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**From Trade Liberalization to Economic Integration:  
The Clash between Private and Public Goods**

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## From Trade Liberalization to Economic Integration: The Clash Between Private and Public Goods

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Over the decades during which Sylvia Ostry has been actively engaged in promoting multilateral trade liberalization, that process has broadened from an exclusive focus on “the shallow integration of the postwar, Cold War era”—the reduction or elimination of trade barriers erected at national borders—to concern itself as well with “the deeper integration of the post- Cold War era of the 1990s and beyond”<sup>1</sup>. Encompassed in this wider scope are pressures to harmonize a wide variety of “domestic” policies that also affect international trade and investment, a process that has received increasing focus in Ostry’s recent work and which she has termed pressure for “system convergence”<sup>2</sup>.

This broadened focus was, in fact, an inevitable result of the success of earlier, more narrowly focused rounds of trade negotiations. As both tariffs and non-tariff border barriers (NTBs) were reduced and, in some areas, eliminated entirely in successive trade rounds, differences among nations’ laws and regulations in such areas as intellectual property **protection**, environmental rules, labor standards, competition (antitrust) policy, and many others increasingly emerged as major factors limiting or distorting the flow of goods, services, and capital across national boundaries. At the same time, this shift has made the process of international trade negotiations more complex and more difficult, impinging as it does on issues of policy traditionally regarded as domestic, and therefore belonging exclusively to the jurisdiction of national governments.

### Market Integration and Policy Autonomy

The tension between the integration of markets across international boundaries and the preservation of policy autonomy (“national sovereignty”) at the level of the nation-state is hardly new. In its modern incarnation, it was presciently, and succinctly, stated by Richard Cooper in 1968 in his classic book *The Economics of Interdependence*: “The central problem of international economic cooperation—and of this book—is *how to keep the manifold benefits of extensive international economic commerce free of crippling restrictions while at the same time preserving the maximum degree of freedom for each nation to pursue its legitimate economic objectives*”<sup>3</sup>. A number of developments in succeeding decades have escalated this tension, however.

First and foremost, the increase in transnational economic integration has itself generated a growing demand for rules to govern international economic interactions, what John Jackson has called the “interface issue”<sup>4</sup>, particularly as multinational corporations (MNCs) have increasingly played a dominant role in this globalization process. Somewhat independently, the rise and proliferation of non-governmental organizations communicating and operating across international boundaries (Sylvia Ostry has dubbed

them INGOs) has intensified such pressures, “pushing for a codification of international norms in a variety of issue areas”<sup>5</sup>. According to one estimate, the number of such entities increased over the last quarter of the twentieth century from about 2500 to some 16,000<sup>6</sup>. And, as one would expect in response to increased demand, the supply, or number, of international organizations and treaties that make international law has also expanded substantially.

The tension between market integration and policy autonomy has also been sharpened, ironically, by the spread of democracy. The number of countries where an authoritarian régime has given way to some form of democracy has grown steadily in recent decades and, although accelerated by the fall of the Berlin Wall in 1989, this welcome development has been by no means confined to the countries of Eastern (now Central) Europe and the former Soviet Union (FSU). As a leading scholar of international law has noted, “Citizens of democracies are naturally reluctant to cede decisionmaking authority to unelected international bodies unless the benefits of doing so are crystal clear.”<sup>7</sup> And the desire of national governments to preserve policy autonomy is likely to hold greater moral sway with the international community at large when those governments are democratically elected.

Finally, this tension has been given concrete and immediate reality in Western Europe, as the customs union established by the Treaty of Rome in 1957 has evolved in the European Union (EU) and European Monetary Union (EMU) of today.<sup>8</sup> In fact, the autonomy and effectiveness of individual countries’ monetary and fiscal policies in targeting domestic goals had begun to erode with the progressive liberalization of international capital flows and deregulation of financial markets beginning in the 1970’s. But this de facto erosion of national economic sovereignty in the macroeconomic sphere took a dramatic leap into de jure reality during the final years of the twentieth century. It was then that the member countries of the EMU formally gave up monetary independence entirely, as national currencies were replaced by the Euro and the European Central Bank (ECB) took over the formulation and execution of monetary policy from the central banks of member nations.

Although in principle the member nations of the EMU retain some control over fiscal policy, their fiscal autonomy is severely constrained by the Stability and Growth Pact, adherence to which is one of the requirements for EMU membership. The Pact requires member countries to limit government deficits to no more than 3 percent of gross domestic product (GDP), except under exceptional circumstances, and imposes other limitations as well.<sup>9</sup> Although the draconian fine for violations provided for in the Pact has not so far actually been imposed on any member country, both Germany and Ireland have received formal reprimands for exceeding the 3% limit and France, Italy, and Portugal have been the subjects of somewhat softer “warnings”. The fact that several members of the EMU, including the two largest, have failed to adhere to the Pact’s requirements has led to a lively debate within the EMU regarding whether its provisions should be made more flexible.

In the micro-economic sphere, it is the EU's commitment to the creation of a "single market" that has stimulated the process of deep integration, in order to facilitate the free flow of goods, services, labor, and capital among member countries. In principle, the commitment to subsidiarity<sup>10</sup> enshrined in the 1992 Maastricht Treaty should preserve considerable micro-economic policy independence for the member states. And the repeated confirmation by the European Court of Justice of the principle of mutual recognition,<sup>11</sup> stating that compliance with the regulatory requirements of one member state will confer legitimacy in the other member states as well, has gone some way toward reconciling a measure of national regulatory independence with the goals of a single market.

