difference whether trade is **simply** in manufactured goods or in services as well, whether the protection considered consists only of tariffs, or also of norms, regulations, tax regimes, and so on. As to the legal and institutional structure, the issue is, in broad terms, how the classic—legislative, executive, and judiciary—functions of government are exercised in the stipulation and management of the agreements. How much discretion is allowed in implementing and interpreting the agreed provisions? To whom is it entrusted? Are there law-enforcement mechanisms? More generally, how much “supranationality” is involved in the arrangements?

For each of the three elements (geographical extension, economic content, and institutional structure), arrangements can range from “limited” to “comprehensive,” in an almost continuous spectrum, forming a three-dimensional space in which individual countries, groups of countries, and the world can be mapped. Thus a nation state with no internal decentralization and no economic relationships with the outside is very local on the first account and **very** comprehensive on the other two, lying in one corner of the box, whereas the United Nations is close to the opposite corner.

If we disregard these **complexities** and use the term trade and currency zone to designate arrangements that are completely different with respect to these three elements, then disagreement is due more to terminological confusion than to **diverging** analyses and policy judgments.

Consider trade zones: the European **Community**, which is certainly limited in geographical extension, notwithstanding three successive enlargements, has an economic content that extends to movements of goods, services, capital, and persons, and it is taking liberalization to the point of literally eliminating borders. In addition, the European Community has far-reaching legislative, executive, and judiciary powers applying to such areas as external relations, competition policy, industrial concentration, public procurement,

health and safety regulations, **and** state monopolies in public services, and so on. As regards its structure, the EC has a complete set of institutions that is much closer to the legal and institutional apparatus of a nation than to any of the other existing regional arrangements.

Turning to the content of a currency zone, we can use the classification of the possible ways of organizing a currency zone proposed yesterday by Andrew Crockett and David **Laidler**: floating rates, crawling pegs, adjustable pegs, and monetary union. I shall not return to this theme, except to note that here, too, the institutional structure has to be considered along with the two other elements. Take the notion of monetary union, which is interchangeably identified with a regime of irrevocably fixed exchange rates or with a single monetary authority. Analytically, there is not much difference between the two: a system with permanently fixed exchange rates is a system in which effectively only one monetary policy exists for the whole area, "as if" there was only one central bank. But this **means** disregarding the institutional element. In practice, it would make an enormous difference, for both the economics and the politics of a monetary union, if the union were based on an exchange rate rule or the replacement of a plurality of monetary authorities with a single authority.

When the simplistic one-dimensional approach is replaced by the more accurate three-dimensional approach, the two main issues discussed so far—are trade and currency zones "good" or "bad?" and 'does a trade zone imply a currency zone?—become clearer and probably less controversial. Without dwelling on them, I shall make two points.

First, on the "good or bad" issue, the nontrivial question is how to assess a regional agreement that in terms of economic content and institutional structure goes further than a global arrangement could conceivably go. Determining whether there is a **tradeoff** between progress on different axes and, if so, what is the best mix, is a matter for political judgment. I doubt whether economists have much to say. For my part, I think that, while the preservation and strengthening of the global system is a most important objective, economically and

institutionally "deep" regional systems are desirable both because they may lead the way to a similar evolution of the global system and as useful intermediate layers in an otherwise unmanageable world of 190 sovereign countries. I also think that the global and the regional approaches may well be mutually reinforcing.

Second, on currency zones, there is a need for consistency between trade and currency arrangements. This is hard to deny. Indeed, what economist would affirm that all monetary regimes are alike for the economy? The issue can only be discussed with reference to a refined classification of trade and currency zones, by asking what currency arrangement is consistent with what trade arrangement and accepting that, as trade arrangements evolve, currency arrangements have to adapt. It is not my task here to explain why and how the EC has decided to move to **Economic** and Monetary Union. I shall only recall that the EC has largely passed the stage of pondering the pros and cons of EMU and is well advanced in the process of drafting a treaty to move to a single central bank and a single currency.

