PART IV

Interactions of Actors: Economic Relations

CHAPTER 10

Interdependence Among Rich States: International Political Economy in the North

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Summary

Key Terms

international political economy Area of study focusing on the relationships between international political and economic relationships.

Having examined the security relationships between states, we now begin to look at economic interactions in global politics. The study of the **international political economy** concerns the relationships between political units and political relationships, on the one hand, and economics and economic relationships, on the other. This relationship between politics and economics is important for understanding global politics.

Economics, simply put, deals with the exchange of goods and services. An economic market is composed of producers and consumers of these goods and services. Economists tell us that a market functions on the supply of goods and services produced by the sellers and the demand for goods and services consumed by the buyers. Without any restrictions on this exchange, the price of a good or service on an economic market will be determined by the relative supply and demand. But there are restrictions on the exchange of goods and services in the international economic system (just as there are in all domestic economic systems). In other words, there is no such thing as a "free" economic market. The restrictions come from politics—from values and goals of states. States may impose restrictions on economic exchange for the sake of security or for moral considerations, for example. This tension between economic forces of production and consumption and other political forces is the center of the international political economy. Economics cannot be divorced from politics (even the choice to pursue a "freer" market is a political choice), but the exact nature of what the relationship between economics and politics should be is a source of disagreement among major economic philosophies, as we will see in the discussion of economic liberalism, mercantilism, and Marxism in this and the next two chapters.

Just as economics cannot be divorced from politics, politics is fundamentally shaped by economics. Politicians around the world are continually concerned about the economic impact that their policy decisions will have on their own citizens. Failing to manage such politically and socially volatile issues as unemployment and inflation, for example, can leave a political system weak and vulnerable and may result in the removal of leaders from office. Indeed, a large part of what government officials do is attempt to provide economic resources—like jobs, tax cuts, and government subsidies—to their constituents or supporters. This is true in democracies and nondemocracies alike: All types of governments rely to some extent on the support of key groups within society, such as workers and businesses. Moreover, economic interdependence has increasingly connected the fortunes of citizens around the world, and a decision by one state to alter its trading practices, devalue its currency, or increase its minimum wage, for example, can have dramatic consequences on the economies of other states. Today, trade accounts for high percentages of the gross domestic product (GDP) of industrialized states (see Table 10.1). One of the fastest-growing areas of trade is in the service sector, which

TABLE 10.1

An Indicator of Interdependence: Trade as a Percentage of Gross Domestic Product, 2003

Country	Trade as % of GDP
Germany	67%
China	57%
United Kingdom	54%
France	50%
United States	24%
Japan	22%
Average for high-income states	45%

Source: World Bank, *World Development Indicators Database,* June 2006.

covers such areas as retail, entertainment, and banking. From 1980 to 1995, services trade more than doubled, to over $1.3 trillion annually.[1] Because of this interdependence, as we have seen time and again, an economic downturn in one part of the world results in hard political choices elsewhere as jobs are lost, investment dollars dry up, and the economic landscape becomes filled with uncertainty. Just as there can be no markets free of politics, politics cannot free itself from economics.

developed countries Wealthier, more industrialized countries.

developing countries Poorer, less industrialized countries.

This chapter analyzes relationships among the wealthier, more industrialized, or **developed countries,** sometimes referred to as the North, since most are located in the Northern Hemisphere (although countries such as Australia are included in this category). Chapter 11 focuses on the economic relationships between the industrialized states and the poorer, **developing countries,** mostly in the Southern Hemisphere and therefore often referred to as the South (although again, states such as Vietnam are an exception). Chapter 12 looks at efforts at regional free trade and economic integration, particularly the European Union.

Until the 1970s, most people considered the topics discussed in this chapter to be too technical and apolitical to be of much interest to students of international political relations. The rules by which the rich industrialized states conducted international commerce with each other were devised in the four or five years after the Second World War, and several factors worked to make those rules uncontroversial, as well as apparently uninteresting. One of these factors was a steady, positive rate of economic growth in almost all the industrialized countries. Another important factor was the unquestioned U.S. domination of the world's economic transactions. As long as these factors persisted and the United States supported the structure of the economic system in the non-Communist world, economic relationships among rich countries seemed rather divorced from politics, which centered on meeting the Communist threat. But when the system ran into serious problems and American economic preeminence began to fade, those technical problems suddenly seemed

very political. They had always been political, of course; what had been missing was overt political conflict over economic arrangements in the non-Communist world. This chapter examines the structure of economic relationships among the rich industrialized countries of the world and the process by which those relationships have become an increasingly prominent political issue.

The Era of U.S. Economic Predominance and the Liberal International Economic Order

The contemporary international economic system has its roots in the economic problems of the 1930s (see Chapter 2) and how the leading states after World War II attempted to build institutions and international norms to prevent a recurrence of a global economic depression. The architects of the post–World War II economic system were not solely interested in making economics work better, and thus making more profit from economic exchanges. They also believed that economic prosperity and certain types of relationships between states and other economic actors were the key to security. Many blamed the economic troubles of the 1920s and 1930s for the war. Recall from Chapter 6 that one explanation for World War II points to the poor economic conditions in Germany, which played a key role in Hitler's rise to power. This explanation also blames the protectionist policies that states adopted to try to isolate themselves from the effects of the worldwide depression. These policies did not always achieve prosperity for states, and they served to disconnect states from each other, making the choice for war a less costly one. This, of course, is liberalism's explanation of World War II, and thus the plans for the new international economic system rested on the liberal philosophy about the relationship between economics and politics. The architects of the new system attempted to build a **Liberal International Economic Order.**

Liberal International Economic Order Post–World War II attempt to construct international economic relations based on economic liberalism.

Economic Liberalism Versus Mercantilism

As we saw in Chapter 1, liberalism is a perspective on global politics that focuses on interdependence, nonstate actors, and incentives for cooperation among states. It includes, but is not limited to, a recognition that economic actors such as multinational corporations have become more important in world politics and that economic interests of states and nonstate actors can constrain states, pushing them away from war and toward cooperation.

Liberalism is a general perspective and is related to a narrower philosophy of **economic liberalism.** Economic liberalism is narrower in the sense that it focuses on only economics and the relationships among individuals, firms, markets, and governments in the economic sphere.

economic liberalism Economic philosophy advocating free trade to increase efficiency and wealth.

The two terms, however, share the word *liberalism* and thus share a focus on individuals, self-interests, and rights. Liberalism recognizes that individuals following their interests will diverge from the interests of the state and thus constrain states. In an open economic system and in an open, democratic political system, individuals have the most freedom to pursue their interests and constrain the state. This is why liberalism expects democracies to be more peaceful than nondemocracies. Liberalism is founded on ideas of eighteenth- and nineteenth-century liberal philosophers such as Montesquieu, Immanuel Kant, John Stuart Mill, and Jeremy Bentham.

Economic liberalism, the narrower philosophy, also borrows ideas of individual self-interest from liberal philosophers, applying them to the realm of economics. The writings of Adam Smith are particularly important. Smith, considered to be the father of modern economics, wrote in his book *The Wealth of Nations* in 1776 about the importance of free markets and individual economic interests.[2] He argued that the way to greater wealth for all was through complex divisions of labor, determined by individual interests, and that production and efficiency were best achieved through market mechanisms, allowing what Smith referred to as the "hidden hand" of the market, rather than the government, to direct economic relations. According to Smith, individuals and business firms pursue their individual interests, and these are coordinated by the market system to produce what is in the society's interest: greater wealth for all. Smith wrote that "every individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of society, which he has in view. But the study of his own advantage naturally, or rather necessarily, leads him to prefer that employment which is most advantageous to society."[3] In this quotation lie two very important assumptions behind economic liberalism: that individuals do in fact act in their self-interest and that this produces a social good.

For economic liberals, it is the free market system that best coordinates economic activity, making it more efficient and producing greater wealth for all. While Smith was primarily applying these ideas to a domestic economy, others have applied economic liberalism to the international economy. The economic liberal view on international economic relationships also stresses the free market, particularly in the form of **free trade,** or exchange across borders unrestricted by penalties, such as tariffs that place a tax on incoming goods, imposed by governments. A free trade system is Smith's ideas of individual interests coordinated by a market system, on a grander scale. Economic liberals such as David Ricardo, an early nineteenth-century economist and politician in England, argued that each country should pursue its self-interests by allowing firms to specialize in what they most efficiently produce and trade freely with one another to distribute goods to consumers, free of

free trade International commerce unrestricted by state-imposed penalties such as tariffs.

government intervention.[4] For Ricardo and other economic liberals, it did not make sense for governments to protect their country's own jobs or profits at the expense of other countries since the market mechanism would distribute the jobs and profits in the most efficient way, regardless of nationality, and in a way that would provide more wealth for all in the long run. Instead, countries should allow firms to specialize in the production of goods that are in their **comparative advantage**—goods that they are relatively more efficient at producing than other countries—and selling those goods abroad. For goods that are not a country's comparative advantage, countries should import these goods from abroad, not wasting capital and labor on their production. In a free trade system, a division of labor along countries' comparative advantage will enhance global efficiency and create greater wealth for all, according to economic liberalism.

comparative advantage Goods that a certain country is relatively more efficient at producing.

