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International Trade, Borders and Market Institutions

Far greater international flows in goods and services are still a long way off from having abolished the importance of borders in international economic relations. One factor explaining such border effects stems from the national character of institutions that guarantee the contracts on which all trade and financial transactions are based. The variety of existing national legal frameworks creates uncertainties, which carry a considerable costs. While economic institutions have shown signs of converging, the risks of fragmentation have also grown, given the evolving nature of trade and the actors present in goods and capital markets. Furthermore, international integration also requires that States be able to coordinate strong action by their public institutions, guaranteeing the integrity of private contracts, even when these are concluded across borders.

It is often stated in public debate that the international economy has henceforth been wholly "globalised" or at least that it is heading rapidly in this direction. Numerous academic publications also support this hypothesis. While certain qualifiers are usually added, the future is ultimately seen to hold out the prospects of a sort of single global market. Taken to its extreme, this simplified argument suggests that only conservative governments and protectionist pressure groups would fight rear-guard actions to block the ever-greater integration of national economies.

A previous issue of the *Lettre du CEPII* presented recent research showing the extent to which this hypothesis remains premature. If border-effects are becoming less important, they nevertheless remain significant, even within economic areas that are *a priori* highly integrated, such as the United States and Canada, or the Single European Market[1]. In every case, *ceteris paribus*, trade is greater within each institutional area than between two areas, separated by a border.

Border-Effects and the Institutional Guarantees of Contracts

Four factors are put forward to explain the fact that geographic zones remain economically fragmented, despite the liberalisation and technological progress of the last two decades: the remaining tariff or non-tariff barriers to trade, exchange rate volatility, consumer preferences and lastly the impact of migration and social networks. A complementary explanation is put forward here to explain border effects. It is not linked strictly to trade flows, but concerns the institutional and contractual framework on which they are based.

All trade or financial commerce is indeed exposed to contractual risks of varying importance (slow payment, defaults or insolvency). To protect themselves form such risks and to ensure that contracts are upheld and so to defend "market discipline", agents classically resort to a number of instruments: private pressure, the police, informal networks of traders or private bankers, vertical integration, constraints on future market access etc. That said, in developed market economies, private contracts and especially creditor rights always rely ultimately on the State and legal institutions.

A self-employed plumber will thus accept to carry out maintenance work for a large multinational, without facing excessive risks of non-payment and despite being in an unfavourable power relationship with the firm. One reason is that the latter faces reputation constraints, but above all because the plumber can resort to credible commercial law. The same holds true for the credit activities of banks: should payments be overdue or customers default, the bank can ask the authorities to seize mortgage collateral or to enter into bankruptcy proceedings which may authorise the seizure and liquidation of assets.

1. T. Mayer, "National Borders Matter... But Less and Less", *La Lettre du CEPII*, December 2000 (available in English at <www.cepii.fr>). See also K. Head, T. Mayer (2000), "Non-Europe: The Magnitude and Causes of Market Fragmentation in Europe", *Weltwirtschafts Archiv*, 1362 (2), pp285-314.

But the main point to be argued here is that the institutions which guarantee the integrity of contracts and allow for risks to be controlled are mainly defined on a national basis. Furthermore, they show little sign of harmonisation at an international level. On the contrary, such institutions stand out as a durable factor fragmenting the economic space. Apart from the simple, qualitative fragmentation which exists across well-regulated countries, as in Europe for example, emerging countries tend to have intrinsically lower-quality legal systems. From this point of view, bankruptcy law, which functions as the ultimate guarantor of creditor rights, plays a particularly significant role[2].

The Case of Bankruptcy Law

In principle, bankruptcy law should first and foremost discipline company managers and shareholders in order to prevent them from taking excessive risks. In this way it contributes to "good governance", as well as to relatively stable investment and financing behaviour. Next, bankruptcy also provides a way for withdrawing insolvent companies from the market when they fail individually or collectively, and for redistributing their real assets to viable companies and their capital losses to the rights-holders of the failed firms. Such a procedure thus protects the rights of creditors, both *ex ante* and *ex post*. So what about those countries struck by the financial crisis of 1997-1998? On the eve of the crisis, Indonesia lacked an operational bankruptcy law. In Thailand, bankruptcy procedures were known to take ten years to settle a case, while in Korea the application of bankruptcy law to a medium-sized industrial group was the first cause to provoke capital flight, given the surprise it caused to investors. In Russia, the use of bankruptcy procedures has developed somewhat in recent years, but it appears that the law has mainly been used to liquidate competing companies and so capture their most profitable assets[3].

In other words, an investor acquiring private Thai bonds, lending to an Indonesia family firm or buying Russian shares will receive assets whose legal definition is highly uncertain if the means available to enforce the validity of such assets are taken into account. In case of litigation or payment problems, the investor will face local commercial law that he/she knows little; legal bankruptcy procedures that may then be very trying, with an end result which may often by unpredictable. It is not sure that such costs were taken into account when investors entered the Asian or Russian markets massively, between 1995 and 1997, contributing to the speculative bubbles at the time. Ignorance or an underestimation of border-effects linked to the patchy reliability of private contracts thus contributed to important microeconomic distortions, and then crises and massive private losses.

