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**FINANCIAL MARKET INTEGRATION:
THE EFFECTS ON TRADE AND THE RESPONSE OF TRADE POLICY**

by

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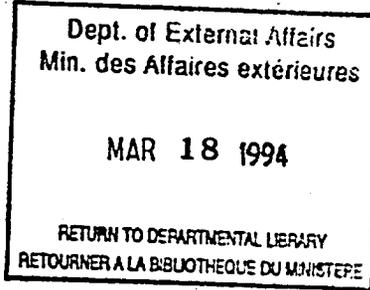
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EXECUTIVE SUMMARY

The integration of financial markets is taking place domestically and internationally. In the domestic context, the provision of financial services is becoming less diffuse. More firms are able to offer more products to more customers, both domestic and international. The international integration of financial markets is a reflection of the free flow of capital across borders.

The relationships between international capital flows, exchange rate movements, financial market integration and trade policy tend to be overlooked by economic theory and trade policy makers alike. Yet, with foreign investment in Canadian stocks and bonds at over C\$250 billion, and daily foreign exchange volumes involving the Canadian dollar topping \$25 billion, Canada's internationally integrated financial markets clearly have important implications for the economy and trade policy.

While the trend towards more open and internationally integrated financial markets has not diminished the effectiveness of monetary policy, particularly in Canada, where there is a relatively long history of financial integration with the U.S., it has resulted in fiscal policy becoming somewhat less effective. The free flow of capital, and the ability of governments to borrow in international markets, however, has increased the options available for deficit financing.

To the extent that internationally integrated financial markets -- when combined with a flexible exchange rate regime -- involve a degree of unpredictable exchange rate variability, firms engaged in the international trade of goods and services face a financial risk not shared by firms active solely in domestic markets. A number of financial instruments have been developed to help firms manage some of the risks associated with international trade, particularly currency risk. Such instruments -- known as hedges -- are equally available to small and large trading enterprises, since the financial institutions that arrange hedges are as concerned with the currency involved (preferring a major currency with a liquid market) as they are with the size, or dollar value, of the hedge. Small enterprises, however, face other export readiness difficulties.

When exporters are faced with exchange rate variability, such as an appreciation of the domestic currency, and they chose to absorb the exchange rate fluctuations rather than alter their export price, they could be exposed to anti-dumping

actions. The threat of anti-dumping for a firm following a rational pricing strategy in order to maintain market share in the export market underlines the inadequacy of anti-dumping as a means of conducting trade relations as they relate to corporate behaviour.

Trade hysteresis refers to a permanent change in the pattern or volume of trade following a temporary -- though sometimes prolonged -- change in the exchange rate. Although it has been argued that between 1989 and 1991 the overvalued Canadian dollar led to a permanent decline in the manufacturing sector by reducing exports, extensive research has failed to confirm the hysteresis hypothesis. A pressing concern to the Department of Foreign Affairs and International Trade is the possibility that prolonged exchange rate misalignments could result in calls for protection in some of our trading partners. If, for example, foreign firms are unable to compete with Canadian exporters due to a temporary decline in the Canadian dollar, they might put pressure on other governments to restrict imports from Canada.

In order to avoid the uncertainty of exchange rate variability and eliminate the resulting impediment to trade, some would argue that the exchange rate between close trading partners, especially in free trade areas, should be fixed. Periodically, it has been proposed that the Canadian dollar be fixed to the U.S. dollar, or that the two countries should share a common currency. However, the surrender of political and economic sovereignty associated with a common currency is such a sensitive issue, that it is not likely to be the subject of any negotiated trade agreement involving Canada until well into the foreseeable future. The best way to assist in creating an environment in which exchange rate variability is less of a concern to Canada's trading firms is to support the Bank of Canada's policy of price stability. This is particularly important given the global move towards lower inflation.

The financial services industry is uniquely affected by the internationalization of financial markets. Trade in financial services has quickly made its way into international trading agreements, as is evidenced by the FTA, the NAFTA and the GATS. To take full advantage of the opportunities associated with integrated financial markets, financial institutions require access to foreign markets to set up local establishments. Of special interest to Canadian banks is the large U.S. market. Although the NAFTA provides little immediate progress in liberalizing trade in financial services between Canada and the U.S., Canadian firms can benefit from any future liberalization within the U.S. (such as the lifting of restrictions on interstate banking) and now have access to a formal government-to-government dispute settlement procedure.

As for the Japanese market, the establishment of direct branches of foreign banks is not prohibited, but a simplification of the licencing procedure administered by the Ministry of Finance would be a welcome improvement. The European Union's single passport for financial services could make it more difficult for Canadian institutions to compete there. If the German universal banking model becomes more widespread, foreign financial institutions might not be able to vie for market share with large, efficient European banking networks.

The universal banking model also raises questions regarding the ability of non financial sector firms to compete internationally. It is yet to be determined whether the close inter-corporate alliances that are typical in Germany and Japan provide domestic firms with specific advantages. If, for example, Japanese firms have more patient sources of capital through formal links to the banking community, allowing them a longer investment planning horizon, does that represent a competitive advantage? If so, should Canada work for the reform of the Japanese system, or should our regulatory approach be adapted to permit such inter-corporate shareholding? These questions merit closer analysis.

Given the integration of international markets and the trend for financial institutions (such as banks) to provide services previously within the domain of other types of financial institutions (such as investment dealers), a further harmonization of capital standards is likely to take place. In addition, the supervision of financial institutions, both within authoritative jurisdictions -- usually extending to national borders -- and across jurisdictions, is likely to be consolidated.

The regulatory reforms of 1992 allow Canadian financial institutions to offer most services directly, or through subsidiaries or networks. This was an important step forward in assisting Canadian financial institutions to compete internationally. Nevertheless, there are still some services that banks are not allowed to provide, the deposit insurance system needs revision and the mix of federal and provincial regulations remains complex. Since the government is committed to reviewing the 1992 reforms by June 1997, and every 10 years thereafter, some of these outstanding issues will be addressed, further enhancing the international competitiveness of Canada's financial institutions.

RÉSUMÉ

L'intégration des marchés financiers se fait en même temps au plan national et international. Dans le contexte national, l'offre de services financiers devient moins diffuse. Un plus grand nombre de firmes peuvent offrir plus de produits à un plus grand nombre de clients nationaux et étrangers. L'intégration internationale des marchés financiers reflète le libre mouvement international des capitaux.

Les relations qui existent entre les flux internationaux de capitaux, les fluctuations des taux de change, l'intégration des marchés financiers et la politique commerciale sont généralement négligées par la théorie économique, tout comme par les responsables de la politique commerciale. Pourtant, avec des investissements étrangers de plus de 250 milliards \$CAN dans les actions et obligations canadiennes et plus de 25 milliards \$ en opérations quotidiennes de change impliquant le dollar canadien, nos marchés financiers internationalement intégrés ont nettement eu d'importantes incidences sur l'économie et sur la politique commerciale.

Si la tendance à l'ouverture et à l'intégration internationale plus poussées des marchés financiers n'a pas réduit l'efficacité de la politique monétaire, surtout au Canada, une assez longue période d'intégration financière avec les États-Unis a quelque peu réduit l'efficacité de la politique fiscale. Le libre mouvement du capital et la capacité des gouvernements d'emprunter sur les marchés internationaux ont toutefois accru le nombre des options de financement par déficit.

Dans la mesure où les marchés financiers internationalement intégrés et assujettis à un régime de change flexible supposent un certain degré de variabilité imprévisible des taux de change, les firmes engagées dans le commerce international de biens et de services sont confrontées à un risque financier que n'ont pas à assumer les firmes limitant leurs activités aux marchés intérieurs. Certains instruments financiers ont été conçus pour aider les firmes à gérer certains des risques associés au commerce international, surtout le risque de change. Ces instruments — ou «couvertures» — sont également offerts aux petites et grandes sociétés de commerce puisque les institutions financières qui les structurent sont autant préoccupées par la devise en cause (elles préfèrent une grande devise et un marché liquide) que par l'importance monétaire de la couverture. Les petites entreprises, toutefois, font face à d'autres problèmes avant de pouvoir exporter.

Les exportateurs qui sont confrontés à des fluctuations de change — comme une appréciation de la monnaie nationale — et qui choisissent de les absorber plutôt que de modifier leur prix à l'exportation pourront se voir exposés à des mesures antidumping. La menace d'une action antidumping contre une firme qui applique une stratégie de prix rationnelle pour maintenir sa part du marché des exportations souligne l'inadéquation de la mesure antidumping comme moyen de mener les relations commerciales en rapport avec les pratiques des entreprises.

L'hystérésis commerciale désigne un changement permanent dans la structure ou le volume des échanges à la suite d'une modification temporaire — mais parfois prolongée — du taux de change. On a soutenu que la surévaluation du dollar canadien entre 1989 et 1991 a provoqué le déclin permanent du secteur manufacturier en réduisant les exportations; mais des recherches poussées n'ont pas permis de confirmer l'hypothèse de l'hystérésis. Le ministère des Affaires étrangères et du Commerce international craint toujours la possibilité que des désalignements prolongés des taux de change ne favorisent le protectionnisme chez certains de nos partenaires commerciaux. Les firmes étrangères incapables de concurrencer les exportateurs canadiens en raison d'une baisse temporaire de la valeur du dollar canadien pourraient par exemple exercer des pressions pour que d'autres gouvernements restreignent les importations depuis le Canada.