Adherence to the principles of subsidiarity and mutual recognition have not, however, eliminated ongoing wrangles between member governments and the EU bureaucracy regarding their application in particular situations. In the sphere of taxation, national policy independence appears to have won out. Early efforts to harmonize levels of value-added taxes were effectively abandoned in the face of resistance by national governments with different views on taxation and government spending and differing degrees of dependence on such taxes for revenues. And, as the *Economist* noted in the mid-1990s, not only do the shares of government in the GDP of member countries vary widely within the EU, but this range broadened rather than narrowing between 1980 and 1995.<sup>12</sup>

In the regulatory realm, by contrast, disputes between Brussels and one or another of the member states, particularly the larger ones, are ongoing. The creation of economic rents through subsidies or other forms of state aid to particular firms or industries constitute one fertile arena for such arguments. In 1996, for example, the European Commission forced the German state of Saxony to reduce its planned subsidy to a Volkswagen plant on the grounds that it did not fully comply with EU rules limiting such assistance. More recently, the European Commission announced that it would investigate a substantial subsidy, committed jointly by the German federal government and the regional government of Saxony to BMW for a new car plant in Leipzig, on similar grounds.

This move was only the latest of several that led the German Chancellor, Gerhard Schröder, to "attack Commission authorities for an alleged anti-German bias on issues such as new proposals on car sales, a new European-wide takeover code and the health of his country's economy."<sup>13</sup> Shortly after that complaint, "the European Commission ordered Deutsche Post, the partially-privatized German postal group, to repay 572 million euros (\$545 million) in public subsidies it said were wrongly used to undercut the prices of rivals in the parcel delivery market"<sup>14</sup>.

Tensions between the EU Commission and national authorities have also arisen from differences in regulatory philosophy, or even simply regulatory history, on a wide variety of issues. These include areas as widely divergent as competition policy, corporate governance, employment protection, privacy rules, regulations governing the taxation and investment of pension funds, and prudential rules for financial institutions. The scope for such conflicts is likely to increase, furthermore, as the drafting of a constitution for a larger and more integrated Europe proceeds toward its planned completion in 2004. This

exercise, in the eyes of some observers, is likely to favor increased pressure for harmonization (that is, convergence) of laws and regulations of member states and reduced reliance on the principle of mutual recognition. As these pressures for steps akin to Federal preemption of state laws in the United States confront the reality of an increasingly diverse group of member countries in an expanded EU, more frequent conflicts between national governments and EU institutions are a likely outcome.

Although such deep integration has not proceeded nearly so far at the global level, the Uruguay Round of multilateral trade negotiations under the auspices of the General Agreement on Trade and Tariffs (GATT), completed in 1994, moved significantly beyond negotiating reductions in border barriers to trade. At the insistence of a group of American MNCs, who took the leadership in forming a coalition with their counterparts in Europe and Japan, this round was brought to successful completion only by incorporating agreements on such matters as access to foreign markets for service providers, the protection of intellectual property (TRIPS) and national requirements pertaining to foreign direct investment (TRIMS). The simultaneous creation of the World Trade Organization, with a filled-out organizational structure and a much-strengthened mechanism for the settlement of disputes, offered a framework within which tensions similar to those experienced within the EU could be played out.

As Ostry has noted, although the deeper integration agenda successfully pursued in the Uruguay Round largely reflected the economic concerns of MNCs, the issues that have more recently risen to prominence and are likely to be particularly difficult to negotiate in future rounds arise from advocacy by cross-border coalitions of INGOs "...linked less by a rule of reason than by a rule of morality or values".<sup>15</sup> The most prominent of these conflicts involve pressures for and against incorporating such issues as environmental and labor standards into multilateral trade agreements. Those who favor such inclusion do so in the name of eliminating policy-induced distortions of international trade and investment flows and deterring a competitive "race to the bottom" by nations attempting to stimulate exports and/or attract foreign investment by offering cost advantages based on low standards of protection for workers or the environment.

Opponents argue, on the other hand, that efforts to harmonize such policies on a global basis would violate legitimate differences in national needs, preferences, and priorities as revealed through democratic processes. Even more to the point, they note, is that using trade sanctions to punish countries found to have violated the standards incorporated into WTO-sponsored agreements is likely to be counter-productive. The reasoning is that, because poverty is the major factor associated with low levels of labor and environmental protection, sanctions which slow the economic development of poor countries by blocking their exports are likely to perpetuate rather than alleviate the very situation the sanctions purport to address.

Above and beyond the various arguments pro and con incorporating such harmonization of standards into trade agreements is the fact that the overwhelming majority of developing nations are vehemently opposed to any such broadening of WTO authority. They regard it simply as a vehicle for disguised protectionism on the part of rich

countries fearing competition from goods and services produced at lower cost in poorer nations.<sup>16</sup> Indeed, it was President Clinton's surprise endorsement of labor standards enforced by some form of sanctions that many observers believe to have been the major cause of the collapse of the ill-fated Seattle Round even before it got underway.<sup>17</sup>

Although the member nations of the WTO recouped the Seattle debacle by agreeing, in November 2001, to an agenda for the Doha Round, planned to conclude in 2005, these standards issues will almost certainly cause further difficulties in the actual negotiations. And the persistent tensions, papered over in the agenda-setting discussions, between the provisions for the protection of intellectual property incorporated into the Uruguay Round agreements and the demand of developing nations for access to low-cost drugs to treat diseases wreaking havoc among their populations has already delayed agreement on this issue (with the United States the lone holdout) beyond the anticipated end-2002 deadline.

I have just described a number of developments that have exacerbated the tension between international economic integration and the desire for policy autonomy on the part of nation-states. These include the increased demand for the codification of international norms arising from the expansion of economic transactions across international boundaries, the rising prominence of both MNCs and INGOs, the proliferation of international organizations and treaties that create international law, the spread of democracy giving enhanced legitimacy to national preferences and priorities, and the concrete examples of how these contradictory demands play out, at the regional level in the European Union and at the global level in the World Trade Organization. The question then arises, are there any analytical principles or concepts that can help bring order to these contradictions and alleviate the tensions inherent in them?