Most economic liberals believe that governments should play some role in domestic and international economies. "The role of the state is to perform the limited number of tasks that individuals cannot perform by themselves, such as establishing a basic legal system, assure national defense, and coin money."[5] Basically, the role of government in economics is to provide for **collective goods**—goods such as security, law, and education—to all. Collective goods are indivisible, so that once they are supplied to one member of a group, all members benefit, and recipients cannot be singled out and excluded from receiving the collective good. A government's role in providing for collective goods, according to economic liberals, makes sense because it would be inefficient for firms to provide for them themselves. Imagine if McDonald's or IBM had to educate its own work force, build and maintain its own roadway, and provide for its own defense from external threats! It is more efficient for businesses to pay taxes and allow the government to coordinate efforts to provide for collective goods. Overall, however, economic liberalism sees a relatively narrow role for governments. Most important, economic liberals put economics first, above politics, and see the two as separate spheres of activity.

collective goods Goods that, once provided, are available to all group members, regardless of their individual contributions.

David Ricardo and other economic liberals of the nineteenth century were reacting to another prominent philosophy of economic exchange and the relationship between economics and politics. **Mercantilism** is the philosophy that economics and politics are related, that politics should come first, and that economic activity should serve the interests of the state. Mercantilism has its roots in the fifteenth through eighteenth centuries, when states were established and the great powers began engaging in international economic relations. The rulers of the time viewed economic relations with other states as a way of amassing wealth for their own state in order to maximize power. Wealth was a tool of influence rather than an end in itself; it was used to purchase guns, territories, and mercenaries. What is important about economics, according to mercantilism, is that

mercantilism Economic philosophy that asserts the primacy of the state and protection of the state's economic power.

it serves the interest of the state in the competition for more power and influence. As long as international economic transactions benefit the state, such as when the state is selling more to others than it is buying, then all is well. When economic relations threaten the power and autonomy of a state, such as when a state is buying more than it is selling or when it becomes dependent on others for something it needs, then all is not well.

Thus, for mercantilists, economic relations with other states need to maximize profit as a means toward more power relative to other states and minimize economic loss and dependence. It is the role of the state to structure its foreign economic relations to this end. States should, for example, grant **subsidies** to their own industries so that they better compete with the industries of others. States should also protect their own industries with restrictions on imports such as **tariffs,** which are taxes on imports that make them more expensive and thus less attractive to consumers, so that profits stay at home and the country does not grow too dependent on foreign sources. There are a variety of methods of **protectionist policies** in addition to subsidies and tariffs. States can, for example, impose **import quotas** on goods (limiting the number of goods that can be imported into a country), place health and safety regulations on imported goods (making it difficult for imported goods to meet these standards), and engage in **dumping** (selling goods abroad for less than they are sold at home).

subsidies Financial aid from governments to domestic industries.

tariffs Import tax on foreign products.

protectionist policies Policies directed to protect domestic economy from foreign competition.

import quotas Limits on the number of goods that can be imported into the country.

dumping Selling products abroad at below-cost prices.

balance of trade Value of a state's exports minus its imports.

The bottom line for mercantilism is a positive **balance of trade:** more exports to other countries and fewer imports from other countries. This is important not for reasons of simple profit but for what profit buys: political power. The focus on power and state autonomy links mercantilism, an economic philosophy, with realism, a more general perspective on global politics (as described in Chapter 1). Economic liberals disagree with the protectionist policies of mercantilism and argue that politics should not drive or limit economics. The fundamental difference between mercantilism and economic liberalism is that the former sees competition with other states as the *raison d'être* of states, while the latter sees cooperation with other states as the key to economic prosperity for all. For economic liberals, it does not matter that one state may be benefiting more economically, with, for example, a positive balance of trade, than another state. What is important is that they are both benefiting more from a division of labor and free market system than if restrictions are imposed on economic activity. Put another way, mercantilism focuses on the relative gains of states (how states are faring in relation to each other) in a zero-sum competition, and economic liberalism focuses on the absolute gains of states (how states are faring generally, regardless of the gains for other states) in non-zero-sum relationships.

Map: Exports, Atlas page 24

Map: Imports, Atlas page 25

Mercantilists and economic liberals also disagree about the value of multinational corporations (MNCs). As discussed in Chapter 4, the

number and importance of MNCs in the global economy accelerated in the second half of the twentieth century. Economic liberals see foreign direct investment (FDI) by MNCs as positive in that it facilitates free trade based on comparative advantage; MNCs can be the architects of a worldwide division of labor that is efficient, without political interference by states. Mercantilists, on the other hand, are suspicious of MNCs because they fear that they put profits over state interests and because they take away from the national economy by relocating jobs to other countries. Similarly, American labor unions are particularly concerned about the contribution of MNCs to U.S. unemployment. As many critics of the North American Free Trade Agreement (NAFTA) (discussed in Chapter 12) point out, MNCs repeatedly shut down factories in the United States and set up new ones in **export platforms,** where labor is cheaper—for example, in Mexico. According to labor union leaders in many industrialized countries, domestic jobs are lost directly to the laborers in the export platforms, and even more jobs are then lost indirectly because the foreign subsidiaries monopolize export markets that otherwise could be served by national factories with domestic workers. In this view, by exporting jobs, investing money overseas, and having subsidiaries overseas that make it impossible for products made in the home country to be exported, MNCs exacerbate balance-of-trade and balance-of-payments problems for industrialized countries. In addition, goods made by domestic companies are made by overseas subsidiaries, and these products must be imported into the home country, adding further to its balance-of-trade and balance-of-payments deficits.

export platforms Countries that use incentives to attract foreign direct investment and production by MNCs.

It can also be argued that MNCs are exacerbating the unequal distribution of wealth in industrialized societies such as the United States by moving a variety of productive jobs out of the country, leaving nothing but highly specialized occupations for which only their wealthy and highly educated citizens can qualify. A study of nine industries in the United States reveals that "multinationals create . . . jobs but that many of the jobs created [are] in the white-collar and managerial areas whereas the jobs lost [come] from the blue-collar ranks."[6]

MNCs and their defenders, including economic liberals, do not take these criticisms lying down, and in some cases their counterarguments are convincing. The contribution of foreign investment activity by MNCs to unemployment is direct and visible, but foreign investment also makes substantial, less direct, and less visible contributions to the number of jobs in industrialized countries. The wages MNCs pay to workers overseas, for example, create increased demands for domestic-made products in the countries where they operate. And these subsidiaries need parts and capital equipment from the home country, adding again to the number of jobs in the domestic economy. The fact that DVD players can be made more cheaply in China than in the United States saves American consumers thousands (or millions) of dollars a year, and since those machines are available to them at these lower prices, they can spend the money

they saved on additional American products. It is also important not to overlook the fact that imports create jobs. When the United States imports automobiles from Japan, for example, *people* must transport them to dealerships, advertise them, sell them, and service them, and most of these people are Americans.

Defenders of MNCs argue that if they were somehow prohibited from setting up subsidiaries in export platforms, it would not mean more jobs for workers at home. MNCs from other countries would simply use such platforms to full advantage instead. Production facilities in the home states would not be economically viable, because they could not compete with those foreign MNC subsidiaries in places with lower costs. Of course, the governments could forbid home-based corporations from investing overseas (or tax such activity so heavily that it would not be feasible) *and* prevent the import of products made by foreign MNCs taking advantage of conditions elsewhere. But this, economic liberals argue, would be the beginning of an escalatory process involving tariffs and countertariffs, quotas and counterquotas, that would be disastrous for the entire world.

The extent to which MNCs are inclined to export jobs to states with lower wages may also be somewhat exaggerated in the minds of their critics. Low wages are obviously only one consideration these corporations take into account when they decide where to set up a subsidiary, and the available evidence suggests that it is far from the most important consideration. Developing countries have attracted an increasing share of FDI today, but it is still true that most FDI comes from and is received by developed countries.[7] Indeed, the United States has become the largest recipient of FDI in the world.[8] Most of this investment comes from Great Britain, Japan, the Netherlands, Canada, Germany, and Switzerland; that is, like most FDI, it originates in a rich industrialized country and is transferred to another rich industrialized country. For economic liberals, this transfer of wealth across borders is important for an efficient and prosperous global economy.