Certains sont d'avis que, pour éviter l'incertitude associée à la variabilité des taux de change et éliminer les obstacles au commerce qui en résultent, il faudrait maintenir la fixité du taux de change entre les proches partenaires commerciaux, surtout dans les zones de libre-échange. Il a été périodiquement proposé de maintenir un taux fixe entre le dollar canadien et le dollar américain, ou d'utiliser la même monnaie dans les deux pays. Toutefois, la cession de souveraineté politique et économique associée à une monnaie commune est une question tellement sensible que le Canada ne va probablement pas la négocier dans l'avenir prévisible. La meilleure façon de promouvoir un environnement dans lequel la variabilité des taux de change préoccupe moins nos sociétés de commerce est d'appuyer la politique de stabilité des prix appliquée par la Banque du Canada. Cela est particulièrement important étant donné la tendance mondiale à réduire l'inflation.

L'industrie des services financiers est tout particulièrement affectée par l'internationalisation des marchés financiers. Le commerce des services financiers a été rapidement intégré aux accords commerciaux internationaux — comme le montrent l'ALE, l'ALENA et le GATS. Pour pouvoir tirer pleinement avantage des possibilités offertes par l'intégration des marchés financiers, les institutions financières

doivent avoir accès aux marchés étrangers pour y implanter des établissements locaux. Les banques canadiennes sont tout particulièrement intéressées par le vaste marché américain. Même si l'ALENA libéralise peu, dans l'immédiat, le commerce des services financiers entre le Canada et les États-Unis, les firmes canadiennes pourront profiter de toute libéralisation future à l'intérieur des États-Unis (comme la levée des restrictions sur les opérations bancaires inter-états); et elles peuvent dès maintenant se prévaloir d'une procédure structurée pour le règlement des différends entre gouvernements.

L'établissement direct de succursales de banques étrangères n'est pas interdit au Japon, mais la simplification de la procédure d'octroi des permis qu'administre le ministère des Finances serait une heureuse initiative. L'agrément unique de l'Union européenne pour les services financiers pourrait faire que nos institutions ont encore plus de difficulté à livrer concurrence sur ce marché. Si le modèle allemand de la banque universelle gagne encore en popularité, il se pourrait que les institutions financières étrangères se voient incapables de soutenir la concurrence de réseaux bancaires européens importants et efficaces.

Le modèle de la banque universelle soulève aussi certaines questions touchant la capacité des sociétés non financières de soutenir la concurrence internationale. Il reste à déterminer si les étroites alliances intra-société que l'on retrouve typiquement en Allemagne et au Japon donnent des avantages particuliers aux entreprises nationales. On peut par exemple s'interroger sur l'existence d'un avantage concurrentiel pour les firmes japonaises dont les importantes ressources en capital générées par leurs liens formels avec les milieux bancaires leur permettent de projeter leurs investissements sur le plus long terme. Si tel est le cas, on peut se demander si le Canada devrait appuyer la réforme du système japonais, ou s'il devrait plutôt adapter son approche réglementaire pour permettre ce type de participations croisées au capital. Ce sont là des questions qui méritent d'être approfondies.

Étant donné l'intégration des marchés internationaux et la tendance des institutions financières (comme les banques) à fournir des services précédemment réservés à d'autres types d'institutions financières (comme les courtiers en valeurs mobilières), on peut s'attendre à une harmonisation encore plus prononcée des règles touchant le capital. En outre, on verra probablement un resserrement de la supervision nationale et internationale des institutions financières.

Les réformes réglementaires de 1992 permettent aux institutions financières canadiennes d'offrir la plupart des services directement, ou par l'entremise de succursales ou de réseaux. Cela a grandement aidé nos institutions financières à soutenir la concurrence internationale. Mais il reste certains services que les banques ne sont pas encore autorisées à offrir; de plus, le régime d'assurance-dépôts a besoin d'être révisé, et l'ensemble des réglementations fédérales et provinciales reste complexe. Puisque le gouvernement s'est engagé à revoir les réformes de 1992 d'ici juin 1997, et à chaque dix ans par après, certains de ces problèmes seront abordés dans l'optique d'un renforcement de la compétitivité internationale des institutions financières canadiennes.

1. INTRODUCTION

The integration of financial markets has taken place, and continues to take place, on two fronts.

- Internationally, markets have become more closely linked as capital has become more mobile. A transfer of funds between international markets is instantaneous, and no more complex than a transfer between domestic markets.
- Domestically, financial institutions are offering a wider variety of services due to reduced segmentation of the financial services industry. As a result, traditional divisions between different financial institutions have become blurred.

While financial markets have become more closely linked internationally, the relationships between capital flows, exchange rate movements and trade policy remain largely overlooked by standard international economic theory as well as those involved in the trade policy process. Trade theory provides little, if any, guidance as to how the gains from trade can be realized, or maintained, when firms are faced with international financial risks. Similarly, trade policy is inclined to neglect the potential financial uncertainty firms face when dealing in international markets.

With the expansion of world trade and the integration of financial markets, managing exchange rate risk has become an important corporate strategy. This Paper attempts to outline how the integration of the world's financial markets has had an impact on trade, primarily through exchange rate variability. It is not claimed that more integrated financial markets have led to more volatile exchange rates. Rather, it is recognized that the same factors that caused financial markets to become integrated have caused exchange rates to become somewhat more volatile.

The integration of the financial services industry is largely a domestic phenomenon. At the same time, however, financial services have become increasingly international, and have been part of several trade negotiations. This Paper does not investigate the role that negotiated reductions in barriers to the trade in financial services play in integrating capital markets. It is the author's opinion that trade negotiations on financial services, and their desired economic effects, are well understood, particularly by trade policy makers. This Paper instead focuses on how

the domestic integration of financial services assists financial and non financial firms to compete internationally, as well as possible future developments with respect to internationally integrated financial services markets.

The remainder of the Paper is organized as follows: the second section reviews the history of financial market integration and what it means for Canada; section three briefly considers the economic implications of financial integration; section four focuses on the trade implications of more integrated financial markets and trade in financial services. Finally, a few policy-relevant conclusions and projections concerning the international integration of financial services are presented.

2. THE INTERNATIONALIZATION OF CAPITAL MARKETS

2.1 A Modern History of World Capital Markets

The modern history of the internationalization of world capital markets is generally traced back to the late 1950s when Soviet authorities, fearing a seizure or blocking of dollar balances in the U.S. in the event of hostilities, placed U.S. dollar deposits in banks located in London and Paris. This led to the development of a European market for dollars, which has come to be known as the Eurodollar market. Today, the term Eurodollar is misleading, since the market encompasses any commercial bank deposits outside the country of issue of the currency.

Two important events, both of which took place in the 1970s, stand out in the development of the Eurodollar market and the increase in international financial flows. First, in 1971 the system of fixed exchange rates, as devised in Bretton Woods over 25 years earlier, was adjusted due to huge U.S. balance of payments deficits. This led to a massive flight of liquid capital from the United States. By 1973, exchange rates were allowed to float. The second event of note was the 1973 oil crisis. Following the sharp oil price increase, an imbalance in the form of a payments surplus for oil-producing countries and a payments deficit for oil-importing countries was generated. Euromarkets played a key role in recycling the surpluses via large-scale international bank lending.

Since the 1970s, a number of factors have facilitated the growth of international capital flows and, ultimately, the integration of world financial markets. In the mid 1970s, the removal of capital controls began the financial deregulation process in Germany and the U.S. (Canadian capital controls were lifted in the early

1950s). By the end of the decade, Japan and the UK had begun deregulation, followed later by France, Italy and some other EU countries.

The reduction or elimination of capital controls facilitates increases in foreign direct investment. In so far as the global increase in the stock of foreign direct investment leads to a more "cosmopolitan" approach to business, companies, as well as governments, become more aware of international sources of capital. Borrowing abroad and/or placing equity issues abroad are likely to be more routine for enterprises already active in foreign markets through direct investments.

Another factor often cited as important to the increase in international capital flows is the large current account imbalances experienced by the industrial countries.¹ By 1980, the collective current account deficit of industrial countries reached US\$63 billion.² Partially offsetting capital account surpluses -- implying sizeable international capital flows -- were run to finance the current account deficits. Those international capital flows caused a certain degree of convergence in terms of investment returns as financial markets became more competitive.

The increased integration of world financial markets would not have been possible without advances in technology, particularly in telecommunications and the accessibility of computers. The complexity of new financial instruments, such as financial futures, options on futures, index options and swaps, requires the application of custom software to determine their price and monitor the variables that effect price movements.

Technological advances have led some stock markets, as well as futures and options markets, to establish international links with other markets. For example, between 1985 and 1988, the American Stock Exchange and the Toronto Stock Exchange had an automated trading link for a few of the major companies listed on their markets. However, such links are superseded by around-the-clock electronic trading. Yet, for markets to become 24-hour operations they require more than the

¹ See, for example, W. White, *Some Implications of International Financial Integration for Canadian Public Policy*. Technical Report No. 57. Ottawa: Bank of Canada, December 1991, p. 3. White points out that without sufficient capital, the current account imbalances would have been reduced. It is not clear whether the current account imbalances led to mobile capital or mobile capital allowed current account imbalances.

² International Monetary Fund, *International Financial Statistics Yearbook*. 1992, p. 128.

appropriate technology. Market makers and liquidity are also essential for the smooth functioning of markets.