#### Macro-Economic Aspects of the "Impossible Trinity"

In *The Economics of Interdependence*, Richard Cooper posed the "impossible trinity" of open-economy macroeconomics: that a country cannot simultaneously maintain fixed exchange rates, an independent monetary policy, and unrestricted international capital flows, but must choose any two of the three and give up the third. Some thirty years later, Dani Rodrik offered a parallel "trilemma" in the political sphere, asserting that international economic integration, the nation-state, and mass politics cannot coexist. Once again, he argues, we must choose any two of the three, where "mass politics" is defined as a situation in which democratically-controlled political institutions are responsive to a popular will expressed through the exercise of an unrestricted franchise combined with a high degree of political mobilization.<sup>18</sup> The tensions I have described in the preceding section can, in fact, be seen as examples of the pulling and hauling among these three mutually inconsistent goals.

Rodrik himself resolves the trilemma by opting (in the double sense of regarding it as both most likely and most desirable) for sacrificing the sovereignty of the nation-state in many areas in favor of a form of global federalism, with ". . . *supranational* promulgation of rules, regulations, and standards".<sup>19</sup> But, as he freely admits, this prediction is nothing

more than a “bet” based on optimism and his own preferences. The question remains: what further light, if any, can the existing body of analysis and alternative models in the realm of political economy shed on a possible resolution of this conundrum?

One possibility might be to extend the concept of an optimum currency area to encompass fiscal as well as monetary policy, thus creating an analytical construct for an optimum policy area or, more precisely if more awkwardly, an optimum macro-policy area, where macro-policies are defined as policies directed toward income stabilization and economic growth. Such an extension indeed might seem logical, in light of the myriad practical problems that are likely to interfere with the effective application of monetary and fiscal policies for these purposes if their domains are different.<sup>20</sup>

There is, of course, a rich literature focused on defining the characteristics of an optimum currency area, the geographical boundaries within which the welfare costs of giving up the independent use of monetary policy as a stabilization tool are low compared to the benefits of permanently eliminating the costs of exchange-rate variability and its associated risks. The concept was introduced by Robert Mundell in the late 1960’s, in the course of the ongoing debate on the relative merits of fixed versus flexible exchange rates. Mundell’s criterion was apparently simple: the optimum currency area must coincide with the area over which labor can move freely, out of regions with unemployment and into those experiencing inflationary pressure.<sup>21</sup>

One of the implications of this labor mobility criterion, as Mundell himself pointed out, is that the optimum currency area is likely to be small. This point is reinforced by the fact that Mundell’s definition requires perfect labor mobility in the occupational as well as the geographical sense. His optimum currency area, in other words, must be perfectly homogeneous; “it must, indeed, be coextensive with the single-product region.”<sup>22</sup> But, as Mundell anticipated and others were quick to elaborate, the identification of a small, homogeneous region with the optimum currency area is fraught with contradictions. For such a region will inevitably be extremely open, in the sense that the foreign trade sector represents a large part of its economy which, in consequence, will be heavily dependent on and sensitive to influences from the outside world. In particular, as McKinnon has pointed out, the exchange-rate flexibility required for monetary independence implies loss of control over the domestic price level in a highly open economy, and is thus likely to undermine the liquidity value and the general acceptability of the domestic currency.<sup>23</sup>

In the decades since Mundell and McKinnon wrote their seminal papers, scholarly analysis of the issues they addressed has moved well beyond the simple, static Keynesian and price-elasticities assumptions on which their models were based.<sup>24</sup> But none of these more sophisticated elaborations has, to my knowledge, resolved the basic conundrum posed by the Mundell-McKinnon paradox.<sup>25</sup> That is the fact that the small, homogeneous economy required by Mundell’s labor-mobility criterion is virtually certain also to be highly open, thus contradicting McKinnon’s point that only in a relatively closed or self-sufficient economy is an independent monetary policy and the associated flexibility of the exchange rate likely to be compatible with domestic control over the price level. Without

such control, experience has shown, confidence in and therefore acceptability of the domestic currency is likely to collapse.

The kinds of problems confronted by a currency union that fails to meet one or another of these criteria is illustrated by the issues currently confronting the conduct of monetary policy in the EMU. Stubbornly high unemployment in some of the larger member countries, particularly Germany, indicate the need for monetary ease, while inflationary pressure in others, such as Spain and Portugal, militate against it. Such problems are predictable, given the low degree of labor mobility, both geographical and occupational, not only between but even within EMU member countries. The EMU is clearly not an optimum currency area by the Mundell factor-mobility criterion. The strong political commitment to maintaining and extending the EMU, together with the fact that it is already a fait accompli, make its breakup virtually unthinkable. But the difficulties confronting the European central Bank (ECB) are not likely to attenuate without significant structural changes, including above all a substantial increase in labor mobility.

If extending the concept of an optimum currency area to define the criteria for an optimum macro-policy area, encompassing fiscal as well as monetary policy, is to prove useful, it must be based on a currency-area definition free of the contradictions just outlined. One starting point for such an alternative criterion is the proposition that the macroeconomic costs of being part of a larger currency area are proportional to the extent to which the optimal rate of inflation for the economy under consideration diverges from that for the rest of the currency area.

This criterion can be clarified with the aid of a simple Phillips-curve analysis.<sup>26</sup> The optimum rate of inflation for an economic system is then determined by the point of tangency between the Phillips curve, representing the attainable combinations of unemployment and inflation determined by the structural characteristics of the economy, and the community indifference curve representing, in this case, the politically-determined trade-off function between unemployment and inflation. Deviations in the optimum rate of inflation between different economies can be caused either by differences in their Phillips curves or in their trade-off functions, or both.