The Bretton Woods System

After World War II, most of the leaders of the major states, as well as their economic advisers, embraced the philosophy of economic liberalism as the basis for a postwar international economic system—the Liberal International Economic Order. Mercantilist policies that states adopted in the 1920s and 1930s were blamed for the economic devastation and for World War I. In particular, the protectionist trade policies adopted by states that limited imports (such as the Smoot-Hawley Act, which raised U.S. tariff rates) were blamed for spreading and deepening the economic depression around the world. States' monetary policies were a concern as well. **Monetary policies** have to do with states' decisions on printing and circulating their currency and other financial decisions that affect the

monetary policies State decisions on printing, circulating, and otherwise affecting the value of their currency.

flow and value of money. One tool that states have to increase the cost of imports to their country and decrease the costs of exports from their country is devaluing their currency—making their currencies worth less in relation to other currencies. If Britain, for example, whose base unit of currency is the British pound sterling, devalues its currency by printing more pound notes, then British goods are cheaper in other countries and foreign goods are more expensive in Britain. The effect is that foreigners will buy more British goods and Britons will buy fewer foreign goods, thus influencing the balance of trade in a positive direction, which is exactly what mercantilists want. The problem, according to economic liberals, is that the value of the currency and goods then becomes artificial and does not reflect market mechanisms. The other problem is that when the values of currencies change so rapidly, as they did in the 1930s, business is inefficient. Businesses simply cannot plan if they cannot predict how much goods will cost them and how much profit they will make when **exchange rates** (the values of currencies in relation to each other) are unstable. Thus, the architects of the Liberal International Economic Order were primarily focused on establishing a system of free trade and providing a stable monetary system.

exchange rates
Values of currencies in relation to each other.

One dilemma that economic liberalism has when applied to the international system concerns the anarchical nature of global politics. As discussed, while economic liberals prefer a minimal role for the government in economics, the government does provide a very useful function of coordinating and supplying collective goods, such as a legal system, and ensuring a sound banking system in a domestic economy. In the international system, there is no overarching government that can provide for collective goods that enhance the efficiency and safety of economic exchanges.

Economic liberalism, however, does suggest solutions to this dilemma. First, collective goods, like the rules for a free trade system, can be provided by an overwhelmingly powerful state, or hegemon, that can act like an overarching government, absorbing the costs of providing a collective good and enforcing the rules of the system. (The stable effects of a hegemon were discussed in the security realm in Chapter 6.) In the economic realm, "the liberal theory of hegemonic stability asserts that when a hegemon arises, the world economy tends to grow and prosper, as the benefits of free trade, peace and security, sound money, and so forth, stimulate markets everywhere. When the hegemon fails . . . these public goods disappear and the world economy stagnates or declines."[9] Even if a hegemon's power declines, however, a collective good can be maintained if it has been institutionalized in international organizations. These institutions serve to coordinate states and their individual contributions to collective goods. They can also serve as arbitrators and enforcers of the rules of the economic system. Recall from Chapter 9 that international norms about what is desirable behavior, such as the practice of free trade, can themselves shape state choices, particularly if they are supported by

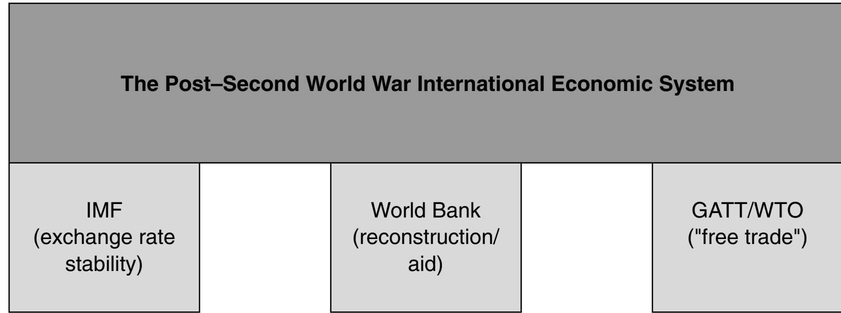


Figure 10.1 The Bretton Woods System
Founded in 1944, the Bretton Woods system strove to manage the international money system, rebuild war-torn countries, and regulate international trade.

international organizations that reinforce norms. Fortunately, for the adherents to the economic liberal philosophy after World War II, there was a single state with a preponderance of economic muscle, the United States, that was in a position to serve as the hegemon and put its strength behind the construction of international institutions in the Liberal International Economic Order.

Bretton Woods system Set of post–World War II agreements and organizations for managing the international economy.

In the five years after the Second World War, the United States led the way in an international effort to create what became known as the **Bretton Woods system.** The name comes from a meeting that was held at Bretton Woods, New Hampshire, in 1944 and attended by forty-four countries, all of them anxious to devise some economic rules and regulations that would help the world avoid the kinds of international economic catastrophes of the 1930s that had seemed to play such a key role in the process culminating in the Second World War. At that meeting in Bretton Woods and at a meeting in Geneva, Switzerland, three years later, the rules of the international economic game in the non-Communist world were hammered out. Those rules, and the system, rested on three main pillars, as shown in Figure 10.1.

The International Monetary Fund

International Monetary Fund (IMF) Organization for promoting international monetary stability and cooperation.

The first of the three pillars of the Bretton Woods system concerned international monetary management, and the organization created to help states cope with problems in this area was the **International Monetary Fund (IMF).** By 1947, the United States and the IMF had set up an exchange rate system based on the U.S. dollar, backed by gold in order to provide a stable monetary environment for economic relations. The United States thus played a hegemonic role in international monetary relations, having a strong currency and economic wealth to back it up.[10] The price of gold was set at U.S. $35 per ounce, and that was the standard by which other currencies were to be measured. In other words, the official value of the Japanese yen, for example, would be stated in terms of its relationship

to a dollar or 1 ounce of gold. The countries that joined the IMF system agreed to keep their exchange rates (the value of their currencies) in relation to dollars and gold fixed within a narrow range. The IMF monitored those exchange rates and stood ready to help any country whose currency threatened to fall lower in real value than its official exchange rate indicated.

Such a threat might originate, for example, from a consistently uneven balance of trade. Let us imagine that Italy went through a period of years when it imported much more from the United States than it exported to the United States. At the end of every year, Italy, in effect, had to settle accounts with the United States to make up the difference in the value of what it imported and exported. According to the rules of the system set up by the IMF and the United States after the Second World War, Italy had to pay up in either U.S. dollars or gold, the two being interchangeable (until 1971), because the United States had promised to support its dollars with gold. If, in order to do this, the Italian government almost entirely depleted its supply of dollars or gold (its so-called reserve currencies), international confidence in the Italian lira (Italy's currency) would have deteriorated. The official value of a lira (plural *lire*) would not have been the same as its real value. The real value (determined by what people would give up in exchange for lire) would have been lower than the official value, and everybody involved in economic transactions based on lire would have started to demand more of them in exchange for U.S. dollars (or anything else of value) than the official exchange rate stipulated. It is crises such as these that the IMF was designed to meet.

In this scenario, to prevent the real value of the lira from falling significantly lower than the official value, the Italian government would have had to support it. That means the government would have had to buy lire at the official price. As long as the Italian government was willing and able to buy lire at the official price, the real value and the official value would have stayed reasonably close. Everybody involved in transactions based on the lira would have realized that the real value and the official value were essentially identical because the Italian government, at least, would pay the official price for its own currency. Therefore, everybody would have paid the official price for lire, secure in the knowledge that they could sell those lire to the Italian government at that price. In time, having built up confidence in the value of the lira, the government would not have to buy such great quantities. The crisis would have been over. Until the crisis passed, the Italian government would have had to obtain dollars or gold with which it could buy lire. As a member of the IMF, Italy can borrow dollars or gold from the fund to support its currency, thus keeping the official value and the real value in line and adhering to a fixed exchange rate.

From 1947 to 1971, this type of arrangement helped the rich industrialized countries to avoid most serious monetary crises, like those of

fixed exchange rates Values of currencies "pegged" to either another currency or to certain commodities, such as gold.

the 1930s, and to keep the different national currencies at **fixed exchange rates.** From the viewpoint of economic liberalism, this stability was significant for confidence in the monetary system and international business. When the values of currencies were threatened, the member states would borrow from the IMF to support them, and the fixed official exchange rates would be maintained. People engaged in international commerce could be confident of the relative value of different currencies, and international trade and commerce were thus simplified and encouraged. The confidence engendered by fixed exchange rates was one factor that contributed to the growth in trade and in the economies of the industrialized countries after the Second World War.

The World Bank

World Bank International organization for economic assistance, first for countries recovering from World War II, then for developing countries.