It may be thought that such problems could be overcome by quickly voting laws and training commercial judges. But even if this were possible, a second issue would remain outstanding, namely the intrinsic differentiation of national bankruptcy laws, along with the variations in the way they are applied. There are in fact no trends to convergence in these areas, nor even towards some hypothetical, supranational law.

In the case of the European Union, the Single Market should in principle favour the emergence of a single legal procedure, given the rapid development of private transactions between different countries. This could be based either on the laws of the country of origin, or on Community law which would replace entirely national laws. In a word, bankruptcy proceedings should not fall under the principle of subsidiarity[4]. If there were no coordination at all, creditors of a defaulting company which happen to be in countries where assets of the defaulter are numerous and debts limited would be in a far better position than creditors in the opposite situation. Bankruptcy proceedings would remain strongly segmented along national lines, and border-effects would indeed be important in this respect.

Yet, all attempts to harmonise bankruptcy rules in Europe have failed, the first occurring in 1964. Neither pressure by private actors, nor the logic of the Single Market, nor the propositions of the Commission have been able to make any headway on this point: contract law and the law on private property remain very strongly attached[5] to national, legal arrangements. This of course does not mean that the bankruptcy of multinational European companies leads to intractable situations. A certain number of basic principles have been adopted which provide for a minimal degree of coordination of national procedures[6]. Lawyers too, manage to obtain reasonable results after a certain time.

However, the point which needs to be made is that even in Europe, where the aim of institutional convergence has received strong political support, bankruptcy and the capitalistic definition of the firm remain deeply rooted in

2. This point is developed in greater detail in *L'économie de panique, faire face aux crises financières*, J. Sgard, Paris, La Découverte, September 2002.
3. On Asia, see M. Stone (1998), "Corporate Debt Restructuring in East Asia: Some Lessons from International Experience", IMF, Paper on Policy Analysis and Assessment, PPAA/98/13. On Russia, see Y. Zlotowski (2002), "La faillite en Russie: les risques d'une tradition formelle", in S. Brana, M. Mesnard, Y. Zlotowski, *La transition monétaire russe*, Paris, Harmattan, pp 283-304. For a more general discussion on the logic of bankruptcy see O. Hart (1999), "Different Approaches to Bankruptcy", Harvard, miméo, November.
4. It may be noted for example, that the American constitution attributed responsibility for bankruptcy proceedings to the Federal Government, as of 1787.
5. The project of creating a European public limited company set out in the Single Act in 1986 did lead to a directive in 2000, though it seems unlikely that it will become a reference for Europe's major companies. The main difficulty from this point of view arises from the problems associated with the status accorded to company employees. As a result, companies must be incorporated in all the countries in which they do business, which implies creating as many legal entities, sets of accounts etc. Another example concerns the directive on public procurement, which was rejected by the European Parliament in 2001.
6. This follows mainly from the Brussels Convention of 1995, which is taking a long time to ratify, and from the Council decision in 2000.

national cultures. This constitutes a factor which strongly fragments the European economic space institutionally and is a cause of relative contractual uncertainty, leading to potential costs, including: numerous parallel bankruptcy procedures, higher management costs, longer total settlement times, greater uncertainty over the final outcome.

An International Economy Increasingly Vulnerable to Local Institutions

It may now be asked whether this is actually a problem, which, though tangible, is not new and should in any case be resolved progressively. Indeed, eventual convergence cannot be excluded, at least as far as the developed countries are concerned. However, the process of "globalisation", at work since the early 1990s, also makes international trade far more vulnerable to the effects of international fragmentation than was the case twenty years ago.

At the risk of some simplification, it may be stated that the internationalisation process which occurred between 1950 and 1980 was essentially based on two types of flows: the trade in tangible goods (raw materials, capital equipment etc.) and financial flows, largely directed towards sovereign debtors. Both types of flows had the advantage of requiring only a limited institutional base, which did not expose the contracting parties to significant risks. For goods trade, it was merely necessary to fix prices and delivery schedules. The same was true for sovereign State debt in the case of default: settlement could indeed take a long time, as in the 1980s, but the procedure was relatively simple and robust. Representatives of creditor banks and public creditors were able to negotiate directly with the indebted countries, within a framework that was entirely defined by multilateral rules, and which was operated by the IMF. And since Nation States also had a tangible stake in negotiating and overcoming crises in order to obtain renewed access to markets, such methods ultimately achieved their objectives.

Today, such interests are still present, but in practice everything has become far more complicated. From a financial stand-point, massive capital flows have been invested in emerging countries, but these are now held in a large variety of assets, whose legal quality is very uncertain. For instance, disintermediated instruments, which currently play a key role in capital flows, raise well-known difficulties when they have to be renegotiated[7]. To this should be added the qualitative diversification of both investors (banks, investment funds, hedge funds, insurance companies etc.) and that of asset issuers. Apart from sovereign States, they now include numerous private operators, financial or industrial, from very different countries. They issue various types of stocks (shares, bonds, commercial paper etc.), denominated in hard or local currencies, which are covered by a great variety of legal arrangements and jurisdictions.

