Editors' Summary

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As they move forward into a new millennium, policymakers are still grappling with the aftermath of a series of severe and unexpected developments. The wave of currency and banking crises during the 1990s shone a spotlight on the risks associated with global financial markets. And opposition to various dimensions of increasing global integration erupted in violent demonstrations against key international institutions. In light of these developments, the *Brookings Trade Forum 2000* focuses on the debates surrounding some of the central policy challenges now confronting world leaders. The first three papers in this volume address macroeconomic or financial issues. Contributors explore the lessons from the 1990s for the appropriate choice of exchange rate regime and for evidence on the extent to which capital controls are effective tools for insulating an economy from external shocks. The last two papers address trade policies and institutions. Here contributors assess how well the World Trade Organization's dispute settlement mechanism has worked and trace the implications of regulatory barriers to international trade. Finally, the policy panel presents three disparate views on the future for U.S. trade policy.

The Brookings Trade Forum held its third annual conference in Washington, D.C., on April 27–28, 2000. This issue of the *Trade Forum* contains the papers and discussion from that conference.

In the first paper in this volume, Guillermo Calvo and Carmen Reinhart take issue with the advice to float exchange rates that is now typically given to policymakers in emerging market economies. As they point out, nearly all of the currency crises that occurred in the past decade took place among exchange rate regimes that have been characterized (in some cases, after the fact) as soft pegs. This has led many analysts to attribute currency crises to pegged exchange rate regimes and to recommend that emerging economies adopt so-called corner solutions: either fixed or independently floating exchange rate regimes. Calvo and Reinhart present evidence that emerging market economies are very different from developed economies in key dimensions. The authors argue that these differences should play an important role in the choice of exchange rate regime, and in particular, that they provide good reasons for emerging markets to fear large exchange rate fluctuations. Floating is no panacea for these countries. The authors also conclude that recent promises to embrace exchange rate flexibility may mean little in practice. Instead, what is likely to prevail are the varieties of soft pegs that characterized the past decade. Furthermore, growing awareness of problems with soft pegs on the one hand and floating on the other is likely to increase the attractiveness of hard-peg alternatives such as dollarization.

The authors begin by examining the behavior of monthly exchange rates among a broad range of countries from 1970 to 1999. Building on their previous work, they show that the classification of a country's exchange regime is a poor indicator of the extent to which its exchange rate actually fluctuates. In practice, most currencies remain within relatively narrow bands. Countries classified as independently floating do not exhibit significantly greater exchange rate fluctuations than those classified as managed floaters. And the authors find evidence of variability in interest rates and foreign exchange reserves that are consistent with active policy interventions to smooth exchange rate movements. Calvo and Reinhart have labeled this phenomenon of relatively little exchange rate movement, even among countries classified as having a high degree of exchange rate flexibility, as "fear of floating."

To explain this reluctance to tolerate large exchange rate movements, Calvo and Reinhart focus on the differences between emerging market and developed economies.

First, the authors examine a sample of twenty-five countries that includes twenty-five currency crises among developed countries and seventy-one among emerging markets. In the aftermath of a crisis, countries in both groups experienced declines in both their current-account deficits and their output growth rates. But declines were significantly more severe for emerging markets. Current-account adjustments were nearly five times larger, and the fall in the average real growth rate was nearly 2 percentage points larger. Indeed, currency crashes are contractionary in emerging markets. Calvo and Reinhart argue that a key reason for these differences is that after a crisis, emerging markets lose access to international capital markets. In support of this view, they show that emerging market countries experienced significantly larger downgrades in sovereign credit ratings than did developed countries.

The paper also highlights other differences between emerging markets and developed countries that are not associated with crises. The authors review the empirical literature on whether exchange rate volatility adversely affects trade. Although the evidence for industrialized countries is mixed, the authors conclude that studies of emerging markets support this hypothesis. They also present new empirical work on the links between exchange rates and prices, finding a significantly greater pass-through from exchange rate swings to inflation among emerging markets than among industrialized countries.