Internal implications

In the EC, where "trade zone" means the single market and "currency zone" means a monetary union with a single monetary authority, the main issue concerning the macroeconomic policy implications of trade and currency zones is: what are the implications of such a zone from a fiscal point of view? In other words: does a trade and currency zone require a fiscal policy zone? By "fiscal policy zone" I mean an arrangement whereby member states' budgetary policies are not completely independent and possibly the "zone" can conduct a fiscal policy of its own. At the outset, a distinction should be made between two aspects of the problem. They could be called the discipline aspect and the policy mix aspect respectively.,

On the discipline aspect, the question is whether a fiscal policy zone is to be considered a prerequisite, or a necessary component, of a monetary union; or, more precisely, whether a fiscal union is necessary for a monetary union to be viable, that is, for price stability to be effectively pursued by the central monetary authority. In the

EC debate, opinions are divided. Those who claim that a fiscal zone is not necessary, argue that creating a strong monetary authority, a central bank that is equipped and willing to pursue price stability inflexibly, would be sufficient to achieve price stability, regardless of the fiscal behavior of member states. After all, they observe, this proposition is valid at the level of a single country. What is crucial is that a strong monetary constitution be designed to ensure a clear separation between monetary policy and fiscal policy. Compared with a sovereign nation, the separation in the European Community would be sharper and, in addition, national governments would be subject to more stringent fiscal discipline on two accounts. First, they would have no authority to regulate and even less to manipulate the capital market to which they would turn to finance themselves. The availability and the cost of funds would depend only on their creditworthiness. Second, they would not be able to monetize their debt (see Padoa-Schioppa, 1988b) as neither their governments nor their parliaments would have control of the printing press. Hence, problems of fiscal indiscipline would, at least in the medium run, be less likely to arise in a monetary union, though they would not be completely eliminated.' They also point out that there is no federation in the world in which there are federal rules concerning the budget; not the United States, not Canada, not the Federal Republic of Germany, not Switzerland, nor Belgium.

Those who claim that a fiscal zone is necessary observe that considerations applicable to other federal systems are not valid for the EC. The member states are large in relation to the EC as a whole, so that their budgets are potentially more destabilizing than state budgets in most federations; and the EC's central budget is too small to have a macroeconomic impact of its own. It should be noted, however, that while these propositions may be true now, the U.S. federation once resembled the EC much more closely, in terms of the relative size of both individual states and the federal budget.

On the whole, the economic argument claiming that a fiscal union is a necessary precondition of a monetary union on monetary stability grounds is weak. While adding a fiscal constitution to EMU does not seem indispensable, there have to be rules to prevent fiscal imbalances from interfering with the conduct of monetary policy. They

include the ban on direct central bank financing of government budgets and the so called "no bailout" provision, whereby neither the EC, nor other member states will take financial responsibility for any fiscally imprudent member state.

The above does not imply that fiscal rules are not desirable. My own view is that they ought to be regarded as an important ingredient of a sound economic constitution. Indeed, in this field, as in other areas such as the organization of the single market, the constitution-making process now under way in the EC is an opportunity that should not be missed to exploit the lessons of the last few decades by adopting economic laws that improve the existing ones. According to this view, fiscal rules would not be simply a corollary of the Economic and Monetary Union, but an additional element of the organization of the EMU.

But how are we to formulate budget rules that would impose discipline? The main difficulty is that no rule can completely eliminate the need for interpretation. The same budget deficit may be "bad" or "good" depending on a number of factors (cyclical conditions, size of the budget, structure and composition of expenditures and revenues, balance-of-payment situation, and so forth) that are almost impossible to pin down in a rule. The question then is who should exercise the discretion that is necessary to decide whether or not a rule has been complied with in a particular case. This leads to the further question of the level of government. Should fiscal rules be embodied in the constitution of the federation, that is, in the EMU Treaty, or, as in the case of the United States, at the level of state constitutions? The Intergovernmental Conference preparing the EMU Treaty is discussing these issues. In the solution that is emerging, the treaty will forbid "excessive deficits" and lay down some criteria for determining what is "excessive." The future will tell how operational these provisions will be.

Let me now turn to the second main aspect of the macroeconomic policy implications of an EC-like trade and currency zone. This has to do with policy-mix considerations. The question is whether the EC should have the (constitutional) means of determining its overall fiscal stance. Two reasons are given by those who suggest a positive

answer: the desire to avoid overburdening monetary policy as the sole EC macroeconomic policy tool and the need to define an EC-wide monetary and fiscal policy mix within the larger context of international (G-7) policy coordination procedures. For both these reasons, it is argued, a fiscal macropolicy capacity should be established at the EC level. However, support for a fiscal policy capacity is much weaker than for rules of budgetary discipline, reflecting the current aversion to forms of fiscal activism.

