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AUTONOMY AND INTEGRATION IN A GLOBAL FRAMEWORK

Economic Forces and Political Institutions

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I've subtitled my paper, Economic Forces and Political Institutions, and I need to spend a few minutes defining these terms. While I know that there have been many forces at work over the 20th century -- certainly political, social and religious forces have helped shape the course of events for these hundred years -- I'm going to focus only on those that I call "economic forces". These include technological changes or innovations; productivity increases; lower information, transactions, transportation and communications costs; the phenomenon sometimes referred to as downsizing; and, of special note, as the century draws to a close, the true value added rising from knowledge-based industries as opposed to resource exploitation activities.

In the 19th century and at the beginning of the 20th century, we tended to measure the wealth of nations by tons of things and numbers of things. Basically, tons of iron ore, tons of coal, the numbers of logs cut, tons of wheat, and so on, all tended to be added up to make a statement about the so-called output or wealth of countries. But, that is no longer

appropriate. Instead, in today's world those things produced by companies such as Microsoft, the world's leader in software, and other human-capital-enhancing enterprises are more important in determining the relative well-being of nations. In fact, we see some of the most natural-resources rich places in the world -- such as Brazil, Russia, and Africa -- are actually quite poor, while the natural-resources poor places of the world --such as Japan-- sometimes are among the most prosperous.

Let me turn now to political institutions. I'm going to define two different types because of the different ways we use the word institutions. First, is organizations, such as ministries, bureaus, departments, agencies, and central banks -- as well as international organizations, such as the IMF, the World Bank, and the Bank for International Settlements. Even the United Nations and NATO could be put into this type of grouping. The second way we use the word political institutions is rules -- meaning contracts, generally accepted accounting principles, labor laws, laws of incorporation, the judicial system, and the enforcement

of property rights. Rules also includes various types of economic controls, such as wage, price, credit, interest rate, exchange, and capital controls, or even margin requirements. One would also include restrictions on financial industries such as loan-loss reserves, capital adequacy standards, debt limitations, credit allocations, leverage ratios, and so on.

Some of both of these types of institutions -- the organizations that are created and the rules that are laid down -- are intended to improve the workings of markets. However, some of both types of institutions -- organizations and rules -- are also intended to inhibit or alter the working of markets because the benefits of intrusion are perceived to be greater than the costs. That is the case when political/social objectives seem to be more important than economic efficiency. Such objectives as income redistribution -- a political decision to give priority to sharing wealth, rather than creating wealth -- result in institutional arrangements that reduce the efficiency of markets.

I'm going to argue that some of what I call

economic forces constitute an irresistible force, while some of the political institutions tend, over time, to become immovable objects. Even those political institutions that are intended to improve the workings of markets and are designed to have a great deal of inherent flexibility or adaptability, tend to become immovable objects. A conjecture is that the degree to which political institutions tend to become immovable objects depends on the scope of government involvement in the economy. The size of government, measured in terms of government spending as a percent of GDP, may reflect the scope of government involvement in resource allocation and control, but it is not sufficient as a complete measure of intrusion of government in the economy.

In a pure market economy, there would be no institutions that we would call immovable objects. On the other hand, in a total command economy, all institutions would take on the characteristics of immovable objects. However, they would prove not to be immovable after all, in the face of the irresistible economic forces in a global economy.

The architects of new rules or organizations usually understand the need to create institutions that are "living organisms" capable of adapting to changing conditions. This is true not only of constitutions for governing, but also of the various agencies of government with specific missions.

The Bretton Woods System established in the final days of World War II had built into it rules for exchange rate adjustment. However, there was an asymmetry in the way the rules worked that proved to be the rigidity that caused the system to break, rather than bend, in the face of specific economic forces.

Much of the history of the 20th century reflects what I think of as the "contest of ideas" -- democracy and capitalism on one hand locked in a struggled with dictatorship and socialism. Essentially, it was a contest for the minds of the people of the world as to the best ways to organize economic affairs and the best ways to organize political affairs.