In the final section of their paper, the authors develop a theoretical framework to illustrate what they believe to be a key reason why exchange rate changes might be avoided—even in the face of balance-of-payments difficulties. In this framework, devaluation triggers a loss of capital market access, which then suppresses the expansionary effects of exchange rate adjustment, in some cases leading to an output contraction. Calvo and Reinhart also discuss several additional channels, such as the dollarization of external liabilities and the lack of a lender of last resort, which they argue compound the difficulties inherent in exchange rate adjustments for emerging markets.

THE SECOND PAPER, by Jeffrey Frankel, Sergio Schmukler, and Luis Servén, also addresses the ongoing debate over appropriate exchange rate regimes. The authors' starting point is the "corners hypothesis," which has become increasingly prevalent in the international finance literature over the last several years. This hypothesis holds that intermediate exchange rate regimes are no longer viable and thus are vanishing. (*Intermediate regime* refers here to any regime that is neither fully flexible nor rigidly fixed, such as a currency board or monetary union.) Surprisingly for a new conventional wisdom, this hypothesis so far is lacking in analytic foundations. The authors note that although the generalization may often be exaggerated, developing such foundations is warranted. Thus a primary objective of their work is to offer a theoretical rationale for the corners hypothesis, which also contributes to the list of arguments against intermediate regimes.

The rationale proposed by the authors is the need for an announced exchange rate regime to be verifiable by the public, as a means to securing credibility. Central banks announce intermediate targets, such as exchange rates, so that the public can judge from observed data whether they are following the policy that has been announced. The authors therefore argue that exchange regime verifiability is "a partial means to the Holy Grail of credibility." Their central point is that a simple regime (such as a pure float or a hard peg to a single currency) is more readily verifiable by market participants than a complicated intermediate regime.

More generally, the authors argue that lack of verifiability should be added to the list of drawbacks associated with intermediate exchange rate regimes. However, it is only one of many relevant criteria in the broader debate over fixed versus flexible exchange rates, and they acknowledge that it may not be the most important one. These criteria should also include the traditional factors, familiar from the literature on optimum currency areas, as well as some of the newer considerations related to financial markets and credibility.

The empirical analysis undertaken in the paper focuses on one type of intermediate regime: basket pegs, with small or large bands. The statistical work shows that it can take a surprisingly long span of data for an econometrician or an investor to distinguish such a regime from a freely floating exchange rate. The authors present two types of results: an econometric study of Chile's basket regime during the 1990s and a set of Monte Carlo simulations. The analysis of Chile confirms that the amount of data that would be required to verify the declared regime may well exceed the length of time during which the regime is maintained. The Monte Carlo exercise shows that the amount of information necessary to verify an exchange rate regime increases with the complexity of the regime, including the width of the band and the number of currencies in the basket. While the results reported in the paper focus only on basket peg regimes, the authors argue that the same basic points would also apply to other types of intermediate exchange regime such as managed floats or pegs with escape clauses.

The second part of the paper considers the implications of these findings for the desirability of choosing an intermediate regime over a regime that makes an institutional commitment to fixity in the form of a currency board or full dollarization. The advantage of flexibility is traditionally thought to be monetary independence, which is viewed as counterbalancing the advantages of fixity. Yet empirical evidence presented in the paper suggests that when the U.S. interest rate rises, Latin American countries with flexible exchange rate regimes (Mexico and Brazil) suffer larger increases in their interest rates than do countries on currency boards (Argentina) or dollarization (Panama). The authors provocatively conclude that if this result holds up, it suggests that emerging market countries suffer from sufficiently great credibility problems that they might as well give up the modicum of monetary independence offered by intermediate regimes.

GRACIELA KAMINSKY AND SERGIO SCHMUKLER tackle the controversial issue of whether or not restrictions on international capital movements are effective tools for insulating domestic financial markets from external shocks. The severe currency and banking crises of recent years re-ignited the heated debate on this topic among policymakers as well as academics. However, existing empirical studies reach mixed results and are widely regarded as inconclusive. Most of this work focuses on a single country's experience or relies on the readily available but imprecise measure of capital controls that has historically been published by the International Monetary Fund (IMF).

Kaminsky and Schmukler present the results of their careful empirical analysis of the experiences of six emerging market economies that imposed capital restrictions during the 1990s. Their bottom-line conclusion is that their work calls into question the view that capital controls are effective. Specifically, they find little or no evidence that capital controls enable a country to insulate domestic money markets. In contrast, they do find evidence that controls helped to insulate equity markets in some countries but only at short time-horizons.