The second pillar of the post–Second World War economic system was the International Bank for Reconstruction and Development (IBRD), or the **World Bank.** This organization was originally designed (as the "Reconstruction" in its name suggests) to provide capital for rebuilding countries devastated by the war. It was also supposed to aid economic development for poorer countries in the South, and at Bretton Woods these states tried to ensure that developmental aid for them would have at least as high a priority as economic assistance to those countries devastated by the war. Those efforts were unsuccessful. The United States felt that postwar reconstruction deserved a higher priority and that economic development should be spurred primarily by domestic efforts. Outside assistance might be necessary, but the capital should come from private rather than government sources. In theory, the documents on which the World Bank was founded gave equal weight to reconstruction and development. But those documents also urged a special regard for the problems of those countries devastated by World War II; "the developed countries that dominated the World Bank unanimously agreed that European postwar reconstruction would be the first priority for the Bank."[11]

The emphasis in World Bank activities began to change as early as the 1950s. By that time, the countries devastated by the Second World War had been reconstructed. Then an increasing number of former colonies achieved independence, entered the United Nations, and began to lobby effectively for economic aid from the developed countries. Also, although under Stalin the Soviets had tended to ignore the poor countries of the world, by 1956 under the leadership of Nikita Khrushchev, the Soviets began to support development efforts and wars of national liberation in the developing world, thus making the South one of the primary theaters of the Cold War. The attitude of the United States and other developed countries about public aid to developing countries changed in response to these developments, and those changes were reflected in the activities of the World Bank. In 1956, the World Bank

created the International Finance Corporation (IFC) to encourage private investment in underdeveloped countries. And in 1960, the United States took the lead in creating the International Development Association (IDA) "as a separate institution closely integrated with the World Bank."[12] The IDA makes loans at low interest rates to developing countries, to be used for development projects. In short, although the World Bank originally was concerned with relationships among the more industrialized countries of the world, over the years it has become primarily an aid-giving institution focusing on developing countries. It has come to serve as a forum for discussion among the richer countries about treatment of less developed countries rather than an organization that is directly involved in relationships among the developed countries.

The General Agreement on Tariffs and Trade

General Agreement on Tariffs and Trade (GATT) Post–World War II multilateral regime for promoting free trade.

The third pillar of the Bretton Woods system was the **General Agreement on Tariffs and Trade (GATT),** with twenty-three original countries as signatories by the time it came into force in 1948. The original plan after the war called for the creation of an institution to be known as the International Trade Organization (ITO), but opposition in the U.S. Congress killed that idea. In the beginning, the GATT was merely a trading agreement among twenty-three nations, meant to be in force only until the ITO came into being. "When the ITO failed to materialize, the GATT was transformed from a temporary agreement into a[n] . . . institutional framework in which governments pursued multilateral regulations and discussed trade policy."[13]

most-favored-nation principle Granting the same low-tariff trade status as enjoyed by a state's most favored trading partner.

The primary function of the GATT was to encourage an increase in international trade and reduce barriers to that trade, whether in the form of tariffs, quotas, or other impediments such as regulations regarding labor standards or environmental protection (see Figure 10.2). One important means of fulfilling its main function was to encourage nations to abide by the **most-favored-nation principle.** This principle involves a commitment not to discriminate. If State A decides to give a break to State B (say, to lower its tariffs on shoes coming from State B), it must, according to the GATT, give the same break to all the other GATT member states from which it imports shoes. In other words, State A is obliged to offer the same favorable terms on shoes to all states that it offers to the most favored nation among its trading partners.[14] The GATT encouraged countries to abide by the most-favored-nation principle in order to remove barriers to trade (especially tariffs). The principles on which the GATT was based come directly from economic liberalism. States should not interfere with the free trade of goods and services determined by states' comparative advantage; they should not favor one state over another for political reasons by granting them preferential trading relations. These are the principles to which states pledged when they joined the GATT.

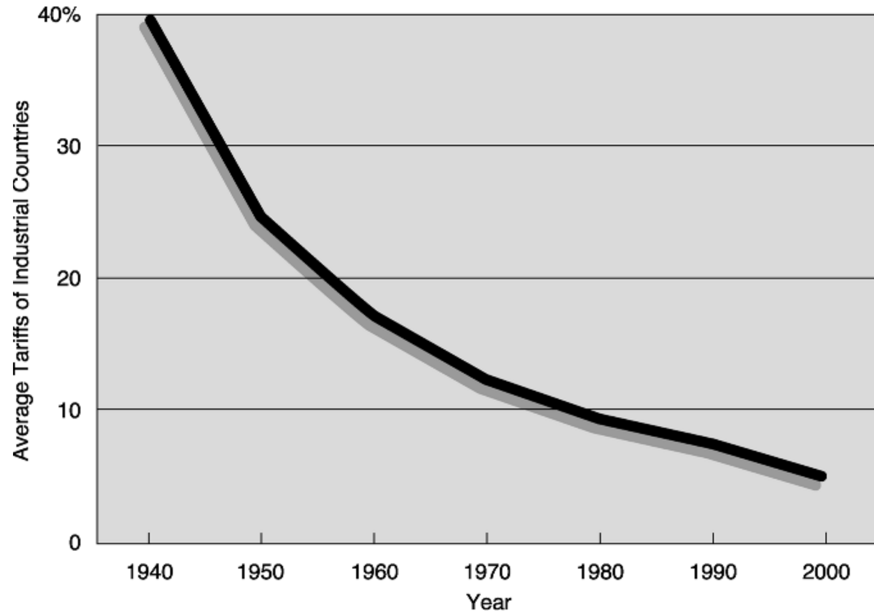


Figure 10.2 Changes in Tariff Rates in the Era of GATT (World Trade Organization)
Source: Data from the Centre for International Economics, office of the U.S. Trade Representative.

In fact, the GATT allowed many exceptions to the most-favored-nation principle and has not come close to creating a system where free trade reigns supreme. Still, until recently at least, it almost certainly helped reduce barriers to international trade and thus encouraged its growth. GATT negotiations occur in what are referred to as "rounds." The Kennedy Round of negotiations, for example, began in 1962 and was concluded in 1967 with agreements to reduce tariffs and expand world trade. The Tokyo Round (1973–1978) focused on lowering nontariff barriers, such as government subsidies and regulations. The Uruguay Round (1986–1993) tackled more difficult and more recently developed issues hindering free trade, such as agricultural subsidies, protection of service industries, and intellectual property rights. The most recent negotiations, the Doha Round, focused on economic development and will be discussed in Chapter 11. With this history of trade negotiations, "there can be little doubt that the GATT has had an important role in the evolution of post-war international trade relations."[15]

Another result of the Uruguay Round of international negotiations was the creation of a permanent organization, similar to the originally proposed International Trade Organization. On January 1, 1995, the GATT, whose membership had reached 122 states at the time, evolved into the World Trade Organization (WTO) (see Chapter 3 for definition). "WTO is more powerful than GATT, incorporating trade in goods, services, and ideas and has more binding authority. . . . Replacing the GATT, which was never more than a provisional set of rules with a small secretariat in Geneva, the World Trade Organization (WTO) will be the umbrella organization

covering the old GATT and all the new agreements reached in the Uruguay Round."[16] The WTO and its role in the current global economy will be discussed in more detail at the end of this chapter.

How the System Worked

In economic terms, this system based on the IMF (supporting a dollar standard), the World Bank, and the GATT (fostering free trade) certainly worked well for the non-Communist industrialized countries. While economic liberalism was the underlying philosophy behind the Bretton Woods system, and the United States acted as the hegemon, and international institutions were established to coordinate collective goods in the absence of an overarching government, purely economically liberal policies were rarely realized in practice. One way that the system was not completely economically liberal was the fixed exchange rate system. In an ideal world, according to economic liberals, the market should determine the value of currencies, and state intervention that fixed these values was a political intrusion into economics. Another way the system deviated from economic liberalism was that free trade was not always the official policy. The United States allowed certain distortions in the system to operate against its own best short-run economic interests and in favor of Western Europe and Japan. For example, one exception to the most-favored-nation principle in the GATT rules allowed nations forming a customs union to discriminate against the outside world. The most important of these was the European Community, or Common Market, now known as the European Union (EU) (see Chapter 12), which was encouraged by the United States even though it adopted tariff barriers against U.S. products and did some harm to U.S. trading interests. Japan was allowed to use a variety of protectionist measures in the 1950s and 1960s even though it became a member of the GATT in 1955. "Free trade was accepted where the United States did not have a comparative advantage and discrimination was tolerated where U.S. products did have an advantage."[17] Also, the United States purposely incurred balance-of-payments deficits in relation to Western Europe and Japan in the 1950s and early 1960s to provide a flow of dollars for the other industrialized countries.

Why was the United States so generous to the Western Europeans and Japanese in the 1950s and 1960s? It is safe to say that more than altruism was involved. Perhaps the most important reason concerned security. The United States felt threatened by the Soviet Union in the first couple of decades after World War II and also believed that economically prostrate (and politically valuable) countries in Western Europe and Japan were vulnerable to Communist subversion. The United States did what it could to foster its allies' rapid economic growth and thereby substantially decrease their vulnerability to such subversion, as well as increase their value as allies against the Soviet threat.

