BOOKS

Richard J. Herring and Robert E. Litan

Financial Regulation in the Global Economy

Brookings Institution, Washington, 1995, 187pp., $28.95 (cloth), $10.95 (paper).

This readable and informative book discusses recent developments in the provision and regulation of financial services internationally, and proposes a regulatory approach that relies primarily on market discipline.

Herring and Litan discuss the recent rapid improvements in electronic information processing and telecommunications, which, combined with increased financial liberalization (for example, the elimination of capital controls), lower the cost of obtaining financial services across borders. As a result, international competition has been enhanced, and the ability of regulators to impose regulations that are more costly than elsewhere has been reduced (by regulatory arbitrage).

Increasing international financial integration and cross-border provision of financial services pose new challenges for the efforts of banking regulators to ensure bank safety and soundness. Early in the book, the authors review the principles that justify regulatory intervention in banking. Among the many types of financial institutions found in market economies, the authors rightly focus on banks as having particular importance because of their role in providing payment services and the systemic risk posed by bank failures. According to the authors, intervention in the banking business is justified by, and should be limited to, reducing systemic risk. The authors examine the risks particularly associated with banks' cross-border business (that is, foreign exchange, transfer, and settlement risks) to identify the issues of prudential regulation that may need to be addressed in the international context. They also review theories of regulation to determine the appropriate scope and governmental level of various types of bank regulations.

Taking bank safety and soundness as the proper objective of banking supervision, the authors focus on the moral hazard created by most efforts to protect depositors and to reduce the risk of bank failure. Government guarantees of deposits (whether implicit or explicit) remove an important source of market discipline because depositors have no incentive to evaluate the financial health of a bank. Deposit insurance should be avoided or limited to small deposits, if market discipline is to be preserved. The risk of moral hazard is particularly serious if a bank's capital falls to low or negative levels, because its owners no longer would have anything to lose in taking long shots with depositors' or taxpayers' money. To the extent market discipline is reduced, reliance on government supervision must increase, and governments may not be up to the job, especially in a rapidly changing world.

The authors are critical of the policy of many central banks to be "intentionally vague about arrangements to provide emergency liquidity assistance," which "has been defended as necessary to promote market discipline of banks." One can only agree with the authors' general preference for openness and clarity with regard to central bank policies, both as a matter of effectiveness and honesty. It is difficult to defend supervisors who withhold information from the public about bank weakness unless the authorities are prepared to fully protect deposits, which would not be a good idea. Full disclosure and closing banks before their capital is used up are the best ways for supervisors to discharge their responsibilities.

The authors provide a useful history of efforts, primarily through the Basle Committee on Banking Supervision, to strengthen the supervision of banks operating internationally and to limit regulatory arbitrage by harmonizing regulatory requirements (for example, minimum capital standards). Supervision of international banks has been strengthened by the clarification of supervisory responsibilities, but regulatory arbitrage has been limited by attempts to level the playing field, the most complete example to date being the Basle Accord of 1988 establishing minimum bank capital adequacy standards for OECD member countries' banks with international operations.

In general, the authors favor caution in extending financial sector regulation internationally, preferring to strengthen market discipline of financial institutions.

In summary, this book provides a thorough grounding in the subject of financial regulation, even though some of the discussion is superficial. But the authors' suggestions for future approaches to financial sector regulation are sound, interesting, and, occasionally, provocative.

Warren Coats

William R. Cline

International Debt Reexamined

Institute for International Economics, Washington, 1995, 560 pp., $25.

William Cline's book presents a complete description and assessment of the debt crisis. He suggests that the strategy to deal with the crisis was successful and provides convincing evidence to support that conclusion. Cline asks three key questions, which broadly reflect different phases of the debt strategy: Was the new lending approach appropriate in dealing with the crisis? Was the Brady Plan successful, and if so, in what sense? And what should be done in the future with international debt policy?

In answering the first question, and in describing the initial reaction to the debt crisis, Cline explains that the view that "the crisis was one of illiquidity rather than insolvency" was heavily supported by international creditors, policymakers, and academia. This consensus shaped the "concerted lending" approach adopted in the early phase of the crisis. Cline challenges the view that an earlier change in the strategy from new lending to debt forgiveness could have lessened the impact of the crisis on economic growth in debtor countries. He stresses the role that analytical work played in helping design the strategy. This work provided no clear evidence at the time that the problem was one of insolvency.