Today, the financial markets of industrialized countries, including Canada, are said to be integrated in the sense that capital is mobile and investors substitute assets with the expectation of similar returns. There are a number of more precise definitions of market integration focusing on interest parity.³ In a recent Bank of Canada study, William White considered the evidence on the integration of Canada's financial markets with those of the United States. He concluded that the short-term markets are fully integrated, and we can not dismiss the possibility of long-term markets being integrated as well.⁴

2.2 The Importance of Financial Integration for Canada

Two examples illustrate the extent of foreign participation in Canadian financial markets, and the size of financial markets relative to the economy.

- By the end of 1992, foreign investment in Canadian bonds was C\$232 billion, over one-third of total bonds outstanding.⁵ Not surprisingly, investors from the United States accounted for the largest share, with 38% of all Canadian bonds held by foreigners. Foreign holdings of Canadian stocks was lower, at C\$18 billion.
- As of the latest survey conducted in April 1992, the average daily volume of foreign exchange transactions involving Canadian institutions was about US\$22 billion.⁶ This means that, on a yearly basis, turnover in the Canadian foreign exchange market amounts to over nine times the Gross Domestic Product.

³ See A. Blundell-Wignall and F. Browne, *Increasing Financial Market Integration, Real Exchange Rates and Macroeconomic Adjustment*. OECD Department of Economics and Statistics Working Paper No. 96. Paris: February 1991, pp. 8-14.

⁴ W. White, *op. cit.*, pp. 3-4.

⁵ Statistics Canada, *Canada's International Investment Position Historical Statistics 1926-92 #67-202*. Ottawa: March 1993, p. 27.

⁶ N. Close and C. Duenwald, "Survey of the Canadian Foreign Exchange Market." In *Bank of Canada Review*. October 1992, p. 23.

One implication of the extensive foreign participation in Canadian financial markets is that economic events which take place outside Canada can have an immediate and/or more intense Canadian impact. The Japanese asset deflation that began in 1989 caused Japanese investors to reconsider their positions abroad, including their holdings of Canadian securities. The Japanese retrenchment continues. In September 1993, Japanese holdings of Canadian bonds declined to C\$45 billion from C\$49 billion a year earlier.

3. THE ECONOMIC POLICY IMPACT OF FINANCIAL INTEGRATION

As a proxy for an economy with internationally integrated financial markets, consider a situation of flexible exchange rates and mobile capital.⁷

3.1 Monetary Policy

The monetary policy transmission mechanism works in two steps:

- First, a change in the money supply causes a change in interest rates and the exchange rate.
- Second, a change in interest rates and the exchange rate causes a change in aggregate demand.

With flexible exchange rates and mobile capital, monetary policy becomes more effective. If the central bank restricts money supply growth and domestic interest rates rise, foreign capital will enter the country -- attracted by higher returns -- and the currency will appreciate. Higher interest rates reduce output in interest-sensitive sectors of the economy and the currency appreciation reduces output in tradeable goods.

As tradeables have expanded to account for a larger share of GDP, the trade sector has become relatively more important in the transmission of monetary policy. The interaction between rising interest rates (or falling rates), an appreciating currency (or a depreciating currency) and the reduction (or increase) in aggregate demand has grown in importance.

⁷ A flexible exchange rate regime is key to the analysis which follows.

Instead of reinforcing the notion that monetary policy is now more effective, the integration of international financial markets has led to questions concerning both steps of the transmission mechanism.⁸ The argument is that central banks can no longer control domestic interest rates; changes in money supply growth that would normally cause interest rates to change are outweighed by international capital flows that equalize returns across markets. Further, any movement of interest rates that might have altered aggregate demand are partially offset by the availability of alternative sources of financing and changes in the composition of money holdings.

Nonetheless, research conducted by the IMF, the Federal Reserve Bank of New York and the Bank of Canada all suggest that the effectiveness of monetary policy has not been diminished due to either the liberalization or the internationalization of financial markets.⁹ Canada has a relatively long history of financial integration with the United States and the recent growth in international capital flows has had little, if any, negative impact on the ability to conduct Canadian monetary policy.

3.2 Fiscal Policy

As in the above section on monetary policy, we consider the effectiveness of fiscal policy in an environment of flexible exchange rates and mobile capital. While theory suggests monetary policy will be more effective in such an environment, it suggests fiscal policy will be less so. An expansionary fiscal policy, if it is not accompanied by an easing of monetary policy, will cause domestic interest rates to rise. The increase in interest rates will attract foreign capital, causing the domestic currency to appreciate and net exports to decline. The decline in net exports will at least partially offset the fiscal stimulus.

Just as the trade sector has become more important to the transmission of monetary policy, it has also become more important to fiscal policy. However, instead of making fiscal policy more effective, as is the case with monetary policy, the

⁸ See, for example, White, *op. cit.*, p. 12.

⁹ For a discussion of financial market integration and the effectiveness of Canadian monetary policy, see J. Murray and R. Khemani, *International Interest Rate Linkages and Monetary Policy: A Canadian Perspective*. Technical Report No. 52. Ottawa: Bank of Canada, December 1989, p. 39. For discussions of monetary policy and the interest sensitivity of output, see International Monetary Fund, "Effectiveness of Monetary Policy After Financial Market Liberalization." In *World Economic Outlook*. Supplementary Note 5, 1991, p. 105, and B. Hirtle and J. Kelleher, "Financial Market Evolution and the Interest Sensitivity of Output." In *Quarterly Review*. New York: Federal Reserve Bank of New York, Summer 1990, pp. 56-70. For an explanation of what other factors can effect the transmission mechanism see W. White, *op. cit.*, p. 12.

interaction between exchange rates and net exports tends to make fiscal policy less effective.

Fiscal policy may be less effective, but the free flow of capital increases the flexibility of fiscal management with respect to deficit financing. With an international capital pool to draw from, government deficits need not be financed solely by domestic savings. Canadian provinces, for example, have drawn heavily on foreign markets. Of the C\$85 billion worth of new bonds issued by the provinces in 1991 and 1992, C\$43 billion was placed abroad.

4. TRADE IMPLICATIONS

The globalization of business has an impact on virtually all sectors of the economy, especially trade and investment.¹⁰ To separate those trade effects into parts of the globalization process such as the integration of financial markets is a difficult exercise. The problem is that there are a number of simultaneous events that work to reinforce each other. In essence, there is a circle in which increased investment leads to increased trade which leads to the interdependence of economies which leads back to increased investment. The circle can start anywhere and move in either direction. The following are some of the issues concerning the relationship between trade and the flow of investment in financial markets.

4.1 Increased Access to Capital for Developing Countries

An indirect implication for Canadian trade involves the emergence and internationalization of capital markets in developing countries. For the year ended June 1993, the world's top performing stock markets were in Turkey, Brazil and Indonesia. The rise of developing markets is, in part, thought to be the result of lower yields in developed countries. Whether the interest in developing countries disappears with the return of higher yields in developed countries remains to be seen. In the meantime, increased activity in developing markets should, over time, reduce risks associated with investing in developing countries and provide developing country firms wishing to raise funds with more alternatives to bank financing.

¹⁰ For a comprehensive discussion of globalization, see D. Seebach, *Globalization: The Impact on the Trade and Investment Dynamic*, Policy Planning Staff Paper, No. 93/7 (June 1993).

Another source of capital to developing countries is the issuance of equities in developed markets. Mexican firms, for example, have issued shares in U.S. stock exchanges. Shares in the Mexican telephone company -- Telefonos de Mexico SA -- were among the most actively traded on the New York exchange in 1992.

The expansion of capital markets in developing countries and the integration of developing country firms in developed markets could present Canadian firms with new trade and investment opportunities. With the availability of capital and participation in international markets comes an opportunity for developing country firms to grow. As Telefonos de Mexico grows, particularly with Canadian firms enjoying a degree of preferential access to the Mexican market under the NAFTA, we should expect an increase in telecommunications equipment trade.

4.2 The Role of the Exchange Rate

For an open economy such as Canada, the exchange rate is one of the key macroeconomic prices. The ability of Canadian enterprises to compete internationally depends on their production costs, which, in turn, depend on a number of other factors including interest rates and productivity levels, and the exchange rate. Low production costs accompanied by high levels of productivity can allow a firm to compete domestically, but without an appropriate exchange rate, the firm will not be able to compete internationally.

Two derived variations of the exchange rate that are often used to measure a country's competitive position are the effective exchange rate and the real effective exchange rate. The effective exchange rate is an index of the domestic currency price of a basket of foreign currencies, with each foreign currency weighted according to its trade share. It is a summary measure of the average cost of foreign exchange. The real effective exchange rate is an inflation-adjusted effective exchange rate. It takes into account the fact that nominal exchange rates move in response to inflation differentials between countries. Movements in the real effective exchange rate are thus often cited as indicators of change in a country's competitive position.

The importance of exchange rate movements to Canadian trade is outlined in a 1989 Bank of Canada study.¹¹ It found that a one per cent depreciation of the effective exchange rate resulted in a C\$2 billion improvement in the Canadian trade balance over a period of about four years. It was recognized that dynamic effects, such as increased imports of intermediate products and higher domestic demand and prices, could reduce the \$2 billion improvement by as much as 50 per cent. Nevertheless, the effects are sizeable considering the Canadian dollar fell more than one per cent against the U.S. dollar in a single month on four occasions in 1992.

4.3 Exchange Rate Volatility and Trade

The questions of whether exchange rate movements overshoot new equilibriums or are excessively volatile in relation to underlying economic fundamentals -- such as growth of the money supply or real income -- are critical to interpreting their impact on trade.¹² The notion that exchange rates are too volatile is aided by anecdotal evidence, such as the fact that the U.S. dollar rose more than 2 per cent against the German mark in one day on seven separate occasions in 1992. Such volatility can not be entirely attributed to movements of underlying economic variables.