In many respects, especially from a U.S. standpoint, there were two watershed decades of the century: the 1930s and the 1980s. In the 1930s,

during the world-wide economic depression, there was a massive increase in the intrusion of government in economic affairs. If governments did not outright nationalize and directly control resources in a command structure, then they set up regulatory agencies that were designed to decide what was to be produced, where it was to be produced, how much could be charged for products, how much could be paid to workers, or for other inputs to production, what interest rates could be charged, what interest rates could be paid, and so on.

The subsequent several decades after the 1930s were a period in which the role of the nation-state in economic affairs was large and tending to grow. Much of the underlying conceptual framework was based on what I think of as the "stagnation thesis," as set forth by John Maynard Keynes in The General Theory in the 1930s. That thesis is that even economies that are based on private property and that rely on market forces to allocate productive resources, tend to stagnate at less than full potential in the absence of governmental initiatives to cause growth. In other

words, a view widely held through much of the 20th century, one that maybe even continues to be held today by a lot of people, is that governments cause growth, and the so-called economic "policies" of government are appropriate and necessary for influencing economic activity.

The rival conjecture from the 1930s, which had little following for most of this century, was the "inherent resiliency proposition" of Friedrich A. von Hayek and other economists of the Austrian school. Their view was that an economy that relies on a price system to allocate resources in a market environment, relying on private property rights, tends to be inherently resilient -- that is, it naturally gravitates toward full utilization of its productive resources without any government pump priming. Whenever shocks of various types -- such as oil price increases, droughts, wars, or perverse government policies -- knock the economy down, there is a general tendency to start to grow again as the perverse effects of these negative shocks tend to dissipate.

Common threads of the contest of ideas in the 20th

century have been: (1) That political and economic institutions tend to ossify or to rigidify over time, mainly because these institutions, especially organizations created by people and operated by people, become resistant to changes of the status quo; (2) The fundamental economic forces -- technological innovation, falling information and transaction costs, increasing economies of scale and economies of scope of production, globalization of goods markets, financial markets, and asset markets -- all lead to what is called the "global village" or "borderless world". A recent book by Walter Wriston titled the "Twilight of Sovereignty," expressed this view.

The main thesis is that, while the efficient-sized marketplace for many goods and services at the beginning of the 20th century was a small town, village, or a province, increasingly, over the course of the century, the size of the naturally efficient market expanded to the point that even large countries such as the United States find it increasingly difficult to regulate or control various products or services. That is because, for many products and

services, the entire world has become the naturally efficient market, so the ability to regulate or control depends on the ability of the nation-states to collude in common regulation. The Basle Accord of 12 countries agreeing on capital standards for commercial banks is one example of this.

The ultimate implication of the conflict between the irresistible forces that are of an economic nature, confronting the political institutions that take on the characteristics of immovable objects, is that institutions must change, or they will fail. In other words, there must be an effective political and economic regeneration in which various institutional arrangements, especially organizations, take on the characteristics of living organisms -- that is, they must be adaptable to a changing environment.

Joseph Schumpeter, another Austrian economist, said "the essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process . . . . Capitalism, then, is by nature, a form or method of economic change and not only never is, but never can be, stationary."

Schumpeter's observation about capitalism applies equally well to all of the institutions that define the parameters of our global economy. Propelled by technological change and chance economic events, these institutions undergo a continual process of change. Those qualities that enhance economic well-being tend to survive, and those that do not eventually disappear. People develop institutions -- laws, rules, conventions, and customs -- to define and enforce property rights and, more generally, to reduce the costs of economic exchange. The various laws, rules, conventions, and customs that define money, protect its purchasing power, and govern its use, are examples of such institutions.