There were long-run economic advantages, too, in the types of policies adopted by the United States in the years immediately following the war. An impoverished Western Europe and Japan would not provide lucrative markets for U.S. exports. But U.S. generosity would create economic leverage for the United States in Western Europe and Japan, which would be advantageous to the United States once the other industrialized countries were back on their economic feet. Economic liberalism claims that the pie will grow larger for all in the long run, but those that have the largest slice (as the United States did with its overwhelmingly bigger economy) will benefit the most. Leading the establishment of a Liberal International Economic Order also enhanced the agenda-setting power (discussed in Chapter 4) of the United States. Agenda-setting power, or structural power, was "the power to shape and determine the structures of the global political economy . . . the power to decide how things will be done, the power to shape frameworks within which states relate to each other."[18] To sum up, after the Second World War, the United States was by far the most important entity within the non-Communist world's economic system, and it had the most urgent need to see that the system worked well. Because it could not work well unless Western Europe and Japan recovered economically from the ravages of war, the United States provided important support for that recovery.

During the Bretton Woods system, trade policies deviated from pure economic liberalism in other ways. The United States, for example, protected some of its older industries such as shoes and textiles, and it subsidized agricultural products. These policies primarily stemmed from domestic political pressures rather than mercantilist principles. Simply put, "domestic groups seek protection or liberalization because such policies increase their incomes."[19] Not all domestic groups or economic sectors resist protection. Some, in fact, benefit from trade liberalization—such as shipping industries and other businesses that are dependent on imports and exports—and with increasing interdependence, more economic domestic groups organized to promote liberal trading policies.[20] With some groups pushing for liberalization and some groups advocating protectionist policies, political institutions are important factors in trade policy as they affect which groups will have greater access to influence leaders. Furthermore, some institutions insulate leaders from societal pressures, and then it is the leaders' beliefs—liberal or mercantilist—that become critical factors in promoting or inhibiting free trade.[21] Politics affects trade policies in other ways as well. Trade sanctions and other restrictions against the Soviet Union, Cuba, and South Africa are examples of economics being used for political ends, which economic liberalism says states should avoid.

Overall, the Bretton Woods system was quite successful. World trade grew at a rapid rate, and by the 1960s, Western Europe and Japan staged remarkable recoveries from the devastation of the Second World War. By this time, the preponderant position of the United States in the

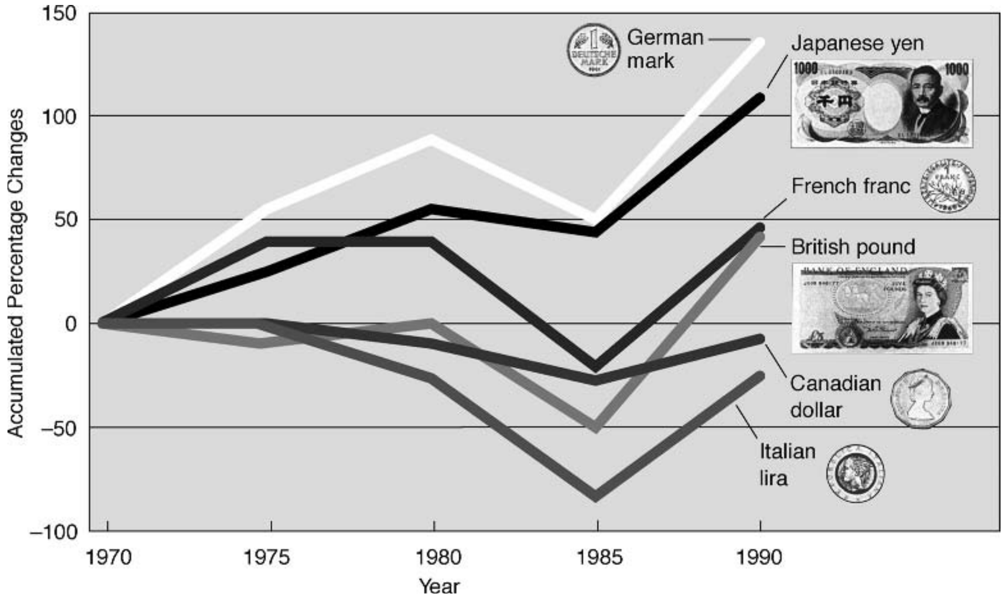
non-Communist industrialized world was modified in important ways. By 1960, the United States had already allowed so many dollars to leave the country that for the first time, the value of dollars overseas became greater than the value of U.S. gold reserves. The flow of dollars out of the country continued throughout the 1960s and accelerated during the Vietnam War. In 1952, the United States held 68 percent of all international monetary reserves; by 1977, that share had fallen to 6 percent. A similar deterioration occurred in the U.S. position in international trade. In 1947, the United States accounted for 32 percent of world exports. In 1974, it accounted for only 11 percent of world exports. In the meantime, the European Community had become the largest trading entity in the world. By 1971, the flow of cash out of the United States was so great, and imports into the United States so far exceeded U.S. exports in value, that a balance-of-payments crisis and a balance-of-trade crisis occurred simultaneously.

Nixon's Surprise

Under the rules of the Bretton Woods system in operation at that time, the United States could not devalue its currency because the U.S. dollar, tied to the price of gold, constituted the standard by which all the other currencies were measured and on which their values were based. Since the dollar served as the anchor of the system, it could not be tampered with. In August 1971, President Nixon decided to change the rules of the system dramatically. He announced that the U.S. dollar would no longer be convertible to gold. Ever since the creation of the Bretton Woods system in the 1940s, the United States had promised to exchange dollars for gold at the rate of $35 an ounce whenever holders of dollars wished to make such an exchange. But by 1968, U.S. holdings of gold were so low that the United States was quite reluctant to give up gold for dollars; thus, it did its best to discourage such transactions. In 1971, President Nixon abandoned even the official promise to back up dollars with gold. He also imposed a 10 percent surcharge on imports into the United States, distancing the United States further from its official policy of economic liberalism. To maintain the gold standard and the collective good of fixed exchange rates, extreme financial responsibility by the United States was necessary, but the economic effects of responsibility would probably have not been acceptable politically at home.[22]

Two fundamental aspects of the Bretton Woods system were thus substantially altered in 1971. First, when the United States pulled the props out from underneath the international monetary standard, which asserted that U.S. $35 equals an ounce of gold, all the currencies of the world were deprived of a fixed standard by which their value could be ascertained. Fixed (and therefore stable) exchange rates

Figure 10.3 Fluctuations in Exchange Rates After Bretton Woods, Six Industrialized Countries, 1970–1990
The values of national currencies in relationship to the U.S. dollar fluctuated substantially after fixed exchange rates were eliminated in 1971.



Source: Data compiled by the author from tables in the *New York Times,* circa July 1, in the selected years from 1970 to 1990.

floating exchange rates Relative values of currencies as determined by supply and demand of market forces.

soon came to an end because the standard according to which they were fixed was abolished. After the early 1970s, **floating exchange rates** replaced fixed exchange rates (see Figure 10.3). This shift means that the relative value of the different currencies is established by market forces, and the value of one currency in exchange for another is determined by what people (and central banks) are willing to pay on any given day.

The other aspect of the Bretton Woods system that was affected by President Nixon's announcement in August 1971 was the U.S. commitment to support the system itself. Until 1971, the United States had been willing to base its monetary and trade policies at least in part on considerations of what was good for the world economy as a whole. (Again, as noted earlier in this chapter, this does not mean that U.S. policymakers were astoundingly altruistic.) By 1971, the economic problems of the United States, both domestic and international, had become so serious that the U.S. government "demanded the right to manage its own currency in the pursuit of national objectives, just like any other country."[23]

The International Political Economy After Bretton Woods

The Economic Turmoil of the 1970s

The impact of Nixon's announcement in 1971 would have been profound under any circumstances. But the world economy was just beginning to recover and accommodate itself to that shock when it was hit in 1973 with a 400 percent increase in the price of oil. The members of the Organization of Petroleum Exporting Countries (OPEC) (see Chapter 3 for definition) set the price of oil in terms of U.S. dollars and are generally paid in dollars. With the price of oil dramatically increased, a torrent of dollars left the industrialized countries, including the United States, and went to Saudi Arabia and other leading oil producers. It can be said of any kind of money that the more of it that is around and available, the less valuable it is. When the price of oil increased, the number of dollars in circulation also increased, and that is one reason that throughout most of the 1970s, the value of the dollar fell relative to gold and other foreign currencies. This fall was also probably an important factor contributing to the double-digit inflation that hit the United States and several other industrialized countries in that decade.

It was during the 1970s, too, that analysts of relationships among industrialized countries began to focus on their interdependence (as discussed in Chapter 1).[24] What were once seen as purely domestic problems in the industrialized countries came to be seen as problems with an important impact on other industrialized countries. Such feelings give rise to protectionist pressures (that is, pressure to erect high tariff barriers or quotas to keep foreign imports out) and temptations to adopt other policies that might bring short-run benefits to individual countries. "Throughout this period international trade continued to grow, but not at the rate at which it had earlier. Under increasing pressure to stimulate economic growth, many nations reduced their tariff barriers. At the same time however, they devised new and more sophisticated ways of protecting their exports and otherwise limiting imports."[25] Indeed, in the 1970s, states began using more nontariff barriers such as government subsidies to export producers and government-imposed product standards.[26] As a result of protectionist policies, "trade among the industrialized nations quadrupled from 1963 to 1973, but increased only two and one-half times in the next decade."[27]

Group of Seven (G7) The major economies (Canada, France, Japan, Germany, Italy, the United Kingdom, and the United States) who held annual economic summits; now known as the G8 to include Russia.