There are at least two views on why exchange rates have become so volatile.¹³ One argues that capital markets are so efficient that huge volumes of funds switch from currency to currency in response to small disturbances. It is the large-scale capital movements from one currency to another that alter the exchange rates. Another view is that there is too much destabilizing speculation. As a currency moves away from its long-run equilibrium, speculators exacerbate that movement by betting, at least temporarily, that the market will continue in one direction.

¹¹ R. Dion and J. Jacob, *The Dynamic Effects of Exchange Rate Changes on Canada's Trade Balance, 1982-87*. Working Paper 90-1. Ottawa: Bank of Canada, December 1989.

¹² Since the exchange rate is the price of foreign exchange, its equilibrium is ultimately determined by supply and demand. With little indication of the supply and demand curves for foreign exchange, the purchasing power parity (PPP) theory was developed to estimate equilibrium exchange rates. Simply put, the relative version of the PPP states that if one country's inflation rate is higher than that of its trading partners, the value of its currency should decline. Otherwise, its tradeable goods and services would be overpriced and internationally uncompetitive. Foreign exchange markets react to any indication of either impending or eventual movements in the price level. Thus, we are able to understand the attention central banks pay to the relationship between stable prices and a stable exchange rate.

¹³ See J.A. Frankel, "International Capital Mobility and Exchange Rate Volatility." In *International Payments Imbalances in the 1980s*. Boston: Federal Reserve Bank of Boston, 1988, pp. 162-85.

It is easy to accept on an intuitive level that the integration of capital markets and the increase in international capital flows have led to more exchange rate volatility. Yet, the causation is not that simple. It is difficult to separate the effects of the integration of capital markets from other events such as the shift from fixed to flexible exchange rates. Indeed, if one traces the causes of financial integration back to large current account imbalances or technological changes, for example, one could argue that it was those changes that caused exchange rates to be more volatile. It is important to keep in mind that financial integration did not take place in isolation. The same factors that caused capital markets to become more integrated caused exchange rates to become more volatile.

4.3.1 Short-term Fluctuations

The bubble theory of exchange rates attempts to explain how exchange rate movements can lead away from, rather than towards, an equilibrium based on real economic variables.¹⁴ There is evidence to suggest that speculative bubbles have influenced the exchange value of the Canadian dollar.¹⁵ Speculative bubbles are essentially a short-term phenomenon, but their impacts on firms involved in international trade should not be casually dismissed.

A Reduction in Trade

A primary concern of firms involved in international trade is the risk associated with uncertain exchange rates. An exporting firm whose revenues are in a foreign currency faces fixed costs -- assuming its inputs are domestically sourced -- and potentially variable revenues. The profit outlook for trading firms is, therefore, subject to an additional degree of uncertainty compared to firms active only in the domestic market.¹⁶

¹⁴ See R.G. Harris, *Trade, Money and Wealth in the Canadian Economy*. Toronto: C.D. Howe Benefactors Lecture, 1993, p. 34.

¹⁵ See W. White, *op. cit.*, p. 18, and A.K. Rose, "Discussion," following S. van Norden, "Regime Switching and Exchange Rate Bubbles." In *The Exchange Rate and The Economy*. Ottawa: Bank of Canada. 1993, p. 323.

¹⁶ That is not to say that firms servicing the domestic market do not face any exchange rate risk. It is difficult to imagine a large Canadian firm whose inputs have no foreign content. Exchange rate movements can alter the prices of foreign sourced inputs.

Assuming the sunk costs of becoming an international enterprise are not too large, the uncertain profit outlook due to variable exchange rates would reduce the volume of trade if risk-averse firms chose to drop out of international markets. While empirical research on the relationship between exchange rate variability and trade volumes is not conclusive, a growing body of work points towards exchange rate volatility causing a modest decline in trade.¹⁷

A point not addressed in the empirical studies is whether exchange rate variability discourages firms from ever entering international markets. There is only scattered evidence of the negative impact exchange rate swings have on firms already engaged in trade, and no evidence concerning the decisions of firms considering entering international markets. If volatile exchange rates do act as a barrier to firms becoming international traders, the volume of trade could be considerably higher in a more stable exchange rate setting.

An Increase in Trade

There is at least one line of thinking that suggests exchange rate volatility and trade volumes are positively related. A recent study considered the effects of exchange rate risk on the relative attractiveness of foreign direct investment versus the development of an export strategy.¹⁸ It concluded that exchange rate volatility makes exporting relatively more attractive. Given the choice between investing in a foreign country and investing in export facilities in the home country, firms tend to invest at home during periods of currency uncertainty. The decision to export instead of investing abroad reduces the firm's total exposure to exchange rate risk.¹⁹

¹⁷ See V. Kumar and J.A. Whitt, "Exchange Rate Variability and International Trade." In *Economic Review*. Atlanta: Federal Reserve Bank of Atlanta, May/June 1992, p. 17.

¹⁸ See P. Sercu and C. Vanhulle, "Exchange Rate Volatility, International Trade and the Value of Exporting Firms." *Journal of Banking and Finance* 16. North Holland Press, 1992.

¹⁹ The relationships between foreign direct investment, exports and the exchange rate are not without debate. See D. Julius, *Global Companies and Public Policy*. Chatham House Papers, The Royal Institute of International Affairs. London: Pinter Publishers, 1990, p.90. Julius suggests that investing abroad rather than exporting reduces a company's exposure to exchange rate fluctuations.

A Diversion of Trade

Trade can also be diverted due to exchange rate volatility.²⁰ Trade between two countries could grow, even though their bilateral exchange rate is volatile, if a third country, with which both countries had previously traded, has an even more volatile currency. In order to avoid conducting business which requires managing risks in the more volatile foreign exchange market, firms move to other markets.

4.3.2 Longer Term Misalignments

In the typical textbook approach to international trade, monetary factors are assumed to have no long term effect on real trade flows. The question then is how long is the long term? If monetary factors have no effect on trade in the long term, it might be just as well to wait out short-term disturbances such as exchange rate fluctuations. Yet, the movements of financial markets can not be dismissed as mere short-term occurrences that will, over time, correct themselves.

There are cases in which exchange rates are misaligned for extended periods of time. An example is the exchange rate between the Japanese yen and the U.S. dollar. Since 1986, the dollar has fallen from over 200 yen to just over 100 yen (as of February 1994). It does not matter if one believes that the rate was in equilibrium at 200, is closer to equilibrium near 100, or belongs somewhere in between.²¹ The fact is that the movement has been going on for eight years; to dismiss it as a short term phenomenon having no impact on trade would seem naive.

Leaving aside what causes longer term exchange rate misalignments, if we accept that currency movements can influence trade over time, there are a number of implications. To the extent that overvalued currencies discourage exports and encourage imports and undervalued currencies do the opposite, an economy can experience a misallocation of resources. The shifting of capital and labour between the production of tradeable goods and services and non-tradeables is costly. If the

²⁰ See V. Kumar and J.A. Whitt, *op. cit.*, p. 29.

²¹ Although it is theoretically possible that the exchange rate was in equilibrium at 200 yen to the dollar and again at 100 yen to the dollar, i.e., underlying economic fundamentals changed so much that the exchange rate movement was justified, we dismiss this as a real possibility in this case. In other cases, exchange rates might move by such wide margins and still not be misaligned.

resource shifts are caused by misaligned exchange rates, the collective efficiency of trading nations is suboptimal.

Pass-through Options

A trading firm can try to avoid short-term exchange rate volatility by abstaining from international activities, or it can try to hedge the uncertainty by employing appropriate financial instruments. For long-term misalignments, the firm needs a more comprehensive strategy. Among other things, this strategy entails determining the appropriate price response of tradeables to changes in the exchange rate.

One of the key roles of the exchange rate is to relate domestic and foreign prices. If the domestic price level rises, for example, the value of the domestic currency must fall in order to maintain the same relationship between domestic and foreign prices, when expressed in a common currency. Otherwise, domestic exports will be priced out of the foreign market and imports from the foreign country will displace domestically produced goods.

An issue that firms involved in international trade must deal with is what to do when the exchange rate moves unexpectedly. The relationship between domestic and foreign prices is altered. Firms must decide whether to change the prices of traded goods to offset the exchange rate effect. At stake is the profitability of trade.

The Federal Reserve Bank of New York has looked at the impact of an exchange rate appreciation on the profitability of U.S. manufacturers.²² The study concluded that regardless of the ways in which exporters adjusted their pricing strategies, their profits declined. If the dollar appreciates and the firm raises the foreign currency price of its exports, passing the full effect on to consumers in the foreign market, the per-unit dollar profit stays the same, but total profits fall because the products are less competitive in the foreign market and sales decline. If the firm keeps the foreign price the same following the currency appreciation, passing none of the effect on to consumers in the foreign market, the dollar price of exports falls by the same amount the dollar has appreciated. In this case, the firm preserves market share, maintains export volumes and foreign currency profits, but the profit in dollars will be lower.

²² See J. Hung, "Assessing the Exchange Rate's Impact on U.S. Manufacturing Profits." In *Quarterly Review*. New York: Federal Reserve Bank of New York, Winter 1992-93.

Since the pass-through of a currency appreciation is generally somewhere between these two extremes, the profit of exporters will usually fall for two reasons. The volume of exports declines due to their price increase in the foreign market, and the new exchange-rate reduces the domestic-currency-value of foreign currency profits.