Recent international monetary developments can be explained in terms of these general ideas about institutional transformation. What appear as conflicts between global monetary integration and regional monetary autonomy are artificial, resulting largely from vested interests in maintaining local governmental monopolies over the issuance of the national media of exchange. History demonstrates, however, that national

currencies inevitably compete in the international financial arena. Earlier in this century, the U.S. dollar gradually replaced the British pound as the dominant global reserve currency and as the primary unit of account for international transactions. Following Hayek, approaches to international monetary relations that foster competition among alternative currency units are more likely to enhance world welfare than systems like Bretton Woods that mandate change directed by supranational governmental bodies which will tend to rigidify or ossify over time.

Unlike most people, economists think of money as merely an institutional convenience for greatly reducing the costs of transacting. Overall, a stable monetary unit allows greater specialization in production and wider choices in trade, thus enhancing the associated economic benefits.

Building on these ideas, many economists and political scientists contend that extending the geographical area in which a common monetary unit is used would confer significant gains on the residents of that area. Monetary integration can take two

institutional forms: The first is complete monetary union with a common currency and a single central bank. This is already the case among the 50 United States and among the 10 provinces of Canada. And, it is the ultimate objective of the European Monetary Union.

A second and weaker form of monetary integration is fixed exchange rates, such as experienced under the gold standard or the Bretton Woods System, as well, of course, as under the European Exchange Rate Mechanism. The conditions under which the second form is viable needs to be addressed.

Although a system of fixed-exchange rates could confer significant benefits on participants in terms of reduced transaction costs, it also imposes specific costs in terms of international cooperation and macroeconomic policy coordination. The external value of a national currency ultimately reflects the relative internal purchasing power of that currency. So, to maintain an exchange-rate, participants must coordinate their monetary policies to generate the same inflation rates. Monetary sovereignty is incompatible with fixed-exchange rates. This is why inflation

convergence is so crucial.

Under certain circumstances, however, the costs of integrating monetary policies across countries can exceed the benefits of having a common currency. Countries are most likely to form a monetary union with other countries that share common economic conditions. To understand the macroeconomic sources of the conflict, consider the history of the Bretton Woods System.

The Allies established Bretton Woods in 1944 to promote rapid recovery among war-torn economies. Close cooperation was seen as necessary to avoid the competitive devaluations and trade restrictions of the 1930s, which many economists believe contributed to the severity of the Great Depression.

In the late 1940s, Germany and Japan for instance, had a common unit of account, or standard of value -- it was called the United States dollar. However, they gave it different names. In Germany, one quarter of the U.S. dollar was called a mark and in Japan, one three hundred and sixtieth of a dollar was called a yen. The point is that the standard of value or unit

of account was not the same as the media of exchange. The latter are created or issued by governmental authorities, but the former is the crucial dimension of a currency. There never has been a Phoenix-like currency that arose from nowhere, unlinked to anything of accepted value.

The Bretton Woods System required all participating countries to define a parity for their currency against the dollar and to maintain the resulting fixed-dollar exchange rate. The United States, as the "anchor", or "key", currency, defined and maintained a dollar peg to a fixed quantity of gold. The dollar then functioned as a stable unit of account for the entire Bretton Woods System. The rules of the game required all countries to adopt a monetary policy similar to that of the United States. In other words, the Bretton Woods System implied reduced monetary autonomy for participating countries.

My review of macroeconomic factors suggests that monetary integration is more likely to be successful if: (1) All regions in a monetary union have similar preferences for inflation, reflecting similar

theoretical or conceptual views of monetary policy, and (2) All regions within a monetary union experience similar macroeconomic conditions.

While common responses to macroeconomic shocks are a desirable condition to enhance the likely success of monetary integration, they are not necessary. Regions of the United States often experience different macroeconomic conditions, especially responses to shocks such as energy-price changes, defense spending increases or decreases, and so on. What is crucial is that other avenues for adjustment between regions are available, so that exchange rate changes are not the issue. In the 1980s, we had what was called a bi-coastal economy, referring to boom conditions in California and New England while we had depressed conditions through much of the middle part of the country. Now, in the early 1990s, we once again have a bi-coastal economy with the opposite implications. Namely, we have severely depressed economic conditions in California and a continuing recession in New England, while the Rocky Mountains and the midwest are, by comparison, considerably stronger. If it were not

for the _political_ integration and the associated high degree of resource mobility (investible capital resources as well as labor resources) then it would be more tempting for various regions within the United States to contemplate devaluation of their currencies in today's environment. The severe three-year old recession in California might lead some to believe that devaluing the California dollar against the Ohio dollar, or against the Rocky Mountain dollar, would be an attractive option. But, because of political unity and resource mobility, this option is not under consideration.