The authors analyze six countries using consistent data and a consistent methodology. Their sample (Brazil, Chile, Colombia, Malaysia, Thailand, and Venezuela) includes the major emerging market experiences with capital controls over the past decade. They construct their own data on capital, which are more detailed than the data used in many previous studies. In particular, their indicators distinguish between controls on capital inflows and controls on capital outflows—a distinction that economic theory suggests may be quite important. These indicators also provide a measure of the degree of restrictiveness, enabling the authors to consider how controls in each country evolved over time. Indeed, the paper provides a useful chronology of capital control policy for each of the six countries.

Kaminsky and Schmukler study the effects of capital controls on the comovements between domestic financial markets and external markets. If controls are effective, one would expect to see a significant decline in these comovements during control periods relative to periods in which controls are absent. The empirical work considers both stock markets and money markets for each country. Regional indexes are used as proxies for developments abroad. Finally, an innovation in this paper is the use of band-pass filters, which enable the authors to examine effects of capital controls at different horizons, ranging from short horizons of one to two weeks to longer horizons of up to four months.

A shortcoming of the work is that because it uses daily financial market data, the authors are unable to control for variables such as output, inflation, or policy indicators that would also be expected to influence financial market volatility. The authors plan to address this concern by incorporating other economic and political variables in future work.

Overall, the authors find that there is considerable comovement among regional stock markets, both in East Asia and in Latin America. This relationship is most pronounced at lower frequencies. In other words, there is greater correlation among regional stock markets at three- to four-month horizons than there is over shorter-run horizons. They also find that Asian money markets are highly integrated. In contrast, the authors find much less evidence of comovements among interest rates in Latin America.

The key results in the paper come from comparisons of comovements in periods with and without capital controls. For stock markets, Kaminsky and Schmukler conclude that controls provided some insulation in Brazil, Venezuela, and Malaysia but only at horizons of less than three weeks. Strikingly, they find no evidence of insulation for either Chile or Thailand, even in the very short run. With respect to money markets, the authors find that controls reduced interest rate comovement in only one episode—Malaysia's controls on capital inflows, which began in September 1998.

THE WORLD TRADE ORGANIZATION (WTO), now five years old, is charged with implementing and overseeing the treaty results of the Uruguay Round of multilateral trade negotiations. Given the complexities and ambiguities involved in such a task, the WTO's dispute settlement mechanism (DSM) is not surprisingly one of its most important features. The DSM establishes a legalistic system for dispute settlement, with virtually automatic adoption of panel decisions, and it has an extremely broad purview, including issues that call for balancing national sovereignty against the needs for international cooperation in an increasingly integrated global economy.

To set the current system in context, John H. Jackson begins by surveying procedures under the WTO's precursor—the General Agreement on Trade and Tariffs (GATT)—highlighting the shift from a negotiating atmosphere of multilateral diplomacy to a more arbitrational or juridical procedure. Despite changes to these procedures, many flaws remained, most egregiously the ability of a losing party to block adoption of a panel report by raising an objection. As Jackson explains, the new WTO Dispute Settlement Understanding has improved the GATT dispute settlement procedures in several ways, including the presumptive adoption of panel reports, as well as the creation of a new Appellate Body and the unification of procedures for all Uruguay Round texts. In reviewing current WTO procedures, from consultations through the panel review to Appellate Body review, Jackson notes an apparent increasing difficulty among disputing parties in agreeing on the composition of the three-person panel of experts.

Jackson's review of the WTO caseload suggests a modest trend toward nonappeal of panel reports. Nevertheless, the sheer number of cases constitutes an extremely heavy workload at both the panel and the appellate stages, raising serious concerns about potential overload of the system. Jackson concludes that an evaluation of how well the dispute settlement rules work may still be premature, as the process of implementation and compliance is ongoing in several cases. A useful appendix to the paper, prepared by Young Duk Park, provides a variety of statistics about the 205 cases brought before October 2000.