When an exporting firm chooses to maintain market share by absorbing exchange rate movements rather than altering its market price, it is said to be engaging in a "pricing-to-market" strategy. Japanese and German firms did this in the mid to late 1980s in the U.S. market. This resulted in the persistent U.S. trade deficit despite a declining dollar.²³ Schembri notes that there is sufficient evidence -- both theoretical and empirical -- to suggest that pricing-to-market behaviour is widespread among exporting firms across many countries.²⁴ Export prices are slow to respond to price changes brought about by movements in exchange rates.

One implication of the pricing-to-market approach is that firms pursuing a perfectly rational pricing strategy, without engaging in predatory pricing, can be exposed to anti-dumping action in export markets. By absorbing an appreciation of the domestic currency instead of passing the effects on to foreign consumers, exporters have, in essence, lowered their export price relative to their domestic price (and costs). When such a gap exists, exporters can be accused of dumping.

The Canadian Experience

The Canadian evidence on the pass-through of exchange rate changes shows import prices reflecting exchange rate movements quite closely.²⁵ The prices of Canadian imports are set in U.S. dollars and variations in the exchange rate are passed through to Canadian consumers. If the Canadian dollar declines against the U.S.

²³ It is important to recognize that the U.S. trade deficit represented a fundamental imbalance between savings and investment. With low domestic savings, caused in part by the large federal government deficit, imports were drawn into the U.S. to satisfy domestic demand.

²⁴ See L. Schembri, *Export Prices and Exchange Rates: An Overview*. Presented at the Global Disequilibrium Conference, Montreal, June 1989, p. 17.

²⁵ See R.G. Harris, *Exchange Rates and International Competitiveness of the Canadian Economy*. Ottawa: Economic Council of Canada, 1992, p. 34.

dollar, our import prices rise; an increase in the Canadian dollar results in cheaper imports.²⁶

Harris found that the prices of Canadian exports, in Canadian dollars, are not sensitive to the Canada-U.S. exchange rate. Exporters base their prices on Canadian dollar costs and movements in the value of the currency are passed through to customers. If the Canadian dollar declines against the U.S. dollar, prices faced by U.S. importers of Canadian goods fall; if our currency rises, the price of Canadian exports rises. Harris cautions, however, that this contrasts with some other evidence on export pricing.

The upshot of Harris' work is that the Canadian trade balance responds to changes in the value of the Canadian dollar as economic theory would suggest. A decline in the value of the dollar improves the trade balance and a rise in the value of the dollar worsens the balance.

Trade Hysteresis

Trade hysteresis refers to a permanent change in trade patterns or volumes following a temporary change in the exchange rate. In other words, if the exchange rate climbs and then falls, and the trade balance responds to the climb but is not corrected by the fall, that is an incidence of trade hysteresis.

The standard J-curve explanation of the relationship between exchange rates and the trade balance is related to the concept of trade hysteresis. The J-curve theory says that, immediately following a currency devaluation, the trade balance worsens because the volumes of exports and imports respond slowly to relative price changes. For the new exchange rate equilibrium, imports are too high and exports too low. The term J-curve came about as a description of the shape of the time path of the trade balance, plotting time along the horizontal axis and the balance of trade along the vertical axis. In the J-curve analysis, the trade balance slowly responds to the new exchange rate; in the case of trade hysteresis, the balance responds to an initial exchange rate movement in one direction but does not respond, or at least not as quickly, to a subsequent reversal.

²⁶ Some of the response of import prices is due to the way in which they are calculated by Statistics Canada. In some cases, a U.S. price is taken and multiplied by the exchange rate to obtain a Canadian import price. Then, the pass-through of exchange rate changes is guaranteed.

Trade hysteresis became a topic of discussion following the rise and decline of the U.S. dollar against the Japanese yen in the 1980s and the response of the U.S. trade deficit.²⁷ From 1980 to 1985, the dollar rose from 200 Yen to 250 Yen, and there was some concern that the overvalued dollar had led to a deindustrialization of the United States. The dollar depreciated during and after 1985, but U.S. exports were slow to recover. It was thought that the temporary rise in the value of the U.S. dollar had led to a permanent shift in the U.S. trade balance.

The trade hysteresis theory has also been applied to Canada.²⁸ The Canadian dollar rose 22% against the U.S. dollar from February 1985 to the end of 1991, and was generally regarded as overvalued between 1989 and 1991 when it traded in the US\$.84 to US\$.89 range. It was argued in the press that our overvalued currency led to a permanent decline in the Canadian manufacturing sector by reducing exports and raising imports. Employment in the manufacturing sector fell each year between 1989 and 1992 and real manufacturing output was stagnant at best.

The Bank of Canada and Richard Harris have done extensive research on trade hysteresis and the Canadian experience, focusing on the 1989-91 period.²⁹ They reached two important conclusions:

- It is very difficult to differentiate between long lags and permanent shifts in the response of trade to exchange rate movements.
- An insufficient period of time has passed to determine whether the overvalued dollar has permanently effected Canadian trade.

The existence of sunk costs, or an investment of resources required to enter and/or exit international markets, helps explain why trade flows do not appear to respond immediately to currency movements and why more time may be required to determine the ultimate effects. If, in order to enter a foreign market, a firm must undertake certain expenditures on plant expansion, setting up a local distribution

²⁷ See R.G. Harris, *op. cit.*, p. 37, and R.G. Harris, "Exchange Rates and Hysteresis in Trade." In *The Exchange Rate and the Economy*. Ottawa: Bank of Canada, 1993, p. 362.

²⁸ See R. Amano, E. Beaulieu and L. Schembri, "Trade Hysteresis: Theory and Evidence for Canada." In *The Exchange Rate and the Economy*. Ottawa: Bank of Canada, 1993, p. 403.

²⁹ See R. Amano, E. Beaulieu and L. Schembri, *op. cit.*, and R.G. Harris, *op. cit.*

network or renewing its marketing plan, then once those costs have been incurred, the movement of exchange rates must be quite large, and/or prolonged, for firms to abandon the investment and drop out of the market. Similarly, a favourable exchange rate might need to be in place for an extended period before firms will undertake the sunk costs required to enter new markets.

4.3.3 Arguments for Protection

A danger to the international trading environment is that currency misalignments could lead to increased calls for protection. An overvalued currency reduces the international competitiveness of domestic firms, and might result in a request for offsetting compensation. Some have argued that the risk-aversion of firms is not nearly as important in reducing international trade as the increased protectionism and adjustment problems associated with misaligned exchange rates.³⁰

4.3.4 Volatility Not All Bad

The experiences of trading firms when dealing with volatile exchange rates need not be universally bad. Just as trade is discouraged, either temporarily or permanently, by an appreciation of the domestic currency, trade is encouraged by a depreciation of the currency. It is possible that, during a temporary fall in the value of the domestic currency, a firm is able to exploit that advantage to capture new markets.³¹ Such a plan requires the exchange rate to be misaligned for a long enough period of time for the firm to act, and the sunk costs mentioned above would preferably be denominated in the domestic currency.

³⁰ See P. de Grauwe, "Exchange Rate Variability and the Slowdown in Growth of International Trade." *Staff Papers* Vol. 35 No. 1. Washington: International Monetary Fund, March 1988, p. 69.

³¹ See R.G. Harris, *op. cit.*, p. 376.

4.4 The Common Currency Debate

A debate related to volatile exchange rates and their effects on trade concerns common currency areas, in which exchange rates are fixed or a common currency is shared between countries.³² The risks associated with volatile currencies are removed in such a system, but the debate on the merits of fixed versus flexible exchange rates encompasses a number of other issues.

The essence of the debate over fixed versus flexible exchange rates is whether one believes the benefits of one arrangement outweigh its costs. In the adoption of one system, its costs are the foregone benefits of the other system. So, we need only consider the costs and benefits of either the fixed or flexible exchange system and, by definition, we will also have the costs and benefits of the other.

The significant costs and benefits of a common currency area are summarized in Table 1.

TABLE 1	
BENEFITS AND COSTS OF A COMMON CURRENCY	
BENEFITS	COSTS
1. Reduced transactions costs	1. Reduced policy independence.
2. Reduced economic uncertainty.	2. Less insulation from foreign economic disturbances.
3. Enhanced policy discipline and credibility.	
4. Improved functioning of the monetary mechanism.	

Source: *The Exchange Rate and the Economy*, Bank of Canada, 1993, p. 489.

³² For simplicity, this Paper will not differentiate between a system of fixed exchange rates and a common currency area. In fact, the two are quite different. With a fixed exchange rate, macroeconomic divergences can build up and put pressures on currencies to adjust, as happened in Europe in 1992 and 1993. In a common currency area, monetary policies would not be allowed to diverge. In fact, for a common currency area to work, it would require a single monetary policy, possibly set by a cross-country central bank.

With respect to the effects on international trade, the decision on whether to adopt a fixed exchange rate or enter into a common currency area essentially rests on three questions:

- (1) Is the exchange rate excessively volatile?
- (2) If the exchange rate is volatile, does that represent an impediment to trade?
- (3) If volatile exchange rates are an impediment to trade, is the removal of that impediment worth the surrender of sovereignty required to fix exchange rates?

4.4.1 Free Trade Areas and Common Currency Areas

There is no widely accepted relationship between free trade areas and common currency areas. Some researchers feel that the gains from free trade can never be fully realized without a common currency. They tend not to address, however, the role of the exchange rate as an adjustment mechanism.³³ Others suggest that common currency areas require more than free trade agreements. A common currency is viewed as being as much a political decision as an economic one.