The recent history of our global monetary systems suggests that attempts to impose monetary integration by a fixed-exchange rate on a broad scale are not likely to succeed. In part, as I've argued, this results because regions of the world that experience disparate economic conditions and low resource mobility can adjust to economic shocks more efficiently by allowing their exchange rates to change. Furthermore, monetary integration cannot proceed in a credible manner, even among regions in which it is feasible,

unless governments first adopt domestic institutions that credibly assure their commitment to maintain domestic price stability.

History teaches us that institutions, including those that determine the use of national currencies, inevitably compete. Through competition, efficient wealth-enhancing institutional forms tend to emerge. In the interest of fostering greater international stability and integration, we should encourage such institutional competition. This requires, above all else, the free movement of resources through the elimination of artificial restraints on the movement of capital, goods, services, and labor. This could include the removal of any national legal tender laws so that individuals could be assured of enforcement of contracts written in any currency. More likely, we could urge that the various parliaments legislate "specific performance" so that the courts will enforce contracts denominated in any currency unit. This would enhance the rule of law across borders of nation-states.

Individuals would then hold their assets in

currency units that are most stable in terms of their expected long-term purchasing power. A free flow of resources would foster a convergence of institutional forms across participating governments as they compete for these resources by providing stable economic and political environments. Governments that fail to provide such an environment will lose resources as markets vote on policies. The resulting convergence of monetary and fiscal regimes will achieve the highest sustainable degree of monetary stability.

When some observers look at the centrifugal and centripetal forces at work in various regions of the world, there seems to be a conflict. That is, when one looks at the efforts under way to achieve European Community objectives -- economic integration, and, maybe ultimately political integration among twelve or more European nations -- in contrast with the political and economic disintegration of the former Soviet Union, it might appear that these trends are going in opposite directions. I do not think that that is the case. The common element in both developments is that, in the case of Europe, the move toward political and economic

integration involves a very large number of specific steps to reduce the role of the participating nation-states in economic affairs. In other words, it consists of specific actions to improve the workings of the markets <u>within</u> <u>Europe</u> -- to strengthen property rights within Europe and to eliminate a whole host of rules, regulations, barriers, and obstacles to the free mobility of goods, labor, and capital.

In the former Soviet Union, we see that political and economic <u>dis</u>integration is a process of tearing down the highly centralized command and control socialist economy. It is a process of searching for ways to make markets flourish in the 15 or so republics of the former Soviet Union, as well as in the eastern European countries of the former COMECON. So, the move towards economic/political <u>in</u>tegration in Europe and <u>dis</u>integration in the former Soviet bloc both involve the tearing down of previously erected political institutional arrangements that interfered with the workings of markets.

In this final decade of the 20th century, it seems that the clearest trend around the world is to reduce

the role of the nation-state in economic affairs. Deregulation and denationalization/privatization and tax reduction and tax reform, are all part of a process of "economic regeneration" -- to once again restore the wealth-creating capability of markets. Resources, especially investment capital, move quickly to those regions that are making the most progress, such as today in Mexico, Argentina, or the Czech Republic -- while resources move away from those regions making little or no progress. This competition of political institutions -- both of the organization type and the rules type -- is a part of what I view as a very healthy process of reinstituting 19th century economic liberalization. The end result of it will be a much freer and much more prosperous world. The ultimate autonomy is not that of nation-states, but that of individuals. The goal of "economic integration" should be to create institutions in which individuals are free to choose.

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