This point is illustrated graphically, for the two-region case, in Figure 1.<sup>27</sup> It is assumed here that deviations in optimum inflation rates are due to differences in the underlying Phillips curves; that the trade-off preferences of both regions can be represented by the same family of II curves. (The case where the deviation is due to differences in the community preference curves could also be examined graphically, but any conclusion would require specific assumptions about the distribution of adjustment costs between the partner economies.) Note, incidentally, that since both inflation and unemployment are presumed to represent costs in welfare terms, the curves of the trade-off map represent higher levels of economic welfare as they approach the origin, where unemployment and inflation are both zero.



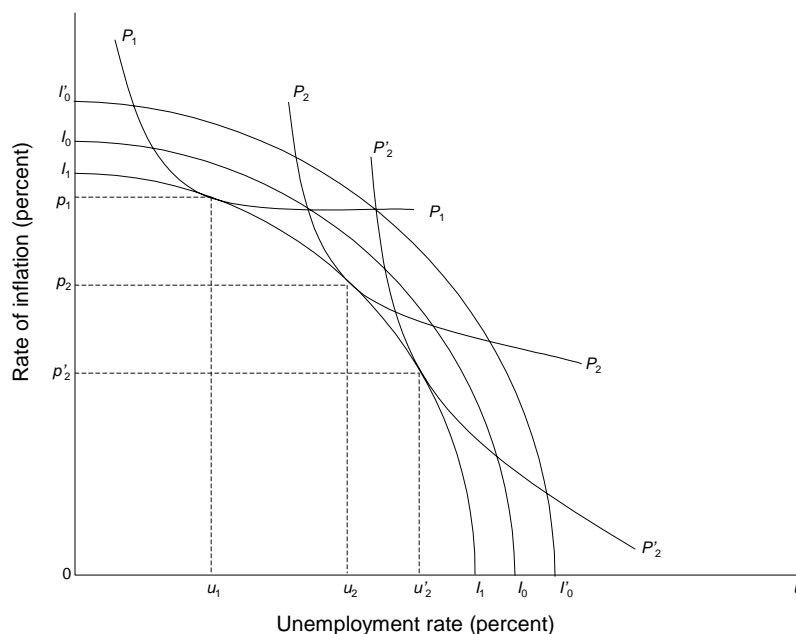


Figure 1: Harmonizing Rates of Inflation: The Welfare Effects

In the special case where the adjustment burden is equalized, in the sense that both regions have the same unemployment rate after joining the common currency area, the common inflation rate can be found in Figure 1 by locating the point where the two regions' Phillips curves intersect and then extending a perpendicular to the vertical axis on which the common rate of inflation is measured. It is then clear that the cost of belonging to a common currency area is greater the greater is the initial (pre-currency merger) discrepancy between the optimum rates of inflation in the two regions. When the optimum rates of inflation are  $p_1$  and  $p_2$ , based on underlying Phillips curves  $P_1$  and  $P_2$ , the constraint of a common inflation rate will reduce total welfare in each of the two regions from the level represented by  $I_1$  to that represented by  $I_0$ . If, however, the Phillips curve of one of the regions were represented by  $P'_2$ , the comparable costs would be represented by the move from  $I_1$  to  $I'_0$ , clearly a greater reduction in economic welfare.

This conclusion is not confined to the specialized case of an equalized burden of adjustment. Assume, on the contrary, that the rate of inflation in the common currency area settles at  $p_1$ , implying that region 1 bears none of the adjustment cost, remaining on the same indifference curve as before. Then the total adjustment burden borne by region 2 will be greater, in the sense of moving to an indifference curve representing a lower level of economic welfare, when its relevant Phillips curve is represented by  $P'_2$  rather than  $P_2$ . Analogously, when it is region 1 that bears the full burden of adjustment, that burden will be greater when the common rate of inflation is  $p'_2$  than when it is  $p_2$ . However the burden of adjustment is distributed, the total welfare loss involved in moving to the common rate of inflation implied by a common currency will be greater, *ceteris paribus*, the greater is the initial discrepancy between the optimum inflation rates in the two regions.<sup>28</sup>

This simple analysis generates an alternative criterion for the delineation of an optimum policy area: the regions or countries comprising such an area should vary as little as possible in their optimum inflation rates. For nations or regions with substantial differences in economic structure leading to substantial differences in the loci of attainable inflation-unemployment combinations represented by Phillips curves, or in the preferences that determine their subjective trade-offs between the two, the costs associated with the maintenance of a common monetary policy and severely constrained fiscal policies are likely to be high.<sup>29</sup>

This conclusion, in turn, yields at least two alternative implications for policy. On the one hand, it suggests that countries widely divergent in this respect should remain as separate policy areas. On the other, if the decision to merge into a common macro-policy area has already been taken, efforts should be made to reduce the divergences among the optimum inflation rates of the member countries, by exerting pressures for either their indifference maps, their Phillips curves, or both to converge.

As regards the preferences and priorities that constitute a community indifference map, one might anticipate that the very fact of membership in a larger “community” is likely to reduce these differences over time. However, such convergence may not occur quickly enough to guarantee the political sustainability of the economic union. A concern that such convergence may not be proceeding sufficiently rapidly among substantial segments of the member countries’ populations is one way to interpret the efforts of the EU’s executive, legislative, and judicial bodies to reduce or eliminate what has come to be called the “democratic deficit”. This term refers to the fact that quasi-governmental decisions are being made by unelected bodies whose accountability to the constituent electorates is very tenuous.