Free Trade Requires a Common Currency

Those who favour a common currency consider the volatility of exchange rates to be sufficient to deter international trade.³⁴ They favour giving up an independent monetary policy in order to do away with the uncertainty of volatile exchange rates as well as the resource misallocation and adjustment costs associated with medium-term exchange rate movements that are often unrelated to economic fundamentals.

³³ It is important to remember that if, by virtue of being fixed, exchange rates are not allowed to adjust for macroeconomic divergences, other variables will need to do so. For a brief discussion of how fixed exchange rates require certain policy actions to keep them fixed, see T.C. Mills and G.E. Wood, "Does the Exchange Rate Regime Affect the Economy?" In *Review*. St. Louis: The Federal Reserve Bank of St. Louis, July/August 1993, Vol.75, No. 4, p.4. Specifically, Mills and Wood mention the necessity of exchange rate intervention and short-term interest rate manipulation. They cite several other studies that suggest the adoption of a system of fixed exchange rates results in the replacement of exchange rate variability with interest rate variability.

³⁴ See R.G. Harris, *Trade, Money and Wealth in the Canadian Economy*. Toronto: C.D. Howe Benefactors Lecture, 1993, pp. 41-7.

Crockett says that liberalized financial flows are an essential element of free trade.³⁵ He maintains that greater cooperation in exchange rate policies is required, since the large capital movements within a free trade area could lead to exchange rate instability. Crockett concludes that the financial integration that accompanies free trade may necessitate a currency zone.

Free Trade Does Not Require a Common Currency

Laidler explains that the situations in Europe and North America with respect to the requirement for, and feasibility of, a common currency are quite different.³⁶ In Europe, a common market is being created, within which a degree of national sovereignty has already been foregone. In North America, there exists only a free trade area, and the surrender of national sovereignty associated with a common currency would extend the countries' obligations well beyond those usually associated with free trade. This is a political, as well as an economic, argument.

There are other objections to common currencies beyond the concerns with the loss of policy independence and national sovereignty. Feldstein notes that there are cases in which a common currency is actually an obstacle to trade.³⁷ If two countries with a common currency are engaged in trade, and a third country's currency depreciates, exports from the third country become more competitive in the common currency area. It is possible that some trade between common currency countries would be displaced by the third country. By not being able to alter exchange rates, the market shares of member countries can vary within a common currency area.

4.5 Financial Instruments to Reduce Risk

Presumably, the higher risks faced by firms trading internationally -- which include exchange rate risk and political risk as well as standard business risks encountered in all markets -- are matched by higher returns for those that continue to

³⁵ See A.D. Crockett, "Financial Market Implications of Trade and Currency Zones." In *Policy Implications of Trade and Currency Zones*. Kansas City: Federal Reserve Bank of Kansas City, 1991, pp. 111-36.

³⁶ See D.E.W. Laidler, "One Market, One Money? Well, Maybe. Sometimes." In *Policy Implications of Trade and Currency Zones*. Kansas City: Kansas City, 1991, pp. 85-6.

³⁷ See M. Feldstein, "Does One Market Require One Money?" In *Policy Implications of Trade and Currency Zones*. Kansas City: Federal Reserve Bank of Kansas City, 1991, pp. 79-80.

trade. But there are a number of ways companies can reduce some of the risks inherent to international trade. By reducing risk (or hedging) and maintaining the same return, the net return on trading internationally rises. As international trade has grown, so has the availability of services and products to manage the associated risks.

Given that exchange rate volatility is one of the main risks associated with international trade, several risk management techniques exist so as to reduce, or at least spread, that risk.

In 1972, currency futures were first introduced. The holder of a currency future agrees to either purchase or sell a fixed amount of foreign currency on a future date at a fixed exchange rate.³⁸ Options contracts are similar to futures, except the holder has the right, but not the obligation, to purchase or sell foreign currency by a future date at an agreed exchange rate.

By the early 1980s, another instrument was developed to manage currency risk. A currency swap is an exchange of liabilities in two different currencies.³⁹ If a French firm wants to raise U.S. dollars and an American firm requires French francs, each can borrow domestically where it is likely to receive more favourable loan terms and agree to a swap. Both companies benefit by obtaining funds more cheaply than if they had directly accessed their desired currency market. The French company pays, in dollars, the U.S. company's debt and the U.S. company pays, in francs, the French company's debt, presumably out of the proceeds of export sales into each other's market.

Swaps are also used to reduce the cost of borrowing. If interest rates are lower in a foreign market or a company or government has already borrowed heavily in domestic markets, a swap can be arranged to take advantage of lower borrowing costs abroad. The borrower acquires funds in the foreign market and swaps back to the domestic currency.

³⁸ The forward market in foreign exchange is an informal network of banks and brokers set up to trade contracts similar to futures except they are not standardized.

³⁹ The explanation of currency swaps and their use is drawn from B. Solnik, *International Investments*. Second Edition, New York: Addison-Wesley Publishing, 1991, pp. 176-7. The term "swap" generally refers to interest rate swaps, where the payment terms of two liabilities are exchanged. Typically, a swap involves the exchange of fixed-rate and flexible-rate debt instruments.

In 1992, over 50 million currency options and futures contracts were traded on organized exchanges worldwide. Through the first half of 1992, US\$156 billion worth of new currency swaps were arranged.⁴⁰ Canadian dollar swaps amounted to US\$16 billion, with nearly US\$14 billion of those involving the U.S. dollar. The largest Canadian banks had about C\$2.2 trillion worth of derivatives outstanding in 1992, over C\$1 trillion of which was forward contracts on foreign exchange.⁴¹

Clearly, the instruments available to large companies or multinational corporations in the management of their foreign exchange risk are numerous. One question that emerges, however, is whether those same instruments are as readily available to small and medium-sized enterprises (SMEs). If the cost of managing foreign exchange risk is too high for SMEs, international trade might not be profitable. Yet, the availability of foreign exchange hedges to Canadian firms depends more on the currency they need to hedge than on the size of the firm or the size (dollar value) of the hedge. Although SMEs face other export readiness difficulties, with respect to currency risk, large and small firms alike tend to use currency forwards. Banks are far more receptive to the arrangement of such contracts if the currency is one in which the market is large and liquid.

What Does It Mean For Trade?

It would be difficult to provide evidence that directly links the existence and expansion of instruments to alleviate certain risks associated with international trade and an increase in trade volumes. There are many circumstances unrelated to trade in which some of the instruments listed above could be applied. As there are active secondary markets in futures and options, they can be purchased as investments and not necessarily as hedges.

To the extent that hedging instruments remove some uncertainty, we can cite them as trade enhancing. By themselves, hedging instruments will not likely stimulate trade in markets previously thought of as being too risky. Rather, they facilitate trade where opportunities have already been identified and exploited, and profits can be enlarged with proper risk management. An anecdotal point, which leads us to no firm

⁴⁰ Bank for International Settlements, *63rd Annual Report*. Basle: June 1993, pp. 124, 126.

⁴¹ S.M. O'Connor, *The Development of Financial Derivatives Markets: The Canadian Experience*. Technical Report No. 62. Ottawa: Bank of Canada, June 1993, p. 55.

trade conclusion but does suggest at least a heightened corporate awareness of swaps as a means to reduce risks or borrowing costs, is that swap market growth in 1992 was concentrated among Asian and U.S. corporations.

4.6 Trade in Financial Services

4.6.1 What is Trade in Financial Services?

When discussing the effects of integrated financial markets on international trade, trade in financial services warrants special attention. This includes the international activities of banks, trust companies, securities dealers and insurance companies.

Strictly speaking, trade in financial services occurs only when the location of the provider and consumer of a financial service differ.⁴² By this definition, trade in financial services encompasses activities such as financial institutions extending loans to, or accepting deposits from, customers in other countries. It also includes financial institutions in one country underwriting issues, or providing brokerage services, for clients in other countries.

4.6.2 Financial Integration an Opportunity for Increased Trade

As discussed earlier in this Paper, the integration of world financial markets implies that there are few barriers to the free flow of capital. With that free flow of capital, we would expect an increase in the trade of financial services, even using the above -- rather restrictive -- definition.

Canadian banks are very active in international markets. In 1992, one-third of the total value of their loans went to non-residents.⁴³ According to the OECD, domestic banks that establish in foreign countries count on foreign subsidiaries of

⁴² See The Economic Council of Canada, *Globalization and Canada's Financial Markets*. Ottawa: Supply and Services Canada, 1989, p. 145.

⁴³ Bank of Canada, *Bank of Canada Review*. Ottawa: Bank of Canada, Fall 1993, Table C8. Of \$190,744 million of Canadian dollar loans, \$2,241 million was issued to foreigners; of \$148,449 million of foreign-currency loans, \$111,926 was issued to foreigners.

home country corporate clients among their main customers.⁴⁴ Banks have focused on foreign exchange operations and the extension of trade credits. One of the problems foreign banks face in developing loan business with local enterprises, is that the banks do not always have access to cheap funding sources, notably retail deposits.

For banks to take full advantage of the business opportunities in foreign markets, it is often necessary for them to establish a presence in those markets.⁴⁵ This helps to gather local market information, make contact and become known in the community and to compete more effectively with the larger branch and distribution networks of domestic enterprises.