In surveying the WTO jurisprudence Jackson notes the application of general principles of international law to the WTO agreements. He believes that the Appellate Body has exercised considerable restraint to the extent that it has typically deferred to national sovereignty and argues that this may be beneficial, since longer-run acceptance of the WTO's dispute settlement procedures depends on the extent to which the organization protects the decisions of sovereign governments. However, Jackson also cautions that a number of potentially significant problems have emerged in WTO jurisprudence. One is the growing pressure to use the dispute settlement process to address an expanding range of contentious issues that are either ambiguous or not fully covered in the Uruguay Round. These include trade in services, labor rights, and competition policy. Another is that the need to rely on legal representation puts smaller countries at a disadvantage, especially vis-à-vis the United States or the European Union. He recommends providing assistance to these countries so as to improve advocacy and offset the costs of participation. In the final section of the paper, Jackson discusses dispute settlement in terms of the broader WTO "constitution," focusing on its impact on diplomacy and power distribution, emerging constitutional problems, and reform proposals and prospects.

Jackson concludes that over its first five years, and measured against other comparable international tribunals, the DSM's record has been exemplary.

Nonetheless, the DSM has performed better according to some metrics than others. Jackson praises the WTO's effectiveness in promoting settlement of cases and its ability to develop jurisprudence of high quality and sophistication. However, the institution has done less well in effectively implementing results of its settlements and in achieving political and public acceptance of those results. Jackson also notes particular concern about the WTO's growing caseload and the growing range of issues brought forward, all of which could overwhelm the system.

GATT AND, MORE RECENTLY, THE WTO have contributed to the substantial elimination of tariffs. Indeed, tariffs on imports of manufactured goods by member countries of the Organization for Economic Cooperation and Development (OECD)—which account for two-thirds of world trade—average only 3.8 percent, with duty-free treatment applying to fully two-fifths of these trade flows. While tariffs are still high on food and clothing imports by rich nations and on industrial goods by poorer nations, these items account for relatively little of world trade. Industrial tariffs—those of poor nations, at least—seem to be falling of their own accord, but despite the low level of tariffs, trade is far from unfettered. There remain myriad cost-raising, behind-the-border measures that continue to inhibit trade substantially.

Richard Baldwin examines some of the implications of trade barriers that are sometimes termed *regulatory protection* or technical barriers to trade (TBTs). He argues that although most of these measures seem innocuous individually, their collective effect on world markets is significant. In particular, the elimination of tariffs, in combination with lower transportation and communication costs, means that remaining barriers have an important impact on where goods are produced. Baldwin believes that the influence of regulatory protection on production will continue to grow, forcing the liberalization of TBTs ever higher on the negotiators' agendas.

The main thesis of Baldwin's paper proceeds in five steps:

1. TBTs are important;

2. TBT liberalization will continue;

3. This liberalization will involve "hegemonic harmonization" or mutual recognition of rules and tests;

4. Such liberalization will almost surely entail preferential arrangements among rich nations, creating in essence a two-tier system of market access with developing nations in the second tier. This discrimination will be higher for advanced products (which are naturally subject to more regulations and

standards), so the discrimination may have an "escalating" feature, much as tariffs did during the early post–World War II period.

5. Given this, the WTO should be modified to address the potentially discriminatory aspects of regional TBT liberalization initiatives.

Baldwin begins by defining TBTs, presenting a simple model of how they affect trade, emphasizing the effects of preferential TBTs and reviewing the empirical evidence on their importance. The modeling shows that unlike tariffs, regional TBT liberalization need not be discriminatory, but it may actually favor firms based outside a particular region. However, empirical evidence, although scarce and somewhat contradictory, suggests that liberalization of preferential TBTs has been discriminatory. Baldwin's thesis is supported by a review of historical liberalization efforts, highlighting the forces that are driving TBT liberalization.

Baldwin points out that the discriminatory liberalization of regulatory protection, unlike preferential tariff-cutting, is largely undisciplined, even though this violates the most favored nation spirit embodied in the WTO. Baldwin believes that as TBT liberalization becomes increasingly important, this lack of discipline may undermine the rules-based system. He advocates modification of the WTO, recommending that bilateral and plurilateral TBT liberalization schemes not include rules of origin, and he proposes that a policy modeled on the Generalized System of Preferences be considered in order to offset the impact of TBT liberalization on developing nations.