The kinds of changes required to bring about convergence of member countries’ Phillips curves (or, more realistically, a three-dimensional version of Phillips curves incorporating rates of economic growth) are quite different. Stated as succinctly as possible, the policies involved here are the provisions governing taxation, regulation, and the creation or reconfiguration of economic institutions that affect the structural characteristics of an economy. It is such policies that, in the majority of cases, figure in the issues regarding deeper integration, at both the EU and the global levels, that were raised at the beginning of this article. And it is to the more detailed discussion of such policies and the prospects for their convergence, that I now turn.

#### Convergence of Structural Policies: Top Down or Bottom Up?

The convergence of structural policies associated with deep integration can come about through two different routes, or through some combination of the two. One is the “top down” application of “hard law” created by formal treaties and conventions signed between sovereign states and ratified by national legislatures. The other is the “bottom up” creation of “soft law” either through guidelines, recommended practices, non-binding resolutions or other multilateral political documents that lack the force of the formal

agreements cited in the preceding sentence or through promulgation by private-sector organizations with a multilateral reach.<sup>30</sup> Examples of the first category of soft law include UN General Assembly resolutions, International Monetary Fund (IMF) codes and standards, or G-20 communiqués. Examples of the second category include the requirements developed by the International Accounting Standards Board and the standards imposed by credit-rating agencies, stock exchanges, or the International Standards organization (ISO).

For the nations of the European Union, the role of hard law promulgated at the supranational level has grown steadily in recent years. As of 1995, one particularly knowledgeable observer estimated that “[I]n the economic sphere, less than 50 percent of existing regulations are now of national origin. One instance of a supranational entity, the European Commission, has become the principal source of regulation . . .”<sup>31</sup> In light of the Commission’s activities since 1995, along with the rulings of the European Court of Justice, which has tended more often than not to uphold the rulings of the Commission in disputes with national authorities, the percentage of economic regulations originating at the supranational rather than the national level has almost certainly increased further since that year.

At the global (or at least massively multilateral) level, the promulgation of hard law affecting policies and institutions traditionally regarded as “domestic” was stimulated in the mid-1990’s by the Uruguay Round’s creation of the WTO and the expansion of its scope to encompass such policy areas as TRIPS, TRIMS, and market access for services. But the regulatory areas affected by this 1994 Agreement have been relatively limited, and efforts to extend them have been thwarted so far by the strong opposition of many developing-country members of the WTO. Similarly, efforts to promulgate a Multilateral Agreement on Investment (MAI) that, after ratification, would have been binding on the member countries of the OECD, that is, virtually all the industrialized countries, collapsed in the face of opposition by several member countries, particularly France, and the powerful adversarial tactics of a number of INGOs.

Although expansion of supranational hard law in the economic sphere has been limited where large numbers of countries that are geographically dispersed, culturally divergent, and at widely varying levels of economic development are concerned, the growth of soft law has not been similarly constrained. As Ostry points out, “[I]n the financial sector there are a number of intergovernmental institutions such as the venerable Bank for International Settlements (BIS) created after World War I, the 1984 International Organization of Securities Commissions (IOSCO) and, most recently, the International Association of Insurance Supervisors (IAIS) formed in 1995.”<sup>32</sup>

In Ostry’s view, however, the inability of governments and intergovernmental institutions to keep pace with the accelerating pace of global economic integration has produced a move toward self-regulation, not only in financial services but also in the new marketplace of electronic commerce.<sup>33</sup> Such self-regulation may occur through private-public interactions such as that between the International Accounting Standards Board (IASB), a private organization created in 2001, which is in the process of developing a

hotly-debated set of supranational standards for accounting practices, and the EU Commission, which has mandated the adoption of the IASB standards by all EU firms by 2005. Or it may occur through the pressures stemming from standards promulgated by purely private organizations whose multinational reach has a significant effect on international capital markets, such as credit rating agencies and stock exchanges.

The received wisdom in most discussion of the pressures for system convergence as a result of deepening economic integration is that these pressures are making it increasingly difficult and costly for nations to resist moving toward the American (sometimes also called Anglo-Saxon) style of capitalism. Certainly, this is the view popularized by Thomas Friedman in his description of the policies required by what he has termed the Golden Straitjacket.<sup>34</sup> As summarized by Rodrik, these policies are “tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around,”<sup>35</sup> for which the U.S. represents the gold standard. Similarly, Ostry argues that “[A] confluence of unrelated events. . . are accelerating the global reach of investor capitalism and deepening the push for convergence to an ‘Anglo Saxon’ corporate governance model in which the stockholder is king”.<sup>36</sup> Or, as she puts it more colloquially in conversation, “convergence toward the American model, which is fluid, flexible, disposable”.

Certainly the increasing globalization of private markets for goods, services, and capital has intensified pressures on countries to increase their competitiveness in international trade and to create a legal and regulatory climate attractive to foreign capital in both direct and portfolio forms. But pressures to adhere to the sorts of policies described in the preceding paragraph have also been generated by such multilateral institutions as the IMF and the World Bank through their insistence that current or would-be borrowers adapt their policies to what has come to be called the “Washington consensus”. This set of prescriptions essentially extends the requirements imposed by private capital markets, as described in the preceding paragraph, into the sphere of public borrowing and lending as well.

Just in the last year or so, however, the lessons learned from recent currency crises, together with heavy pressure from INGOs, including embarrassing and sometimes paralyzing street demonstrations, are causing these organizations to begin to question the Washington consensus and rethink their criteria for credit-worthiness. Similarly, while the GATT-WTO has in the past tended to focus on and promote issues and policies favored by American-style capitalism, the agenda for the new round of trade negotiations initiated at Doha late in 2001 reflects a commitment to make this the “development round”, that is, to bring to the fore and deal with matters of particular concern to developing nations.

In a variety of non-financial areas, in contrast, it is the rules and standards of the European Union, rather than those of the United States, that are extending their reach in the global economy. The most widely-noted instance of this dominance was Brussels’ refusal in 2000 to approve the GE-Honeywell merger. This negative decision resulted in

the abandonment of the deal, even though both companies are U.S.-based and the American antitrust authorities had already given their approval.