Here again, if such a capacity were to be established at all, its design should incorporate appropriate safeguards against the excesses of fiscal activism we have witnessed in the recent past. An EC fiscal policy could operate through national budgets or through the EC budget. For a number of reasons,² the first solution seems preferable. Indeed, empowering the EC to control national budget balances would require member states to relinquish too large a measure of sovereignty. It would imply that the European Community was empowered to determine the size and structure of public expenditure and the taxation of otherwise sovereign nations and to devise sanctions for noncompliance. Budgetary power is inextricably linked to the exercise of an allocative function which is a strict prerogative of elected national assemblies. On the other hand, as experience has repeatedly shown, relying on a voluntary coordination of national budgetary policies would be too weak a procedure to produce meaningful decisions. If scope for fiscal activism at the EC level had to be provided one day for the purpose of stabilization, the natural policy tool would be the EC budget. Although small, today's EC budget of about 1.5 percent of the EC's GDP is already sufficient to conduct a more than purely symbolic fiscal policy, and it seems reasonable to expect that its size will grow in the future. Needless to say, the balanced-budget constraint that presently characterizes the EC budget would have to be relaxed. A budget balanced over the cycle would suffice. Mechanisms would have to be devised whereby the EC would have the instruments to shift over time the collection of the revenues that finance its expenditures. The double constraint of balancing the budget over **multiyear** periods and weaving revenues instead of expenditures would clearly tie EC fiscal activism to a much sounder constitution than the ones we have seen so far.

In conclusion, neither economic theory nor the constitutional experience of other federal systems provide compelling arguments to conclude that European monetary union will be viable only if it is coupled with a transfer of fiscal authority from national to EC authorities. What is important is that a strong monetary constitution be in place. However, fiscal rules should be regarded as desirable per se to reduce governments' budgetary discretion. As for the determination of a fiscal policy stance for the EC area as a whole, the arguments in favor of giving the EC such a capacity are valid. The way to establish such a capacity, however, should not be to grant the EC the power to impose decisions on national budgets, but rather to allow more flexible use of the European Community budget.

External implications

While the internal macroeconomic policy implications are mainly fiscal, the external ones are mainly monetary: As a matter of fact, macroeconomic policy cooperation between countries has historically taken the form of an exchange rate regime. Although both fiscal and monetary domestic policies produce significant spillover effects, in these two areas coordination procedures have generally not gone beyond soft exercises of mutual information. The question then is to identify the significance and implications of EMU for the international monetary system, a task that is not facilitated by the fact that such a "system" is rather ill-defined today, perhaps nonexistent.

If the European Community becomes a single market cum single currency entity, its role in the international monetary and financial world can be expected to increase significantly compared with those of the member states today. It will have an integrated banking system and capital market, several important financial centers and considerable financial strength, based on an aggregate current account surplus and a large stock of foreign exchange reserves. Its financial structures are likely to play a strategic role in accompanying the transformation and, hopefully, the eventual takeoff of the economies of Central and Eastern Europe. All these are natural premises for significant changes in the present shape of international monetary relationships, characterized by a plurality of reserve currencies with floating rates and a soft management of them.

In an EMU that adopts the ECU as its single currency, private and public investors' portfolios will most likely undergo important shifts in composition to give ECU-denominated assets a share closer to that of the EC economy than the present aggregate of EC countries. This process will require careful management and effective cooperation by central banks to avoid exchange rate shocks.

With EC currencies merging into EMU and the ECU, what is today the main determinant of the demand for deutsche mark-denominated official reserves will **vanish**.³ While this will presumably cause an increase in the dollar share in world reserves, the United States, Japan, and other non-EC monetary authorities will probably have to build up considerable ECU balances in their official reserves. On the whole, I do not think, however, that these portfolio adjustments are likely to dethrone the dollar as the main international currency. It will take more than EMU and a sizable external U.S. debt to eradicate deep-seated habits in the pricing of primary commodities, in the invoicing of many internationally traded goods and services, and in the selection of transaction and intervention currencies. The trend may well be toward aligning the dollar's monetary role with its economic and financial ones, but it is likely to be a slow one. Historical experience of the rise and decline of international currencies supports this view.