THE VOLUME'S FINAL SECTION presents a panel discussion on U.S. trade policy. The three panelists were asked to consider longer-term prognoses for world trade policy, building on their assessments of how trade policy has evolved over the past decade. Several common themes emerged from the presentations. The panelists all believed that U.S. trade policy—particularly the nation's traditional role as a leader for global liberalization—has floundered in the past few years and that this has resulted in significant missed opportunities. All agreed that the next administration should move quickly to seek fast-track authorization and that this should be linked to concrete objectives such as expansion of the North American Free Trade Agreement (NAFTA). All three argued that trade policy needs to be more closely integrated into the process of crafting foreign policy. However, their prescriptions for how this should be accomplished differ substantially, as do their views of the difficulties confronting U.S. trade policy

W. Bowman Cutter sees no group likely to emerge as a force for renewed U.S. government trade liberalization initiatives for four reasons. First, as trade policy liberalization has moved beyond tariff reductions to focus on reducing barriers associated with other types of domestic policies, the issues have become considerably more intrusive and controversial. Second, the key participants now encompass a more diverse group of countries, making agreement inherently more difficult. Third, the number of players has increased substantially, making multilateral trade negotiations a less effective mechanism. Finally, the institutional structure central to trade liberalization—the WTO—has itself become controversial.

Cutter stressed that the current lack of official U.S. trade policy momentum imposes significant costs on the domestic economy. At the same time, he argued that the lack of momentum may have comparatively little impact in some areas because of significant pressures for trade liberalization from other sources. In addition to the effects of global financial markets and the Internet, Cutter noted profound changes in many emerging market economies, which he believes have generated support for opening up markets. He suggested exploring a mechanism for trade negotiations limited to a narrower subset of countries and a new trade round focused on the new economy.

Richard Haass argued that the stakes for getting U.S. trade policy back on track are enormous. In addition to economic considerations, such as the benefits from an expanded NAFTA, he emphasized the centrality of trade issues to the development of a stable new world order. Furthermore, despite its shortcomings, he sees the WTO as a critical model for how to organize and to regulate international relations. He argued that the United States could play an important role in ensuring the organization's further development.

Haass noted that the Clinton administration initially made trade a major policy focus but placed trade on the back burner during its second term. Trade issues remained largely separate from national security issues, and there was a surprising lack of public debate on trade—a topic Haass believes the president should have pushed. Haass argued that the the administration's deferral of trade issues means that the next president will inherit a much tougher policy environment.

Finally, Haass laid out his preferred strategy for revitalizing U.S. trade policy. A key albeit controversial element is changing the way trade policy is formulated by shifting some of the responsibilities from the U.S. Trade Representative to the National Security Council so as to explicitly integrate trade into national security policy. He also advocated finding other venues to handle environmental and labor issues so as to keep them separate from the WTO process—a view that generated considerable discussion.

Daniel Tarullo argued that since there is likely to be a pause in major multilateral liberalization efforts, it is important to focus on other work that can set the stage for significant progress down the road. He began with an overview of the legacy of trade liberalization under GATT. Tarullo stressed that GATT stands out among international arrangements in its record of success, while noting that economic rationales had little to do with the agreement's accomplishments. GATT was able to reduce tariffs because of the structure of the negotiating process and the fact that trade policy was inherently linked to strategic policy during the cold war. Its legalistic approach, however, has put increasing stress on the system.

Tarullo noted the surprising fragility of current domestic support for trade liberalization, despite the strong U.S. economy. He strongly disagreed that the problem was lack of leadership from the president and saw parallels to growing labor and food safety concerns. He also cited the post–cold war geopolitical shifts, the lack of pressure for trade liberalization from the business sector, and the increasingly narrow constituencies (primarily exporters) of the USTR and other trade ministries.

Looking forward, Tarullo advocated focusing on some of the efforts in non-trade forums to address areas of dispute in economic policy. Examples include competition policy and banking standards as well as more difficult areas such as the environment. He argued that such accomplishments would help develop public support for the process, and would alleviate strains on the WTO.