Much more widespread, though less-noticed, has been the impact of EU regulations affecting both the characteristics of goods and services that are internationally traded and the processes by which they are produced. That is because, where protection of consumers or of the environment is involved, EU requirements are generally more stringent than those of the United States or of most other nations. This stringency is grounded in the EU's strong adherence to the precautionary principle which holds that, in cases where there is uncertainty regarding the possibility of harm, rules and standards should err on the side of caution.

The EU has not always prevailed when specific applications of the precautionary principle have been submitted to the WTO's dispute-settlement procedures, whose sanction is necessary for a provision to be incorporated into the formal body of supranational hard law.<sup>37</sup> But its record in creating what is in effect global soft law is more impressive. The EU's 15 nations together constitute the world's second-largest market—the United States remains the largest—and non-EU companies that compete in the global marketplace, or hope to do so, are increasingly designing and manufacturing all their products to conform to EU requirements. That is because customizing products to meet different rules and standards in different countries would vastly increase complexity and expense; uniformity requires the most rigorous regulations and standards to prevail.

Thus it is that Fisher-Price toys, Carrier air conditioners, Toyota (as well as other makers') cars and SUVs, and Procter and Gamble's dishwasher detergents all have been, or soon will be, adapted to meet EU safety, environmental, and recycling rules. And, as regulatory harmonization across the EU proceeds, more and more products, wherever they are made and wherever they are sold, will be de facto subject to the soft law thus created. The same is true of the processes involved in international commerce. Over the past two years, for example, nearly 200 U.S. companies, producing a broad range of goods and services, have signed "voluntary" agreements to abide by EU privacy rules, which affect the transfer and use of online data about individuals and thus have an impact on virtually every firm that has workers, suppliers, or customers within its borders.<sup>38</sup>

Perhaps the greatest impact of such EU soft law is on farmers, primarily but not exclusively American, who make use of biotechnology in genetically modifying their crops. Because of stringent EU restrictions and labeling requirements on genetically altered foods or ingredients, multinational food processors are increasingly refusing to buy them on the grounds that they are likely to cause marketing problems in Europe. In June of 2002, the U.S. threatened to bring legal action in the WTO against the EU for its refusal to approve some genetically modified crops, despite the fact that they have been approved by EU scientists, allegedly because of political sensitivity to European consumers' concerns about their possible health and environmental risks (concerns that have led to such crops being labeled "frankenfoods" by those suspicious of their potential

effects). This illegal ban, the U.S. argues, is costing it millions of dollars a year in lost exports.<sup>39</sup>

The pressures for system convergence created by both hard and soft supranational law have tended to be toward U.S.-style capitalism in the realm of finance and corporate governance and toward EU-style regulatory stringency as regards product and process regulations. In still other areas, the nature of the ultimate compromise is less clear. As regards the soft law of global accounting standards, for example, a fierce struggle for the hearts and minds of the IASB is currently being waged between the “principles-based” approach that prevails in Europe and the “rules-based” philosophy that underlies American generally accepted accounting principles (GAAP). Just how things will settle out by 2005, when all firms publicly-traded within the EU will be required to conform to IASB rules, is as yet unclear, although the recent rash of accounting-related scandals in the United States has certainly unseated GAAP from its gold-standard throne. And on some issues, such as corporate governance, where there is considerable pressure for and anecdotal evidence of convergence toward American shareholder-focused practices,<sup>40</sup> at least one econometric analysis suggests that convergence has been much greater in form than in substance or practice.<sup>41</sup>

Two things seem clear from experience so far, however. One is that the tension between deepening international economic integration and the desire for policy autonomy on the part of nation states will continue into the foreseeable future. Another is that, although top-down hard law and bottom-up soft law will both play a role in the resolution of particular instances of that tension, the latter approach, because of its greater flexibility and more rapid adaptability, is likely to play the starring role.

#### Conflicting Domains: Private versus Public Goods

Once again, Cooper was the first to make a point that now seems obvious: that, for private markets in goods, services, and factors of production, the optimum currency—or macro-policy—area is the world. The welfare justification for nation-states lies in the existence of public or collective goods and of differences in the consumption preferences for such goods among the citizens of different countries.<sup>42</sup> The principle of subsidiarity extends this logic to sub-national governmental units as well.

Among the many public goods regarding which citizens express their preferences through the political process, and with whose provision governments at all levels are concerned, are such myriad determinants of satisfaction, or dissatisfaction, as national defense, income distribution, environmental quality, worker protection, level of physical infrastructure, and countless others. One such public good that has played a significant role in trade disputes is culture. When France imposed a discriminatory tax on foreign films or Canada refused to allow the Borders bookstore chain to open stores there, the rationale given for these barriers to trade and investment was the preservation of the national culture, as exemplified in films by French film-makers and books by Canadian authors, in the face of potential domination by carriers of a foreign (in these cases, American) one. Even such a staunch defender of trade liberalization as Sylvia Ostry has

been heard to remark more than once, in this context, “only the Americans would fail to distinguish between culture and ball bearings or chickens”.

Earlier in this discussion, I suggested that the gross welfare costs (not taking account of the benefits) of forming a common macro-policy area could be described in terms of the size of the pre-merger difference between two countries’, or regions’, optimum inflation rates. This difference was shown graphically to result from differences between the countries’ structural trade-offs between unemployment and inflation, represented by Phillips curves, and-or the subjective combinations of the two preferred by their citizens, represented by community indifference maps.<sup>43</sup> Conceptually, this approach to measuring the costs of economic integration in the sphere of public goods can be extending to the arena of micro-economic policies as well, although mapping it would require as many dimensions as there are pairs of public goods that citizens care about and among which they have particular preferences.