With capital already freely flowing across borders, and the importance of establishing a presence in foreign markets to generate business there, the key issues that surround the liberalization of trade in financial services are concerned with reducing the limits on foreign ownership, the right of establishment, and ensuring what has come to be known as "effective" market access, i.e., the elimination of barriers that impede the operations of foreign and domestic financial institutions alike in a given market. For firms involved in the trade of goods, trade and foreign direct investment are sometimes seen as alternatives, whereas for financial service firms they are more clearly complementary.⁴⁶ In order to fully service a foreign market, financial service providers must often be located in it.

4.6.3 Recent Canadian Experience

The FTA marked the first time that financial services were part of a general trade agreement. Among other things, Canada exempted U.S. firms from certain foreign ownership limitations and the U.S. allowed domestic and Canadian banks to

⁴⁴ See OECD, *Banks Under Stress*. Paris. 1992, pp. 23-4.

⁴⁵ See The Economic Council of Canada, *op. cit.* p. 146.

⁴⁶ This dichotomy should not be drawn too sharply. Foreign direct investment can also lead to trade in goods, particularly at the intra-firm level.

underwrite and purchase Canadian government-backed securities in the U.S..⁴⁷ Although the FTA eased a number of restrictions on trade in financial services, regulators and industry participants in both countries were quick to point out its shortcomings. There were no general principles on market access and non-discriminatory treatment, nor were there any disciplines on measures taken by sub-national governments and self-regulatory organizations. There were no direct links to the FTA's investment disciplines and no rules on dispute settlement.

In the NAFTA, there was a significant change to the approach of disciplining government measures regulating financial services. The NAFTA bases market access in financial services on a set of general rules based on national treatment, MFN treatment, the right of consumers to purchase financial services on a cross-border basis and the establishment of a commercial presence.

Despite the NAFTA, Canadian banks still face significant limits on their activities in the U.S. market. The Glass-Steagall Act and the McFadden Act continue to restrict the scope of services U.S. and foreign banks are able to provide. On a more positive note, Canadian and U.S. financial institutions will be able to establish wholly owned subsidiaries and acquire existing firms in Mexico (with certain transitional safeguards). A binding dispute settlement mechanism, which is tailored to meet the specific needs of the financial services sector, is included in the NAFTA

As Canadian firms become established in Mexico, there is potential for a significant expansion of trade in financial services. The Mexican market is regarded as being underbranched, undermortgaged and underinsured, with underdeveloped corporate lending and derivatives markets.⁴⁸ So far, only one Canadian bank (Bank of Nova Scotia) has made a substantial commitment to Mexico, by purchasing 5 per cent of a Mexican establishment.

⁴⁷ For a discussion of the treatment of financial services in the FTA and NAFTA, see P. Sauvé and B. Hoekman, *Regional and Multilateral Liberalization of Services Markets: Complements or Substitutes?* TD/TC(93)15/ANN2, Paris, December 1993, pp. 12-8.

⁴⁸ See P. Sauvé and B. Gonzalez-Hermosillo, *Implications of the NAFTA for Canadian Financial Institutions*. C.D. Howe Commentary No. 44. Toronto: C.D. Howe, April 1993, p. 2.

5. POLICY IMPLICATIONS

5.1 Globalization And Government Resources Working Together

In the development of Canadian trade policy, it is important to recognize that the international trading environment is continuously evolving. The globalization process is far from over. Issues that were once within the exclusive domain of domestic policy makers continue to draw in international policy makers. There is a requirement for cooperation and understanding between different government departments with seemingly different mandates. As the government's international policy making hub, and the centre of trade policy formulation, the Department of Foreign Affairs and International Trade (DFAIT) will be required to deal with a much wider array of issues.

To the extent that the integration of financial markets has led to concerns regarding the stability of exchange rates and the effects unstable rates have on trade, we all share an interest with the Bank of Canada.⁴⁹ The Bank's explicit goal of reducing Canadian inflation will contribute to a more stable currency.⁵⁰ The long-term relationship between price stability and exchange rate predictability is one that we should be aware of and support. Bank policy assists in the promotion of international trade by providing a setting in which business is confident of the domestic price level, the value of the currency and thus its ability to compete internationally.

5.2 Possible Issues for Action

5.2.1 The Fixed Exchange Rate

Not everyone agrees that the pursuit of price stability should be the Bank of Canada's primary function. There is at least one other suggested way to develop and maintain the setting in which business is able to foresee a stable exchange rate and remain confident in its ability to compete internationally. Instead of a flexible exchange rate and a central bank policy focused on price stability, some would argue -

⁴⁹ This is not meant to suggest that the DFAIT work together with the Bank of Canada on providing a stable currency. Clearly, the Bank alone determines and implements Canada's monetary policy.

⁵⁰ The Bank's policy can *contribute* to a more stable currency, but it will not guarantee stability. Since the calculation of any exchange rate involves two or more currencies, the economic policies of two or more countries are involved. The Bank of Canada alone can not stabilize the Canadian dollar.

- as is outlined in the body of this Paper -- that a fixed exchange rate (i.e., a common currency in practice), particularly when accompanied by a free trade agreement, is more appropriate. Without debating the merits of such a system -- see section 4.4 for details -- suffice it to say that national sovereignty is so politically sensitive that the conduct of an independent monetary policy is not likely to be the subject of any negotiating agenda well into the foreseeable future.

5.2.2 Trade Promotion Considerations

Developing Countries

When identifying export markets in developing countries, greater attention could be paid to the level of development in local financial markets and the access local firms have to international capital. At the risk of oversimplifying, developing countries usually have an abundance of labour, and it is a shortage of capital that limits growth. Focusing on countries that have few limitations on the international movement of capital, control their inflation rates without the use of price controls, and are at least beginning to liberalize their financial markets will likely assist in the search for sustainable export markets.^{51 52}

As was mentioned earlier in this Paper, the availability of hedging instruments to alleviate foreign exchange risk is generally limited to established trading partners with large, liquid currency markets. There might be a role for government to assist in providing hedges against more obscure currencies. Perhaps a hedge fund could be set up, allowing firms to pursue new markets previously considered too risky from an exchange rate point of view. To spread the risk even further, pooling it internationally might be an option. Presently, the pattern of trade might be (inefficiently) skewed towards those countries with whom currency risk is most easily managed.

⁵¹ Price controls are regarded as temporary solutions that result in shortages, black markets and inefficient production and consumption.

⁵² Inflation usually results in real currency appreciation as governments do not adjust the nominal exchange rate in proportion to inflation in order to avoid price increases for imports and exports. Imports then rise, exports fall and often quantitative restrictions on imports are applied to manage a balance of payments deficit.

Developed Countries

When identifying export markets in developed countries, there should be an awareness of the instruments available to firms that reduce financial risks, particularly with respect to exchange rate fluctuations. Encouraging exports to markets that regularly experience a high degree of currency volatility should be accompanied by some knowledge of the management of such volatility. That knowledge will make the trade promotion program more complete.

Anti-dumping and Exchange Rate Pass-through

The relationship between exchange rate fluctuations and export prices could have important implications in the context of anti-dumping actions. As outlined in Section 4.3.2, Harris maintains that Canadian exporters generally pass currency movements through to final customers, in which case there could be no claim of dumping. Yet, there is one industry-specific study that shows currency movements are being absorbed by Canadian exporters, resulting in different prices in the Canadian and foreign markets.⁵³ That price gap, even though it is the result of a rational pricing decision by an exporting firm to keep its prices in line with others in the export market so as not to lose market share in the case of an appreciation of the domestic currency, could expose exporters to anti-dumping actions. The Department must be aware of the effects exchange rates can have on export pricing, the types of decisions Canadian exporters must make, and the risk of anti-dumping action by our trading partners. This issue underlines the importance of seeking the reform of current anti-dumping practices.

5.2.3 Financial Institutions As Export Facilitators

In determining the relationship between the presence of domestic financial institutions abroad and the level of exports, two points can be drawn from this Paper. First is the notion that increased trade and increased investment abroad are usually simultaneous events and often reinforce each other. The second point is that some of the main customers of domestic banks in foreign countries are home country corporate clients that have established foreign subsidiaries.

⁵³ See L. Schembri, "Export Prices and Exchange Rates: An Industry Approach." In *Trade Policies for International Competitiveness*. Chicago: University of Chicago Press, 1989, pp. 185-203.

Given the reinforcing nature of trade and investment and the tendency of banks to count on domestic clients in foreign markets, it would be equally correct to conclude that the presence of domestic banks in foreign markets encourages trade, and that increased trade with a particular country encourages domestic banks to set up facilities there. In so far as some companies might be more comfortable dealing with their domestic banks, the presence of the banks abroad might be one of the factors those companies consider when weighing the costs and benefits of trading internationally.

5.2.4 Market Access for Financial Services

The U.S.

The NAFTA provides little immediate progress on liberalizing trade in financial services between Canada and the U.S., although it does break ground in providing for formal dispute settlement proceedings in cases of disagreement. The market access principles, moreover, will help to ensure that Canadian institutions can benefit from future liberalization, for example, if U.S. interstate banking restrictions are "significantly" diminished.

As long as the U.S. banking industry is subject to the Glass-Steagall Act, which separates commercial banking from the securities business, and the McFadden Act, which prohibits interstate banking, Canadian banks will face considerable limits on their activities in the U.S. market. The U.S. is one of the few countries without a system of nationwide banking, that limits the financial products that banks can offer or be affiliated with, and that has such a large number of regulatory agencies involved in banking, securities and insurance activities. The progress that Canadian trade negotiators can expect in any future negotiations with the United States will continue to be constrained by the complexities of the U.S. financial services industry.