However, the severity of the adjustment that debtor countries were required to make raised concerns about the validity of the strategy. In spite of such concerns and growing reticence on the part of creditors, the Baker Plan (1986) continued to press commercial banks for higher exposure instead of shifting the strategy to debt forgiveness. Cline argues that, at the time, such a shift would have had major systemic implications, due to the lack of loan loss provisioning by banks.

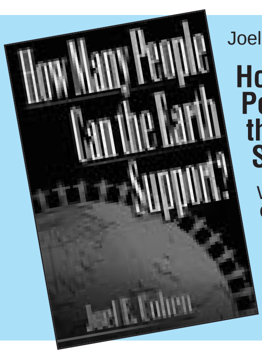
In answering the second question, Cline suggests that the Baker Plan, despite being considered a failure by many, at least paved the way for the Brady Plan (1988) by mobilizing bank lending. In his view, the major importance of the bank debt agreements under the Brady Plan was not in the debt relief that they provided, but the fact that these agreements largely "removed the uncertainty with the level and volatility of external transfers."

Cline's view about the correct timing of the shift in the debt strategy is understandable. His candid interpretation is supported by the evolving assessment of international creditors and by academic research. In his own words, ". . . even the countries that received Brady Plan debt reductions were closer to being solvent than bankrupt, suggesting that the initial diagnosis of the international strategy was not too far off the mark . . . ." However, one is left with the feeling that the uncertainty with respect to the magnitude of the adjustment and the lack of access to capital markets might have had larger welfare implications than originally envisaged, which may have justified an earlier change in the strategy. The lack of a differentiated strategy toward smaller countries suggests that other factors besides insolvency may have played an important role in maintaining concerted lending.

With respect to policy lessons for the future, Cline correctly points out the paramount importance of domestic policies (primarily fiscal) in offseting adverse external shocks. Countries that had adopted sound economic policies (Chile, Colombia, and the Republic of Korea), he explains, were able to weather the storm relatively better than countries that basically had not (Argentina and Brazil). Cline emphasizes the importance of sound debt management for the future. In particular, he focuses on the failure of the analytical work to take into account the importance of exchange valuation losses and capital flight in estimating the debt buildup. Also, policymakers should pay more attention to the currency composition of a country's debt and not be fooled by the illusion of lower non-US dollar interest rates. In dealing with future international debt policy, Cline notes the importance of securitized debt in the recent resurgence of capital inflows to developing countries and points out that this form of indebtedness could pose serious challenges ahead. He emphasizes the need for institutional changes to address this issue and to avoid some of the problems experienced in the 1930s, when several developing countries had to restructure bonds.

Drawing on the experiences of the debt crisis of the 1980s, Cline's timely book provides the reader with key questions and suggests possible approaches to resolving this issue, which is at the crux of current discussions related to providing support to countries in financial crises.

Martin Cerisola



Joel E. Cohen

How Many People Can the Earth Support?

W. W. Norton & Company, New York, 1995, 530 pp., $30.

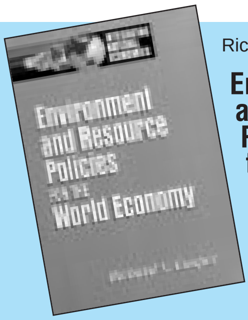
For anyone professionally or personally concerned about population, this book is definitely a "must-have" tome. Professor Cohen addresses a variety of topics rarely compiled in a single volume: world population estimates, future population projections, explanations of historical fertility decline, and, of course, the title's question, estimates of the earth's human "carrying capacity." Although the book is written for a general reader, in that it does not presume any technical background, given the breadth and depth of coverage, it is neither a quick nor an easy read.

The book has three interrelated themes. First, what will future population growth be and what will be the consequences? Malthus (along with Marx) stands as a beacon to all social scientists, as he demonstrates that one's reputation can survive being wrong about (nearly) every prediction. Cohen traces prophecies of population gloom and doom back to ancient times, with writers predicting that the world, or their particular slice of it, would be unable to sustain a (much) greater population. Moreover, even on the much easier prediction of future population, prognosticators in the past have not only consistently just missed the mark with their predictions but also consistently underestimated the range of uncertainty about their guesses, as reality often fell outside even the "high" and "low" ranges. To know if population is going to outstrip the world's capacity in the future, we have to know what the future population is going to be and what the world's capacity is. We don't know the first; the latter is the book's second theme.