All this may be no more than an elaborate way of saying that economic integration between countries with very different needs, tastes, and priorities as represented through the political process are likely to find economic integration particularly difficult. But it does help clarify why the North American Free Trade Agreement (NAFTA), the first free-trade area to encompass countries at widely different levels of economic development, was regarded as a pioneering step into the unknown. And it may also help explain why the accelerating process of deep integration popularly termed globalization, encompassing more and more countries widely divergent in their economic, political and cultural characteristics, has been accompanied by an intensifying backlash.

Because human beings value both private and public goods, the tensions created by the divergent optimum policy domains they imply are certain to persist. But these persistent tensions need not produce, as some have feared, a battle to the death between global economic integration and the nation-state. Rather, one can imagine the two coexisting in a state of symbiosis: not a centralized world government but a networked form of international governance, fostered in part by private organizations and in part by functional parts of nation-states themselves. As described by one legal scholar, “[T]hese parts—courts, regulatory agencies, executives, and even legislatures—are networking with their counterparts abroad, creating a dense web of relations that constitute a new, transgovernmental order.”<sup>44</sup>

Many of today’s most successful corporations exercise control over the resources required to produce private goods and services not simply through ownership but, increasingly, through the ability to coordinate and thus effectively utilize resources owned by others.<sup>45</sup> Similarly, nation-states may in the future find their effective sovereignty expanded rather than shrunk if they can manage a corresponding transformation in the provision of public goods, coordinating not only with other nation-states but also with governmental bodies at both the sub-national and the supra-national levels, as well as with public-private and purely private entities performing regulatory functions, in order to achieve their goals.

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Endnotes

- <sup>1</sup> Sylvia Ostry, *The Post-Cold War Trading System: Who's On First?* (Chicago: University of Chicago Press, 1997), p. 233.
- <sup>2</sup> Sylvia Ostry, "Convergence and Sovereignty: Policy Scope for Compromise?" in Aseem Prakash and Jeffrey A. Hart (eds.), *Coping with Globalization* (New York: Routledge, 2000), p. 53.
- <sup>3</sup> Richard N. Cooper, *The Economics of Interdependence* (New York: McGraw Hill, 1968), p. 5. Italics in original.
- <sup>4</sup> John H. Jackson, *The World Trading System* (Cambridge, Mass.: MIT Press, 1989), pp. 218-221.
- <sup>5</sup> Daniel W. Drezner, "On the Balance Between International Law and Democratic Sovereignty," *Chicago Journal of International Law* 2-2 (Fall 2001), p. 322.
- <sup>6</sup> Dirk Messner and Franz Nuscheler, "World Politics—Structures and Trends" in *Global Trends and Global Governance*, ed. Paul Kennedy, Dirk Messner and Franz Nuscheler (London and Sterling, Va.: Pluto Press, 2002), p. 126.
- <sup>7</sup> Drezner, pp. 321-322.
- <sup>8</sup> Actually, the Treaty of Rome itself involved aspects of deep integration, in the form of the Common Agricultural Policy (CAP) and a Competition Policy. Both of these arrangements involve considerably more supranational government than would be required by a customs union alone.
- <sup>9</sup> The ratio of government debt to GDP is expected to stay below a ceiling of 60% for EMU members. Countries whose ratio rises above that ceiling are expected to achieve fiscal balance within a specified period ranging from about 1 to 3 years.
- <sup>10</sup> The principle of subsidiarity, taken over from Catholic Church, holds that decisions should be made by lowest "appropriate" level of government, the one closest to the citizens affected.
- <sup>11</sup> Michael S. Greve, "New Insights from the Old Continent," *AEI Federalist Outlook* #10 (Jan./Feb. 2002), p. 3
- <sup>12</sup> "The Myth of the Powerless State," *Economist*, 10/7/95, pp. 15-16. At least part of the reason for this continued divergence may be that EU-level regulation of member-state taxation requires unanimity, rather than a qualified majority, in the EU Council of Ministers. Some observers believe, however, that such regulation is imminent. See, for example, Robert T. Kudrle, "Does Globalization Sap the Fiscal Power of the State?" in *Coping with Globalization*, p. 215 and references cited there.
- <sup>13</sup> Francesco Guerrera and Uta Harnischfeger, "Brussels to Probe Subsidy for BMW," *Financial Times*, 4/4/02.
- <sup>14</sup> Paul Meller, "Europe Orders Deutsche Post to Repay Public Money," *New York Times*, 6/20/02.
- <sup>15</sup> "Convergence and Sovereignty. . .", p. 60.
- <sup>16</sup> Speaking at the Annual Meeting of the World Economic Forum, President Ernesto Zedillo of Mexico commented that "[F]orces from the extreme left, the extreme right, environmentalist groups, trade unions of developed countries and some self-appointed representatives of civil society, are gathering around a common endeavour: to save the people of developing countries from. . . development." World Economic Forum, *New Beginnings: Making a Difference: Report on the Annual Meeting 2000 of the World Economic Forum* (Geneva, Switzerland: World Economic Forum, 2000).
- <sup>17</sup> The carrot may be more effective than the stick. For example, in an unprecedented bilateral agreement signed in 2002, the Cambodian government undertook to improve respect for modern labor rights in its garment industry, and accept monitoring by the ILO, in return for an 18% bonus in its U.S. annual textile quota. Amy Kazmin, "US Sportswear Giant May be Ready for a Return to Cambodia," *Financial Times*, 6/18/02.
- <sup>18</sup> Dani Rodrik, "How Far Will International Economic Integration Go?" *Journal of Economic Perspectives* (Winter 2000), p. 180.
- <sup>19</sup> *Ibid.*, p. 185. Italics in original.
- <sup>20</sup> This does not imply, that *all* fiscal policy should be conducted at the same level as monetary policy; most countries have several levels of fiscal jurisdiction. For a more extensive discussion of this issue, see: Marina v.N. Whitman, "Place Prosperity and People Prosperity: The Delineation of Optimum Policy Areas," in *Reflections of Interdependence* (Pittsburgh, Pa.: University of Pittsburgh Press, 1979), pp. 65-66.
- <sup>21</sup> Robert A. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review* 51 (Sept. 1961), pp. 657-65.