In the midst of the economic crises of the 1970s, the industrialized states could not develop a replacement to the Bretton Woods exchange rate system. As a substitute, they began meeting annually in the **Group of Seven (G7)** summits to try to coordinate monetary policy in the absence of a fixed system.[28] The European states also tried to build a fixed exchange rate system on a smaller scale in 1979 with the European Monetary System, a predecessor to the euro (discussed in Chapter 12). Overall, however, there was great concern that with the changes in the

international economy, the stability that had been achieved under the old Bretton Woods institutions could not be duplicated. This concern was partly based on the belief that the United States, which had served as a hegemon in the system, was in serious trouble.

The Decline of American Hegemony?

In the early 1980s, economic growth in most industrialized countries was slow, inflation and unemployment were high, and the price and supply of oil (and other energy resources) were uncertain. Some analysts traced those problems to the relative decline of the United States as an economic power. "Part of the world's economic problems today," explained one well-known economist,[29] "is that the United States has resigned (or has been discharged) as leader of the world economy, and there is no candidate willing and acceptable to take its place."

A widely accepted explanation for the economic problems of the United States stressed the decline in productivity (output of economic goods and services per hour of effort) in various important sectors of the American economy. The Japanese had learned to produce automobiles more efficiently than U.S. automakers, and U.S. steel makers also had been outclassed by several foreign competitors. American productivity had increased, on the average, 3 percent a year before 1965, but from the middle of 1977 to 1981, productivity had been decreasing 1 percent a year.[30] And in the mid-1980s, U.S. productivity was lagging not only relative to its own past record but also in comparison with its chief competitors: Germany, Japan, France, and Britain. Persuasive historical evidence indicates that a productivity decline in a country such as the United States can have profound implications for that nation's role in the global political system. In fact, one prominent analyst of the history of the world's economic and political system argues that a relative decline in productivity is one of the first signs that a predominant state in the world system is losing its grip.[31]

Others agreed that the United States was losing its hegemonic position and were quite pessimistic about the stability of the economy in a "posthegemonic" system. The most publicized example of this speculation and pessimistic prognostication (from the viewpoint of the United States) was historian Paul Kennedy's book *The Rise and Fall of the Great Powers,* published in 1987.[32] Kennedy suggested that the United States was on the verge or in the process of suffering a fate similar to that of many other great powers since 1500. According to Kennedy, Spain in the 1600s, Britain in the 1900s, and Hitler's Germany in the 1940s all had a similar problem: They became overcommitted militarily. Keeping their commitments required military expenditures so great that the economies of their states, and so their political power bases, became fatally undermined. In Kennedy's view, "The United States runs the risk, so familiar to historians of the rise and fall of previous Great Powers, of what might roughly be called **'imperial overstretch'**: that is to say, decision-makers

imperial overstretch The idea that hegemonic powers overcommit resources, thus undermining their power.

in Washington must face the awkward and enduring fact that the sum total of the United States' global interests and obligations is nowadays far larger than the country's power to defend them simultaneously."

Kennedy's arguments reinforced skepticism about the capitalist world system and its leader, the United States, that originated in the era of stagflation (slow growth with high inflation) of the 1970s. Several writers then proclaimed the end of U.S. hegemony and explained the economic problems of the entire industrialized world as a result of that decline.[33] The reasoning, consistent with hegemonic stability theory, was based on an analogy with the Great Depression, during which national economies allegedly continued to contract because no leading nation had the economic strength and willingness to direct and enforce global economic cooperation.[34]

Yet the U.S. economy proved to be more resilient at the end of the twentieth century than many expected. The United States has in recent times been fully exposed to the forces of globalization (discussed in more detail in Chapter 14) and has in fact officially embraced those forces. By 1995, the value of U.S. exports as a proportion of the nation's gross national product (GNP) was higher than Japan's.[35] In addition, foreign investment in the United States and U.S. investment both increased by over 30 percent in the 1990s.[36] On many measures, the U.S. economy has done very well over the last decade compared to both Europe and Japan. Many new jobs were generated and unemployment remained at low levels.[37] Many of the new jobs can be traced directly to increased exports by American firms.[38]American workers, in addition, continue to be more productive than their counterparts in other wealthy industrialized countries. A 1996 report reveals, for example, that "Japanese workers were only 53 percent as productive as Americans, while Germans . . . were 90 percent as productive."[39] And in a recent study of how economically competitive countries are in the global economy, the United States ranked slightly higher than both Germany and Japan.[40] Overall, unemployment declined and growth increased in the United States at the end of the millennium. In Europe, unemployment remained higher and growth much lower over the past decade as a whole. In Japan, unemployment increased and growth slowed.[41] Thus, the rapid decline of the economic hegemon that many had predicted in the 1970s and 1980s did not materialize. The U.S. economy does not dominate the world economy as it did just after World War II, but it remains the largest economy in the world and the major player in world economic processes.[42]

Transition Economies

As the U.S. economy grew in the last years of the twentieth century, the international political economy was facing the challenge of integrating states that were once not part of the North into the global economic system. With political revolutions in Eastern Europe and the Soviet Union and changes in leadership in China, the Communist world economies began transforming. The most dramatic transitions have occurred in the

formerly Communist countries of Eastern Europe and the states that were formerly part of the Soviet Union. We also see significant economic transitions in states that are still Communist, such as Vietnam and China. In many cases, the transition from so-called Communist economies has been destabilizing and fraught with difficulty, and has resulted in profound economic and political crises. These crises have been felt globally and have helped to shape, for better or for worse, the course of the international political economy.

In examining these economic transitions, it is important to understand the nature of economies in Communist countries. This is made somewhat difficult by the fact that we often use the term *Communist* to refer to both a political system and an economic system. Although they are clearly linked, it is possible for different countries with Communist political systems to have very different economic systems. The Soviet Union and China are excellent examples: Both followed Communist doctrines and had single-party Communist states, yet they came to have rather different economic systems. One way to draw a better distinction between economic and political dimensions of communism is to refer to the economics of Communist systems as socialism, or classical socialism. Socialism refers to the extent of social, or public, involvement in the economy, or the degree to which economic activities are directed toward public, as opposed to private, interests. Communism as a political system generally refers to a single-party state (the Communist party) organized around an ideology that supports, among other things, the elimination of social classes within a society and an equitable distribution of wealth among citizens. It is worthwhile to distinguish between the political and the economic aspects of communism as it helps us realize that countries can support socialist economies without necessarily being Communist. Indeed, all countries practice some level of socialism (examples are school lunch programs, social security benefits, and state-owned highways), so the primary question becomes one of exactly how much socialism they practice.

In classical socialist economies, there is very little room for the hidden hand of the free market. Indeed, individual self-interest is seen to be detrimental to the collective interests of society, and thus a free market where individuals pursue their own interests is fundamentally at odds with the good of society as a whole. According to Karl Marx, the founder of Communist ideology, when individuals (private citizens) own factories and other means of production, wealth tends to accumulate in the hands of those individuals instead of in the hands of society at large. Moreover, such practices will result in the emergence of different social classes (the owners and the workers), and this will create further tensions in society. If the interests and values of the individuals who own the means of production differ from the interests and values of society, then the good of the few is outweighing the good of the many. To Marx, this is an injustice promoted by private ownership of the means of production, which promotes individual interests over collective interests. Capitalism is just

such an economic system, with its focus on economic liberalism. The remedy to this problem, according to classical socialist economics, is for everybody to own the means of production, and thus the economy will be oriented toward the interests and values of society, not those of a capitalist elite.

Since a free market will tend to create winners and losers, Communist ideological commitment to social equality and a classless society requires the virtual elimination of a market system. Thus, in most Communist countries, private property (that is, private ownership of economically valuable resources) was officially forbidden or extremely limited (although citizens could own their own household items and personal effects, and an underground economy, or black market, existed in almost every Communist economy). Without an official free market, where producers produce what they think they can sell and buyers buy what they want and can afford, something else must regulate production, consumption, and prices. For Communist countries, that turns out to be the state. Indeed, in Communist countries like the former Soviet Union, the state determined what was produced, how much was produced, what the price of goods would be, and how much money (wages) workers earned. Such a system was called a "command economy" or a **"centrally planned economy,"** and it required an extraordinary amount of attention to planning and control. Bureaucrats were overwhelmed with the responsibility of determining everything from the number of machine bolts to the number of televisions to be produced. Since the state planners in charge of the economy were generally more interested in overall economic growth, they often devoted more attention to the production of goods that would help the economy (like spare parts for factories) than to goods that individual citizens might want to consume (like clothing or meat). Moreover, there were often shortages of goods because of the difficulty of accurately predicting demand, and this contributed to economic inefficiency.

centrally planned economy Economic systems in which the state determines production, consumption, and pricing of commodities.