Compared to the present dollar-yen-deutsche mark tripolar system, a dollar-ECU system would, I think, have the advantage of greater uniformity in the relative size of the component economies. More importantly, perhaps, it would imply a simplification of the present threefold role of the deutsche mark, as a national, EC, and international currency. The potential conflicts between the national and international roles of a currency have long been known, both in theory and practice. Besides not being politically viable, a *de facto* or *de jure* EC monetary union based on the deutsche mark in the role played by the dollar in the early Bretton Woods years is technically unthinkable. Too many of the conditions that made that role possible for the dollar in the 1950s are lacking for the deutsche mark in the 1990s. And it is perhaps not by accident that there are now more restrictions on the use of the deutsche mark by nonresidents in financial transactions than for the other main EC currencies.

International monetary coordination in a multicurrency reserve system is a blend of competition and cooperation. There are reasons to believe that in a tripolar dollar-ECU system, both elements of the exercise would improve. With three currencies of comparable importance, the incentive to be competitive in terms of quality (price stability, efficiency of clearing and settlement procedures, attractiveness of financial centers, and so on) would be equally powerful for all the members. At the same time, bargaining power would be more evenly distributed in the negotiations on cooperative measures.

Another implication concerns the institutional framework for international monetary cooperation. Today this reflects the stratification over time of different fora and **Parkinson's** well-known law that committees can be created, never destroyed. It also reflects the weakness of the role of international institutions, not only as a negotiating partner **speaking** for the "common good" but also as providers of fully independent technical support. The significance of the middle letter of the International Monetary Fund's acronym paled long ago. It should be acknowledged that not all the 155 countries affiliated to it have the same role and responsibilities in managing the international monetary system. In a dollar-yen-ECU system a G-3 should replace the present plethora of Gx, Gy, and so on. This would obviously make the cooperative exercise more efficient, but would run the risk of further strengthening the "ad hoc" nature of such cooperation. It would be therefore desirable to enhance the political and technical role played by the IMF in support of international cooperation. Whether this will be achieved, however, is quite uncertain, not only because of traditional reluctance to strengthen supranational institutions, but also because the latter may seem less, not more, necessary in a game of very few players.

Last but not least, there is the issue of the exchange rate regime of a dollar-yen-ECU tripolar world. Some years ago proposals were put forward for the creation of a "world EMS," that is, a new and formalized adjustable peg regime that would differ from Bretton Woods but not having a formal leader and by opposing less resistance to parity adjustments. I continue to believe⁴ that the EMS owes too much to EC-specific factors to be easily replicated worldwide: the homogeneousness of its economic structures, the high level of trade

integration, the existence of a solid and comprehensive institutional edifice, and continuous occasions for meeting and consultations, and so on. Moreover, the EMS itself has proven to be subject to system erosion, like any policy regime. It seems more likely that the cautious experiment of exchange rate cooperation inaugurated at the Plaza and the Louvre will evolve at a slow pace, without dramatic accelerations.

In conclusion, the external macroeconomic policy implication of an EC-type trade and currency zone could be to establish, much more than has been the case so far, a genuine multicurrency reserve system based on a **tripolar** relationship. The monetary regime could, at least initially, remain one of mildly managed floating and soft coordination among the main reserve centers. This can be seen as no more than a simplification and rationalization of a state of affairs in which we have been for about five or six years now. The importance of such a simplification and rationalization, however, should not be underestimated. Since the problems and potential instability posed by a global financial system, whether in the form of private or public cross-border, cross-currency, debts or in that of crises and tensions in banking or capital markets, are likely to remain with us, any improvement in the existing system is to be welcomed.

Conclusion

The macroeconomic aspects, important as they are, only represent one of the problems posed by trade and currency zones, perhaps not the most important one. They are sufficient, however, to highlight two important features. First, regional arrangements have an internal dynamic involving all the three elements (geographical extension, economic content, and institutional structure) that combine to define a zone. Free trade arrangements tend to evolve into a single market, the institutional requirements increase, the financial integration of a single market calls for some form of agreed monetary regime. Second, there is a need to fit regional arrangements into the global system, to stimulate positive interactions between the two, or at least to prevent conflicts.

Today, the European Community is mainly concerned with the

former feature; the world with the latter. The not forgotten concerns about Fortress Europe and the debate developing in the United States on whether efforts should be directed to regional rather than to global trade negotiations point to the growing danger that an antagonistic view of the relationship between the two will develop. However, since the same economic, and political, and ethical, rationale is at the origin of both regional and global arrangements, it is crucially important that there should be a general philosophy applicable to both and consistent with their common rationale.