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<sup>22</sup> Peter B. Kenen, "The Theory of Optimum Currency Areas: An Eclectic View," in *Monetary Problems of the International Economy*, ed. R. Mundell and A. Swoboda (Chicago: University of Chicago Press, 1969), p. 44.

<sup>23</sup> Ronald I. McKinnon, "Optimum Currency Areas" *American Economic Review* 43 (Sept. 1963), pp. 717-725 and "Optimum World Monetary Arrangements and the Dual Currency System," *Banca Nazionale del Lavoro Quarterly Review*, Dec. 1963, pp. 366-396.

<sup>24</sup> For a survey of this literature, see: Marina v.N. Whitman, "The Open Economy Macromodel: Interactions Between Theoretical Developments and Real-World Behavior," in *The Open Economy Macromodel: Past, Present and Future*, ed. Arie Arnon and Warren Young (Amsterdam: Kluwer Academic Publishers, 2002) and the references cited there.

<sup>25</sup> The United States springs immediately to mind as a counter-example to the paradox. But two points must be noted. First, the United States is characterized by a uniquely high degree of labor mobility. And, second, the structure of federal taxes and transfer payments automatically generates equilibrating changes in the regional allocation of tax revenues and expenditure outlays when different regions of the country experience different exogenous shocks.

<sup>26</sup> The controversy surrounding the long-term stability of the Phillips curve is not critical to this discussion. Even if the Phillips curve is not stationary, desired rates of inflation may still differ between economies.

<sup>27</sup> This figure, and the discussion that accompanies it, is taken from Whitman, "Place Prosperity and People Prosperity. . .," pp. 75-78.

<sup>28</sup> Great distances or other natural barriers to accessibility may, of course, prevent full price-equalization even between regions of a single country (viz. Alaska and Hawaii in the U.S., for example) but, in the absence of such barriers, pressures for price-convergence will be strong.

<sup>29</sup> Some empirical support for this assertion is offered by: G.C. Archibald, "The Phillips Curve and the Distribution of Unemployment," *American Economic Review* 59 (May 1969), pp. 124-134. Archibald derives this result for both the United Kingdom and the United States. His analysis uses data from the 1950s and 1960s, however, and, to my knowledge, has not been updated.

<sup>30</sup> Drezner (p. 324) divides the two sources of international law into "treaty law" and "customary law", a distinction similar to the one above.

<sup>31</sup> Jean-Marie Guéhenno, *The End of the Nation-State* (Minneapolis: University of Minnesota Press, 1995), p. 50.

<sup>32</sup> Ostry, "Convergence and Sovereignty. . .," p. 58.

<sup>33</sup> *Ibid.*

<sup>34</sup> Thomas Friedman, *The Lexus and the Olive Tree: Understanding Globalization* (New York: Farrar, Straus and Giroux, 1999).

<sup>35</sup> Rodrick, "How Far. . .," p. 182.

<sup>36</sup> Ostry, "Convergence and Sovereignty. . .," p. 62.

<sup>37</sup> The WTO Appellate Body ruled in January 1998 that the EU ban on beef treated with growth hormones was not based on adequate scientific evidence and therefore violated international trade rules. When the EU refused to lift the ban, the United States and Canada, which had together brought the complaint to the WTO, imposed trade sanctions against the EU roughly equivalent to their estimated export losses from the ban.

<sup>38</sup> Brandon Michener, "Increasingly, Rules of Global Economy Are Set in Brussels," *Wall Street Journal* 4/28/2002.

<sup>39</sup> Michael Mann, "US Warns EU on Modified Crops," *Financial Times*, 6/21/02. **Since that time, Zambia, confronted by a severe drought and resulting food shortage, has refused to accept American aid in the form of genetically-modified seeds, on the grounds that potential "contamination" might prevent it from exporting such crops to European markets in the future. This action has caused the US to fear that a de facto ban on imports of genetically-modified crops or seeds might spread beyond the EU and has increased the likelihood that the US will bring a case against the EU on this issue.**

<sup>40</sup> See, for example, OECD 2000, "Corporate Governance in OECD Member Countries: Recent Developments and Trends," OECD report available at <http://www.oecd.org/daf/corporate-affairs/governance/> and World Bank 2001, "Corporate Governance: A Framework for Implementation," World Bank paper available at <http://www.worldbank.org>.

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<sup>41</sup> Tarun Khanna, Joe Kogan, and Krishna Palepu, "Globalization and Corporate Governance Convergence? A Cross-Country Analysis," Aspen Institute/William Davidson Institute Conference (Aspen, CO., Sept. 2001).

<sup>42</sup> Richard N. Cooper, "Worldwide vs. Regional Integration: Is There an Optimal Size of the Integrated Area?" in *Economic Integration: Worldwide, Sectoral, Regional*, Proceedings of the Fourth Congress of the International Economic Association, ed. Fritz Machlup (New York: Halsted Press, 1977), pp. 41-53.

<sup>43</sup> I abstract here from the adding-up problems associated with community indifference curves.

<sup>44</sup> Anne-Marie Slaughter, "The Real New World Order," *Foreign Affairs*, Sept./Oct. 1997, p. 184.

<sup>45</sup> In the limit, this process produces what has come to be called a "virtual corporation".