In asking how many people the earth can support, Cohen points out, "I learned to question the question." His questioning occurred on three levels. First, estimates of the earth's carrying capacity range from 1 billion (substantially less than the current 5.5 billion) to 1,000 billion people. While it is obvious that these extreme estimates cannot even be based on the same concept of carrying capacity, even those estimates done on a seemingly similar basis (how much food can the world produce?) range between 5 billion and 50 billion. Second, nearly all estimates of "carrying capacity" are predicated on the question: "if the population is limited by some one or some few goods (typically, food or water) and if something close to present technologies are used, how many people could be sustained at a given standard of living?" Cohen demonstrates with a detailed review of eight different estimates and his own detailed discussion of water as a possible constraint that these types of estimates depend heavily on the technical assumptions upon which they are based. His own conditional calculations of the maximum human population, based on water as the limiting factor, range from 1.1 billion to 137.5 billion. Third, Cohen, though not an economist, does point out that since the current supply and technology for producing the binding constraint (say, food) is a function of the current price, using the present magnitude of supply, or even supply technology, of any commodity or resource as a binding constraint without considering the evolution of its future price borders on the ludicrous.

The book's third theme is that even though we do not know the future population, or the limits to, or consequences of, population growth with any exactness, Cohen does know enough to know why the growth of population scares many people silly. Cohen is arguing that the recent extreme and historically unprecedented increases in the world's population create very serious risks—indeed, the world's population may be likened to someone driving very fast at night with dim headlights toward a brick wall. Arguing that there is no danger because the car has not crashed yet is less than calming. Pushing this simile further, Cohen's ultimate recommendations are similar to those of many others: do those things that would make the trip better anyway (more resources into gender-focused education and development), do what you can to slow the car (even modestly) if it can be done cheaply (family planning), and, finally, do what you can to brighten the headlights (do more, and more sensible, research).

Lant Pritchett



Richard N. Cooper

Environment and Resource Policies for the World Economy

Brookings Institution, Washington, 1994, 86 pp., $28.95 (cloth), $10.95 (paper).

The author of this slim volume, a distinguished Harvard economist with extensive US government and international experience, provides a useful overview of a very complicated set of policy issues. The author focuses on transnational issues and the types of actions that may take place to manage them.

The book covers three analytical categories of natural resources: resources open to general use by common agreement; national ownership that materially affects outsiders through the market only; and national ownership that affects outsiders beyond the market framework through either positive or negative externalities. Professor Cooper distinguishes among these three categories and effectively (and clearly) introduces provocative examples such as the management of Antarctica, outer space, the seabed, and the contentious case of whaling. These examples demonstrate a range of legal, economic, and scientific issues surrounding natural resource management that are far from resolved. The author presents an optimistic picture in demonstrating that international understanding of these issues and increasingly fruitful negotiations have produced sensible short-term, if not yet long-term, results.

While Professor Cooper's perspective is certainly well informed and broadly correct in that international and national understanding has improved on these transnational environmental issues, his presentation is "deceptive"—a term that Professor John Whalley used in his commentary at the back of the volume. It is deceptive because the book gives rise to a sense of well-being by creating the impression that many of these issues are being understood and addressed when, in reality, they have not been solved to any significant degree, with disastrous effects. One example is the protection of marine resources from the consequences of commercial fishermen's short-term profit motives. It is now a fact that disastrous overfishing in areas such as Georges Bank in the Northern Atlantic has dramatically reduced the fish supply for human consumption and, for many species, will have longer-term consequences that are as yet unknown.

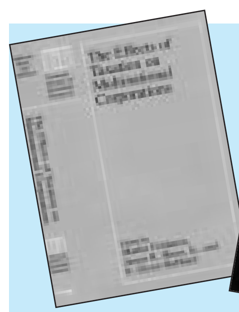
Even where there is awareness of problems such as ozone depletion—and international agreements to address them—the pace at which remediation is being negotiated may be too slow to have a significant short- or medium-term impact. As problems worsen, it may be possible to return to earlier negotiated texts to tighten phaseout schedules of guilty substances or enforce existing agreements. But these possibilities are not guaranteed.

The other "deceptive" feature of Professor Cooper's argument concerns the framework of environmental governance and the economic value of natural resources. While legal agreements are important instruments in the governance process, they are insufficient. Wide variation among nation-states in their institutional capacity to understand these issues and even to enforce agreements they have signed is a big part of the story. This is particularly true for developing countries—they believe, with reason, that industrial countries are mainly responsible for global environmental problems. Developing countries have little incentive to be environmentally responsible if their northern neighbors do little themselves to come to grips with pollution and global emissions issues.