One element of such a philosophy deserves special attention: global arrangements—be they the GATT, the U.N., or the Bretton Woods institutions—should, in their very design, allow for regional arrangements by establishing ground rules for their features and behavior in the global sphere, very much as they do for nations. Any deepening of regional integration, up to the creation of new **fully**-fledged federal entities, should be welcomed, provided it complies with those ground rules. After all, why should Canada or Belgium be free to loosen their centralized constitutional structure and a group of sovereign states not be free to tighten their links as the thirteen North American newly independent states did 200 years ago? And why should the existing number of 190 sovereign nations be considered optimal?

This opens a vast ground for improving and revising the existing global arrangements, with Article **XXIV** of **GATT**⁵ representing a significant precedent. It also opens a vast ground to intellectual work, because we lack a satisfactory economic theory of a multi-tier "government" of the economy; and even our constitutional theory in this field is far from adequate. Thus, this final remark is more a starting point than a concluding one.

Endnotes

¹**Frenkel** and Goldstein in their paper on **EMU** (**Frenkel** and Goldstein, 1991) cite evidence that in federal fiscal systems, such as the United States and Canada, states that pursued a more prudent fiscal policy had lower borrowing costs than others and states that had voluntarily "tied their hands" by enacting constitutional limitations on borrowing also reduced their **borrowing** costs by comparison with others. But—they remind us pointedly—there is no evidence that higher borrowing costs induce governments to correct fiscal policy excesses.

²For a detailed argumentation. see Padoa-Schioppa (1990).

³**Deutsche** mark-denominated reserves are about 20 percent of the world total; these deutsche mark reserves are largely held by EC countries.

⁴See Padoa-Schioppa (1988a).

⁵The article permits customs unions and free trade areas to be formed provided that tariff or **nontariff** barriers imposed by the participant countries are not higher or more **restrictive vis-à-vis** nonparticipants than those prevailing prior to the formation of the union or free trade area.

References

- Cecchini, F. "The European Challenge, 1992. The Benefits of a Single Market," *Gower*, London, 1988.
- Frenkel, J. and Morris Goldstein. "Monetary Policy in an Emerging European Economic and Monetary Union: Key Issues," *IMF Staff Papers*, No. 2 (June, 1991).
- Gomel G., F. Saccomanni and S. Vona. "The Experience with Economic Policy Coordination: the Tripolar and the European Dimensions," *Temi di Discussione*, Banca d'Italia, n. 140 (July 1990).
- Hufbauer, G.C. Background paper for "The Free Trade Debate," Reports of the Twentieth Century Fund Task Force on the Future of American Trade Policy. New York: Priority Press Publications. 1989.
- Keohane, R. O. "After Hegemony: Cooperation and Discord in the World Political Economy." Princeton: Princeton University Press. 1984.
- Lawrence, R.Z. "Comments during a 'Symposium on Europe 1992'," *Brookings Papers on Economic Activity*, No. 2, 1989.
- Meade, J. "The Theory of Customs Unions." Amsterdam: North Holland, 1956.
- OECD. "Regional Integration: A Review of Macroeconomic Trends and Possible Implications," 1989, unpublished.
- _____. "Trade Implications for Non-Participants of Recent Regional Arrangements Among OECD Countries," 1990, unpublished.
- Olson, M. "The Logic of Collective Action." Cambridge: Harvard University Press, 1965.
- Padoa-Schioppa, T. "Toward a New Adjustable Peg?" Per Jacobsson Lecture on The International Monetary System: the Next Twenty-Five Years. *Basle*, June 12, 1988, (1988a).
- _____. "The European Monetary System: A Long-Term View," in F. Giavazzi, S. Micossi and M. Miller (eds.), *The European Monetary System*, Cambridge: Cambridge University Press. (1988b).
- _____. "Toward a European Central Bank: Fiscal Compatibility and Monetary Constitution." A paper presented at the Bank of Israel Conference on *Aspects of Central Bank Policymaking*. Tel Aviv, January 1990.
- Viner, J. "The Customs Union Issue." New York: Carnegie Endowment for International Peace, 1950.
- Vona, S. "Il commercio mondiale verso il 2000: libero scambio o protezionismo?" Milano: Franco Angeli.