Marx clearly came to a very different conclusion than Adam Smith did about the social benefits of self-interested behavior. Moreover, it should be quite clear why classical socialist economies were fundamentally incompatible with the Bretton Woods system, which was premised on economic liberalism. On the whole, the Communist countries (those practicing classical socialist economics) were outside the liberal international economic system established by the Bretton Woods conference. This means that these countries did not engage in any significant international trade with Bretton Woods countries, did not have currencies that were readily convertible into U.S. dollars (and thus did not receive assistance from the IMF), and did not receive loans for development and reconstruction from the World Bank. In effect, the Communist countries' economies developed quite independently from the economies of the rest of the world. This also means that the collapse of the Bretton Woods system had a much less dramatic impact on these countries because their economies were relatively insulated from the rest of the world.

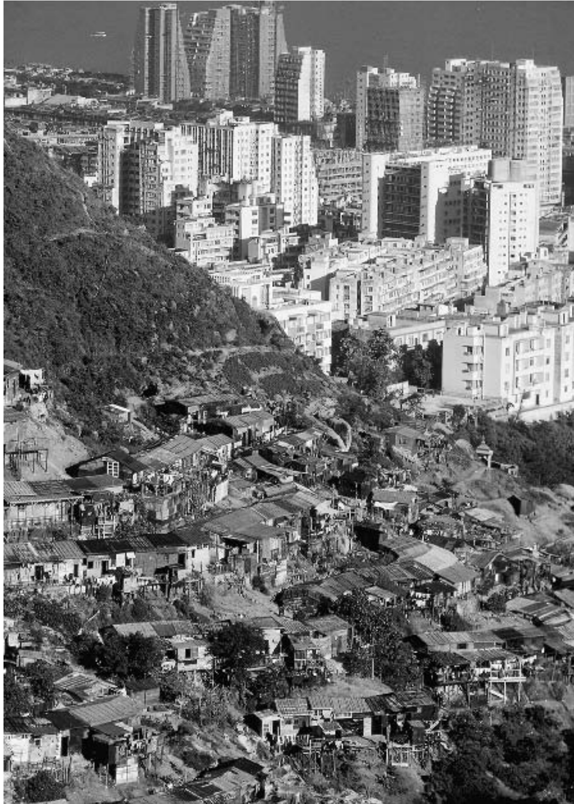
Perhaps most important for the former Communist countries, and for the world economy as a whole, is the tremendous difficulty of moving from classical socialist economic systems to capitalist free market systems. Although it might seem that such a transition would be relatively simple, it turns out to be both complicated and extremely socially disruptive. First, most of the practices that are common in free market systems were completely lacking in the former Communist countries. Prices, stock markets, and competitiveness had been nonexistent, underground, or closely controlled by the state. Learning how such practices work (or fail to work) is an arduous and often painful task. The idea of private citizens' investing in a stock market and buying shares of a company based on its competitive potential in order to make money, for example, was extremely alien to most individuals. Unemployment, officially illegal in many Communist countries, became a hard fact for the less fortunate. For those used to a social system that attempts to provide for the needy, a free market can be a cruel and heartless experience.

Second, the process of transition was very uncertain, and sorting out who should be able to buy the industries that had been owned by the state was a difficult matter. Average citizens did not have the financial resources to purchase a factory, even if they understood the value of doing so. The only persons with such wealth would have been a handful of high-ranking Communist party officials or rich foreigners looking for promising investments. Moreover, who would decide which industries would be sold off, or privatized, first? Certainly the government bureaucrats in charge of those industries would not be eager to have them come under private management (and thus risk their own jobs), and the workers in the industries would be unmotivated to see their factories privatized, as bloated payrolls would certainly be trimmed in the interest of economic competitiveness. Privatizing an economy cannot be done with the stroke of a pen, and thus the process itself becomes fraught with political battles and bureaucratic resistance. Even for those who believe that the long-term benefits of a free market system are great, the immediate consequences of such a transition are extremely socially disruptive and politically volatile.

Unemployment also increased in China, even though the Chinese economic transition has been fairly smooth and the transformation from a planned economy to a market-based economy has created significant annual economic growth rates since 1979. "As economic reform continues, millions of Chinese workers are being laid off each year with little hope of reemployment or adequate social welfare support. In some cities, unemployed workers are now joining together in large-scale protests, involving as many as 20,000 people at a time."[43] In the "special economic zones"—the cities that have gone the furthest toward liberalization—there is growing inequality and income disparity as well.[44] Some estimates put the inequality in China between urban and rural residents at near the highest in the world, and rural unrest has significantly increased

over the last decade.[45] Still, China's economic reforms have meant prosperity for many Chinese:

> According to official statistics, China's annual real GDP growth averaged 9.7 percent between 1989 and 2000. In aggregate terms, real urban incomes more than doubled over the same period. For many Chinese families, the increased prosperity of the 1990s can be measured by the new range of goods that they can now afford. The prizes of the 1980s included basic items such as refrigerators and television sets. Today, many Chinese families find computers, designer clothes, mobile phones, and home-entertainment centers within their reach as well. The growing prosperity is the result of the Chinese government's commitment to structural economic reforms. . . . Today, more than 40 percent of industrial output comes from private companies, and more than 30 percent of nonagricultural employees work for private or mixed-ownership firms. (In contrast, virtually no privately owned industrial firms existed in 1979 when . . . economic reform began.)[46]



Countries in economic transition such as Russia and China often experience great income inequalities and poverty side by side with wealth, as in Hong Kong (pictured here).
(© Brian Brake/Photo Researchers, Inc.)

The international community is interested in the success or failure of these transitional economies for a variety of reasons. The first reason is primarily economic in nature. As we have seen very clearly, all of the economies of the world are connected, or interdependent, meaning that economic events in one part of the world have consequences in other parts of the world. Thus, the success or failure of transitional economies will certainly be important to the capitalist countries around the globe. Moreover, the size of these economies represents an attractive opportunity for both markets and resources. Should countries in transition succeed in joining an international market, global trade would expand at a truly remarkable rate. This would, according to an economic liberal view, greatly enhance the accumulation of wealth globally.

A second reason the international community is interested in the transition economies is more directly political. The primary division of the world during the Cold War was between the capitalist countries and the Communist countries, and this division ultimately cost billions of dollars and thousands of lives. Should the countries in transition

fail to achieve economic stability, some fear a return to a global division pitting the formerly Communist countries against the growing number of capitalist countries. Moreover, the West opposed not only the classical socialism of Communist countries but also the political repression associated with centralized economies and Communist party domination. Fears that countries in economic transition will fail are in part related to fears of an associated loss of political freedom.

One of the great challenges now facing the world economy is how to integrate the transition economies, particularly those of the former Soviet Union and China, into the global economic system. The attempt to integrate took a big step with the admission of China into the WTO in 2001. "China's leadership had determined that globalization was unstoppable and that China could either join the trend or be left behind. This new thinking also reflected a maturing of the Chinese economy as market forces expanded and as more industries developed interests in lowering tariffs to reduce the costs of imports or expanding export markets."[47] Yet the negotiations between China and the United States over first GATT and then WTO admission lasted thirteen years.

China represents a very interesting case since it is attempting to maintain its Communist political system and a single-party state while simultaneously adopting a free market economic system.[48] This stands in contrast to most of the other transition economies, which have chosen to pursue various forms of democracy alongside free market reforms. This raises several interesting questions, such as the nature of the relationship between capitalism and democracy and the ability of a state to separate its domestic affairs from its international commitments and obligations. China, for example, has been quite hesitant to allow foreign intervention into its domestic affairs, but joining the WTO requires certain commitments and a willingness to follow rules established by other countries. Moreover, China's dual path of political socialism and economic capitalism clearly illustrates a common criticism of economic liberalism in that economic efficiency is seemingly being placed above concern for the individual and human rights. As WTO members increasingly embrace Chinese exports and attempt to foster investments and business ventures in China, many have argued that this will simply serve to continue oppressive state practices and further deprive citizens of their basic freedoms and human rights.