This level of complexity is exacerbated when economic valuation of natural resources is introduced into the debate. While it is possible to calculate the marginal cost of water for agricultural or industrial use, it is less clear how to value the impact of waste on natural habitats, the cost of resource depletion, or the impact of resource quality on human health. Without clear understanding of the economic value of these resources, it is difficult to assign priorities for action. In governance terms, this situation gives the signal to decision makers that "everything is important," which, in the daily world of political pressures and budgetary crises, means that it is difficult to mobilize support to address these problems effectively.

Professor Cooper's book is a useful introduction to a global and national drama. But the subsequent acts remain to be written.

Michael Cohen



Martin Feldstein, James R. Hines, Jr., and R. Glen Hubbard (editors)–both volumes

The Effects of Taxation on Multinational Corporations

University of Chicago Press, Chicago and London, 1995, ix + 324 pp., $55.

Taxing Multinational Corporations

University of Chicago Press, Chicago and London, 1995, x + 113 pp., $21.50.

The appropriate income tax treatment of multinational corporations is controversial, in part because both home and host countries tax them. Issues of concern are how much tax should be paid and also whether it should be paid to the home country or to the host country. To remain competitive, multinational companies strive to minimize tax payments, while countries adopt rules—sometimes overreaching ones—to protect revenue. Sometimes, companies face double taxation, but, at other times, their income may be lightly taxed, if at all.

The papers in these two volumes address the effects of taxes on American companies that invest or do business abroad. *The Effects of Taxation on Multinational Corporations* is addressed to professional economists and reports on recent research at the National Bureau of Economic Research. *Taxing Multinational Corporations* is a nontechnical companion volume, distilling the papers in the more technical volume, which is addressed to policymakers and tax professionals interested in the economics of taxation.

The major thrust of both volumes is that American multinational companies may be at a competitive disadvantage when operating overseas. Joosung Jun finds that the cost of capital of US firms operating in major foreign markets is about 20 percent higher, on average, than the cost of capital of domestic firms operating in the United States. US firms are also more likely to face higher capital costs than local firms in foreign markets. Jason Cummins and Glen Hubbard detect that foreign investment is quite sensitive to capital cost. The annual rate of overseas investment falls by 1 to 2 percentage points for each percentage point rise in capital cost. Kenneth Froot and James Hines conclude that US interest allocation rules discourage borrowing and new investments. James Hines finds that higher taxes on royalties induce firms to substitute local research and development for technology imports.

Another thrust of the papers is that multinational companies minimize their taxes subject to many constraints. For example, Andrew Lyon and Gerald Silverstein report that the alternative minimum tax may create a temporary timing opportunity that allows repatriation of income at a lower cost than if the companies were subject to the rules of the regular tax system. Rosanne Altshuler, Scott Newlon, and William Randolph find that permanent tax changes have much smaller effects on dividend remittances than do transitory tax changes. Roger Gordon and Jeffrey MacKie-Mason suggest that there is clear evidence that firms use transfer pricing to shift income from high-tax to low-tax countries. They conclude that one policy response to this would be to tax foreign-source income at accrual rather than at repatriation, thus increasing the tax burden on foreign-source income. This conclusion contrasts sharply with Martin Feldstein's view that to maximize the present value of US national income, the tax burden on foreign investment—particularly on foreign investment that employs substantial foreign debt per dollar of US capital—should be reduced.

The papers in both volumes generally assume—unrealistically—that all types of foreign investment are alike. It would be useful to take into account differences in (i) taking advantage of less expensive foreign labor, (ii) the extraction and processing of natural resources, and (iii) the production of goods for the local market—all of which may not be equally sensitive to tax rules. For example, a high technology company may need to invest in each major country if it expects to sell to foreign governments.

A second weakness is that the authors do not always distinguish between average and marginal tax rates. For example, average tax rates may affect direct investment, and marginal tax rates may affect income shifting and the timing of dividend remittances.

These two volumes represent some of the best research currently being done on the effects of taxation on foreign investment. Although there is an American focus to the papers, policymakers and researchers interested in studying the effects of taxation on the location of investment, its financing, dividend repatriations, and opportunities for income shifting and tax avoidance will find these volumes valuable.

Emil M. Sunley