Japan

Article 65 of the Japanese Securities and Exchange Law, like the U.S. Glass-Steagall Act, imposes a strict separation between banking and securities activities. However, the financial reform law enacted by the Diet in June 1992 permits banks

and securities firms entry into each other's markets through subsidiaries.⁵⁴ Article 65 has not been completely dismantled, as firewalls will be implemented to maintain some distance between banking and securities activities.

While Japan does not prohibit the establishment of direct branches of foreign banks (as Canada does), a separate licence is required for each branch. National treatment is extended to subsidiaries of foreign banks, but Japan, like most OECD countries, reserves the right to approve the establishment of foreign banks on a reciprocity basis.

The European Union

The EU's second Coordinating Banking Directive allows a bank or bank subsidiary licenced in any EU member state to open branches and provide banking services throughout the Community.⁵⁵ The entire bank, including its branches located in other countries, is regulated by the home country, i.e., the EU country in which the bank is established.

It has been suggested that a single EU financial market might result in even larger European banking networks, initiated either through mergers and acquisitions or branch expansions.⁵⁶ While empirical evidence does not conclusively suggest that banks can benefit from the economies of scale associated with operating large networks, the costs of entering a new market in which large networks already exist might be prohibitive. Canadian banks, for example, might find it difficult to enter into and compete in the EU, particularly if the German universal banking model becomes

⁵⁴ Law concerning the Realignment of Relevant Laws for the Reform of the Financial System and the Securities Trading System, Law No. 87 of 1992. Known as the Financial System Reform Law, it amended 15 other laws affecting the financial system and abolished one other. For an analysis of the Japanese financial system and the impact of the Reform Law, see T.F. Cargill and G.F.W. Todd, "Japan's Financial System Reform Law: Progress Toward Financial Liberalization?" *Brooklyn Journal of International Law*. Vol. 19 No. 1. New York: 1993, pp. 47-84.

⁵⁵ This is known as the "single passport". The establishment of a single passport for financial service firms is intended to allow institutions licenced in one EU country to operate in any member country without receiving special permission from the countries in which they wish to do business.

⁵⁶ See International Monetary Fund, *International Capital Markets Part II. Systemic Issues in International Finance*. World Economic and Financial Surveys. Washington: August 1993, p. 41.

more widespread.⁵⁷ A response might be to find and develop niche markets for specific financial services.

5.2.5 The Future of Financial Services: The International Context

Systemic Risk

It is widely believed that the process of international capital market integration, as well as the emergence of new financial instruments (primarily derivatives) and the growth of their markets, has not been matched by developments in the regulatory framework.⁵⁸ Derivative instruments have strengthened the linkages between segments of financial markets, both within countries and across borders. As markets become more closely linked, there is some concern that disruptions can spill over from one market to another more easily. The appropriate response of regulators to such systemic risk is the focus of much attention.⁵⁹ That response will effect the international trade of financial services.

The Bank for International Settlements has identified four longer-term challenges facing authorities, based on the changing nature of systemic risk.⁶⁰

- Prudential regulation and supervision will need to be broadened to cover financial institutions other than banks. In addition, the intensification of international cooperation between banking supervisors in the 1980s will need to be copied by securities and insurance supervisors and regulators (this has already begun).

⁵⁷ Under the German universal banking system, banks are allowed to offer a wide range of services and play a dominant role in securities markets. The alternative "Anglo-Saxon" model limits the activities of banks, principally to deposit taking and commercial lending. One question is whether universal banks will be able to exploit economies of scope, reducing the cost of services as a result of carrying out a wider range of activities. If so, foreign banks would find it more difficult to compete with low-cost European domestic banks.

⁵⁸ See, for example, International Monetary Fund, *op. cit.*, p. 31.

⁵⁹ See W.J. McDonough, "The Global Derivatives Market." In *Quarterly Review*. New York: Federal Reserve Bank of New York, Autumn 1993, pp. 1-5.

⁶⁰ See Bank for International Settlements, *62nd Annual Report*. Basle: June 1992, pp. 209-12.

- The supervision of individual institutions must be complemented with prudential arrangements that can cope with problems resulting from linkages between institutions. The BIS says arrangements for payment and settlement systems are at the top of the agenda.
- As crisis managers, with ultimate control over liquidity, central banks will need to adapt their techniques of intervention to the new financial environment. Complex markets and institutional relationships will require central banks to have intimate knowledge of market mechanisms and participants in order to properly judge the scale and timing of interventions.
- The proper balance between market discipline and the involvement of authorities must be struck. Market discipline alone might not be consistent with systemic stability, while too much involvement by authorities provides a false sense of security to market participants, possibly encouraging them to take on excessive risks.

Capital Adequacy Standards and Consolidated Supervision

The international regulation of banks has focused on capital adequacy standards and consolidated supervision of a bank's foreign establishments.⁶¹ The Basle Accord, reached in July 1988, established international capital requirements proportional to the credit risks undertaken by individual institutions. What will likely emerge in the future, especially since banks can own securities firms in Canada, France, Italy and the U.K., is a harmonization of capital standards for banks and securities firms.

As financial markets become more international, the ability of supervisors to regulate domestic institutions is partly undermined. The 1991 closure of the Bank of Credit and Commerce International exemplified the gaps in cross-border regulation concerning foreign bank branches, foreign subsidiaries and joint ventures. The Group of Ten supervisory authorities have come up with four minimum standards to address the regulatory gap.

- International banks should be supervised by a home-country authority, which should receive information on the banks' global operations.

⁶¹ See International Monetary Fund, *op. cit.*, pp. 33-7.

- Cross-border banking establishments should receive prior consent of both the host-country supervisor and the home-country supervisor.
- Home-country authorities should have the ability (and the cooperation of host-country supervisors) to gather information on international banks which they supervise.
- Host-country authorities should be satisfied that the above conditions are met, or they should impose certain restrictions or prohibit the creation of banking establishments.

Between the recommendations on managing systemic risk and those concerning consolidated supervision, it appears that international financial institutions could face a number of new operating constraints. That will not be the case, however, for all international financial institutions. Those already engaging conservative self-imposed international risk management techniques might not find the new constraints particularly restraining.

5.2.6 The Future of Financial Services: The Canadian Context

The ability of Canadian financial institutions to compete internationally depends critically upon the regulatory environment at home. If, for example, regulations do not keep pace with the fact that traditional bank clients now have a number of options available with respect to acquiring capital, banks will lose market share and their ability to compete in domestic and foreign markets with other institutions able to offer a wider array of services will be diminished.

The ability of non financial firms to compete internationally is also effected by financial sector regulations. According to recent research, German and Japanese firms still benefit from privileged relationships with national financial institutions.⁶² It is thought that the close links between non financial firms and financial intermediaries result in more patient sources of capital and allow corporate managers to have longer investment planning horizons. The disadvantages that Canadian firms face in this regard, whether producing for domestic sales or export or both, are not likely to be reversed by regulatory review. The North American system of corporate transparency

⁶² See U.S. Congress, Office of Technology Assessment, *Multinationals and the National Interest: Playing by Different Rules*. Washington. 1993, pp. 139-41.

and arms-length relationships between management and owners is depicted as consumer-oriented. The German-Japanese system is portrayed as producer-oriented. Yet, the key is whether active competition occurs within and between inter-corporate alliances (e.g., the keiretsu in Japan). The evidence appears to be that such competition can be achieved, and increasing cross-border competition in the domestic market place brought about by freer trade would seem to reinforce the likelihood of achieving the necessary competition. In any event, the interaction between an effective competition policy and such inter-corporate links merits closer attention.

In 1992, the federal government enacted new legislation covering the services financial institutions can offer, their ownership and new prudential safeguards.⁶³ The upshot is that financial institutions can now offer most services directly, or through subsidiaries or networks. Several issues remain, however, that the Canadian Bankers Association (CBA) considers impediments to the enhancement of Canadian financial institutions' competitiveness.⁶⁴

- Banks are not allowed to distribute life annuities and insurance products through their branches. Banks are also prohibited from offering auto leasing services.
- While the activities of banks and trust companies are similar, a 10 per cent ownership limitation by any given individual applies to Schedule 1 banks, but not to trust companies. The CBA suggests all deposit-taking institutions be widely held so as to prevent foreign control.
- Canada's deposit insurance system needs restructuring in order to inject greater market discipline on financial institutions. In the CBA's view, the present policies of the Canadian Deposit Insurance Corporation undermine the market forces that should be the first line of defence against imprudent risk-taking.

⁶³ On 1 June 1992, the Bank Act, Trust and Loan Companies Act, Insurance Companies Act and Cooperative Credit Associations Act were proclaimed. For a discussion of Canadian financial reform, see F. Daniel, C. Freedman and C. Goodlet, "Restructuring the Canadian Financial Industry." In *Bank of Canada Review*. Winter 1992-93, pp. 21-45.

⁶⁴ Drawn from *Reshaping the Financial Sector: The 1991 Bank Act Revision*. Canadian Bankers Association. Toronto: 1992.

- Federal and provincial regulations are not sufficiently harmonized. More uniform and less duplicative standards will increase the international competitiveness of Canadian financial institutions.

Since the statutes will be reviewed by June 1997, and the government has indicated that it will review them every 10 years thereafter, at least some of the above issues are likely to surface again soon. Nevertheless, the most important developments concerning the ability of Canadian financial institutions to compete internationally have already taken place. Expanding the services our financial institutions are able to provide promotes a more efficient Canadian financial industry. That should assist Canadian financial institutions in their activities abroad, as well as other Canadian firms that compete with companies based in countries with efficient, easily accessible financial services.

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