This summarises one of the key problems arising from the search of a "new financial architecture": How are payment crises to be resolved which *a priori* are fragmented between sovereign and private debt issuers, between bank and bond lending, and lastly between assets covered by local or American (sometimes British) law? Before 1990, the law and the legal institutions of borrowing countries had practically no effect on the conditions of capital market access. Now, such capital flows have become far more vulnerable to the guarantees provided locally to private investors. The latter can no longer ignore such risks, apart from by limiting strongly *a priori* the range of financial assets they are willing to acquire[8]. In other words, the qualitative diversification of contracts traded internationally leads to a rise in border-effects.

It is remarkable that a symmetric trend may also be observed concerning real flows. Compared to the simple and robust international markets which emerged after World War II, two markets have now emerged (at least on the "edge of globalisation"), that are far more vulnerable to property and contract failures. The first concerns foreign direct investment, which is still not guaranteed by a wide-ranging international agreement[9]. The second relates to inter-temporal contracts: whereas trade in a barrel of oil or a machine-tool transfers property immediately, new forms of trade only confer rights of usage for a given period of time, without ownership being relinquished. This occurs most frequently concerning intellectual property rights (be it for computer programmes, pharmaceutical molecules, trade-marks or industrial patents). In theory, the advantages of trade are the same as in the case of ordinary goods. But in practice, they may be completely appropriated by the user, if the inventor is unable to protect his/her property rights. To do this, the inventor must rely on Chinese, Russian or Argentine law and on local legal institutions. If a conflict of interests arises, the situation is similar to that of a foreign investor facing a private default on payments, insolvency or the opportunistic exploitation of local institutional weaknesses.

Globalisation and the Rule of Law

While over the long run there has been some institutional convergence (as, for example, in Eastern Europe), the

7. For further information about a bankruptcy law for sovereign States, see A.O. Krueger, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring", National Economists' Club, Washington, 26 November. See also, J. Sgard, "The Ecuadorian Crisis and the International Financial Architecture", *La Lettre du CEPII*, No 188, March, available at <www.cepii.fr>.
8. Calpers, the largest America pension fund, announced in February 2000 that it would in future limit its investments in emerging countries to 13 countries, selected according to the legal protection they provide investors with.
9. See L. Fontagné, "En attendant l'AMI : un bilan des relations entre IDE et commerce", *La Lettre du CEPII*, No 168, May 1998.

evolution of international contracting has greatly increased the vulnerability of markets to fragmentation and to the failure of national institutions to guarantee their integrity.

Indeed, these issues lie at the heart of problems raised by the membership of numerous developing countries of the WTO, especially China at present and Russia in the future. The rule on which their integration is based is in fact comparable to the principle of mutual recognition of norms on which the Single European Market is based: beyond a normative minimum, countries are trusted and expected to apply national laws equally to national and foreign agents. The WTO, by the same token, has not tried to create a single international patent for pharmaceutical molecules, upheld by a supranational body. Instead, it has asked all member states to adopt a law establishing such rights, with the WTO only intervening to settle disputes when national laws are badly applied. This approach, however, is ultimately based on trust. If, once the extended deadlines for applying such laws have run out, China allows illegal copies of molecules to be made and distributed, or if Poland is unable to apply EU norms relating to consumer safety, then the trust on which markets are based will be weakened[10]. In the worst case, this could lead to full-blown a crisis of confidence, seriously undermining the principle of integration. This would parallel the systemic crisis of the inter-bank market, which occurred with the rise in uncontrollable counterpart risks.

The problems raised by the exchange in intellectual property rights and private financial contracts suggest that their stability and their advantages, especially to emerging countries, require the development of reliable legal and judicial institutions, which are able to engage in international procedures of coordination. Globablisation is thus not about "rolling back the State", as has been so often claimed, but is based instead on reinforcing and sometimes extending the rule of law. The impact on border-effects may thus vary. The integration into international markets of countries with inadequate institutional infrastructures and the under-estimation of underlying border-effects could rapidly lead to failure, or even ultimately to crisis. In contrast, if qualitative discontinuity can be controlled, as for the Single Market, border-effects could be managed and limited, thanks to formal agreements among States.

International integration is thus not based solely on markets that are progressively freed from national constraints, all within an ever-more unified economic space. It also requires States to be able to coordinate the actions of their public institutions which need to be solid, and which guarantee private contracts, even when these are made across borders. Progress has been considerable in many areas, as witnessed by Europe since 1985. But in other areas, such as bankruptcy laws, coordination between institutions remains imperfect and border-effects remain significant.

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10. Sgard, "Eastward Enlargement of the European Union: Can Failure be Avoided?", *La Lettre du CEPII*, No 192, July-August 2000, available at <www.cepii.fr>.

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