In many ways, the Russian transition from classical socialism to free market capitalism has been much more tumultuous than has been the Chinese experience. There are many possible reasons for this, including the fact that Russia was a socialist system for a much longer time than China and that Russia simultaneously experienced the breakup of its empire, the Soviet Union.[49] The great difficulty that Russia faced can also be explained by the fact that Russia has attempted to introduce a multiparty democratic system at the same time it has pursued a free market capitalist system. In essence, it has attempted a wholesale

transformation of both its economic and political systems at the same time. Although this was initially met with high hopes and applauded by the Western countries that had opposed the Soviet Union during the Cold War, it has turned out to be extremely difficult and has created a great deal of human suffering. Russian GDP declined almost 50 percent between 1989 and 1999, its unemployment rate (as percentage of economically active population) climbed from .08 to 1.6 percent from 1991 to 2001, the percentage of people living in poverty went from 1.5 to between 39 and 49 from 1988 to 1993, Russian life expectancy for males declined from 64.9 to 58.7 years from 1987 to 2003, and annual alcohol consumption increased from 5.3 to almost 9 liters of pure ethanol per person from 1989 to 2003.[50] Some argue that liberalization during the transition is not the cause of the decline in standards of living and economic growth; rather, the difficulty is Russia's unwillingness to engage seriously in liberalization. According to one observer, "Russia suffers not from too free a market but from corruption thriving on the excessive regulations erected by a large and pervasive state."[51]

The international community has not been immune to the consequences of the Russian transition, nor has it simply stood by and watched. In 1995, for example, "the IMF began to make available a series of major loans to Russia ($6.2 billion in 1995), subject to certain 'conditionalities' regarding official economic policy. The policies imposed by the IMF in exchange for financial support are widely known as the 'Washington Consensus,' which called for a tight monetary policy, coupled with an effort to reduce or minimize the deficit and achieve a primary surplus in the government budget to decrease outstanding debt."[52] Despite the aid packages, the Russian economy remained in dire straits, and in August 1998, the government was forced to devalue the Russian currency, the ruble, and default on $40 billion in domestic debt. The Russian economy did rebound after the ruble devaluation. Since 1999, the economy has been growing at 6 to7 percent a year and the proportion of Russians living below the poverty line has dropped from 34 percent in 1992 to 18 percent in 2004. This growth is not even, however, as the gap between the very rich and the poor has widened, and it is unclear if this growth can be sustained.[53] According to one economist, Russia's prospects for a successful transition to democracy and a market economy are still too early to judge.[54]

Turbulence in World Finance

Life after Bretton Woods in the international political economy has involved numerous international financial crises, particularly in the last decade. "The Russian default was the third stage in the global financial contagion that began with the devaluation of the Thai baht [the Thai currency] in July 1997. In the first stage, Thailand's currency depreciation triggered a sudden collapse in other Asian exchange rates, causing a rash

of bankruptcies among corporations and financial institutions. . . . In turn, the devaluations contributed to a slide in world commodity prices, leading currencies of other commodity producers such as Australia, Canada, New Zealand, Chile, and Mexico to plummet as well."[55]

Since the end of fixed exchange rates, countries have been struggling with ways to keep currencies stable. To encourage investment, Thailand had fixed its exchange rate to keep the baht at a set price per U.S. dollar. "But the baht's fixed value relative to the dollar could not be sustained. The pressure for a devaluation of the baht increased in 1996 and 1997 when the Japanese yen declined by 35 percent relative to the dollar. Since Japan is Thailand's major trading partner, the sharp rise in the value of the dollar (and therefore of the baht) relative to the yen made Thai products more expensive and therefore less competitive and pointed to even larger trade deficits in the future. Foreign speculators as well as local investors began to sell bahts."[56] Argentina followed a similar path, pegging its currency to the dollar and eventually spiraling into economic crisis in 2001.[57]

The frequency and severity of recent financial problems are of great concern to the international community. "Financial crises once made most people's eyes glaze over; they were the subjects of intense interest to only a limited clientele, many of whom wore green eyeshades. Not any longer. The topic has unfortunately acquired a mass audience in the second half of the 1990s. Stunning currency collapses in Mexico (1995), southeast Asia (1997), Russia (1998), and Brazil (1999) have pushed the subject to the front page. Financial conflagrations have become too frequent, too devastating, and too contagious to be ignored."[58]

Bretton Woods Institutions Today

Although the fixed exchange rate came to an end in the 1970s, the institutions created in the Bretton Woods system still function today. They are not, however, without criticism. The IMF, for example, is often criticized for the conditions it attaches to its loans. Often called "austerity packages," these typically require governments to privatize their holdings, cut government spending, and increase interest rates. The IMF attaches these strings to its loans in order to ensure that the money is spent in these ways and so that future loans will be unnecessary. Many, however, argue that IMF conditions are too liberal and force more privatization on economies than exists in most of the leading economies. Furthermore, critics charge, the IMF focuses blindly on the economic bottom line, ignoring the political causes of the economic situation in countries and the political consequences of its austerity packages. Finally, critics say that the IMF often gives bad economic advice and makes the economic situation even worse. In the IMF's handling of the Asian financial crisis, for example, leading economists "suggested that the austerity measures required by the IMF—including the imposition

of high interest rates—helped spread the Asian crisis even to well-managed economies."[59]

The IMF was a player in the Russian financial problems, too. With the Russian economic crisis looming, the IMF offered a $22 billion package in July 1998 to help save it from devaluation. This ounce of prevention, however, failed and the IMF was criticized by some for not doing enough and for not doing something earlier. Others say that Russia itself is to blame because it has not passed essential policies for reform. According to one analyst, the IMF's "miscalculation with Russia demonstrates the complexity of its mission. Russia still deserves Western assistance as a defeated but potentially dangerous nuclear power. The West, however, has yet to create an effective framework to aid a country whose political institutions are still reeling from 70 years of command economy mismanagement and a corrupt redistribution of state assets after communism's collapse."[60]

More generally, "the seemingly relentless spread of the financial crisis from Asia to Russia and possibly to Latin America . . . has left many observers wondering whether the IMF is still able to do its job. Computerized trading has made it increasingly easy for international investors to buy and sell stocks, bonds and other securities 24 hours a day, and liberalized markets have greatly expanded their access to countries around the world. While all this facilitates the free flow of capital by making it easier for investors to quickly move their money from one country to another, it makes it harder for the IMF to keep an eye on things and avert crises before it's too late."[61]

Others defend the institution as the only hope for global efforts to stabilize trouble spots. "The IMF, mistakes notwithstanding, was and remains crucial to economic stabilization and recovery. Despite all the controversy surrounding the IMF's policies and the withering criticism of several highly respected economists, the overwhelming weight of opinion on Wall Street and in Washington favors strengthening the fund. Not everyone agrees on the exact nature of its role, but all believe that some global institution needs to be in the center of the storm and that it is wiser to use the IMF as the starting point than to craft something altogether new."[62]

The World Bank has also come under criticism for trying to do too much. Through the years, the World Bank "has added new tasks to its mandate. In recent years, it has been called on for emergency lending in the wake of the Asian financial crisis, for economic management as part of Middle East peacekeeping efforts, for postwar Balkan reconstruction, and for loans to combat the AIDS tragedy in Africa. By now, its mission has become so complex that it strains credulity to portray the bank as a manageable organization. The bank takes on challenges that lie far beyond any institution's capabilities."[63]

Of all the components of the Bretton Woods Liberal International Economic Order, it is the GATT arrangement that has undergone the

most transformation, particularly recently. With the establishment of the WTO in 1995, the framework of agreements that made up GATT became an international institution that provides regular monitoring of the trade policies of member countries. The WTO is more powerful than GATT and covers broader areas of international trade (such as services, intellectual properties, and trade-related investment measures). By creating an overarching body to monitor trade practices, the member countries hoped to avoid protectionist policies that tended to surface between GATT negotiations and various loopholes to free trade exploited by governments. Proponents of the WTO cited the economic benefits to a permanent institution, but many felt that the WTO might threaten national sovereignty. In the United States, such fears put the ratification of the WTO Treaty in doubt for some time.

Dispute Settlement Mechanism WTO procedures to deal with disputes between member-states over free trade agreements.

Concerns about threats to sovereignty are primarily associated with the WTO's **Dispute Settlement Mechanism,** which has the authority to impose sanctions on member states that violate free trade agreements. Other countries can bring complaints before the WTO if they believe a state is in violation. By 2005, over 300 cases had been brought to the Dispute Settlement Mechanism. These included rulings against the United States on disputes brought by Venezuela and Brazil on U.S. gasoline standards and by many Latin American countries on U.S. prohibition of imports of tuna that did not use dolphin-safe fishing techniques. The United States obtained a WTO ruling against the European Union for its preferences for importing bananas from its former colonies.

According to the WTO itself, it is a myth that the Dispute Settlement Mechanism gives it power to tell other countries what to do:

> The only occasion when a WTO body can have a direct impact on a government's policies is when a dispute is brought to the WTO and if that leads to a ruling by the Dispute Settlement Body (which consists of all members). Normally the Dispute Settlement Body makes a ruling by adopting the findings of a panel of experts or an appeal report. Even then, the scope of the ruling is narrow: it is simply a judgment or interpretation of whether a government has broken one of the WTO's agreements—agreements that the infringing government had itself accepted. If a government has broken a commitment it has to conform. In all other respects, the WTO does not dictate to governments to adopt or drop certain policies.[64]

Yet it is clear that the WTO procedures are changing states' behaviors, even if they are not forced to do so. "So far, it seems that nations have been willing to abide by the dispute panel decisions rather than withdraw from the WTO when such decisions go against them. Because so much appears to be at stake for each nation by way of expected economic gain that would result from further liberalizing trade, states have felt

compelled to participate in the rule-making exercise rather than being left out of it."[65]

What the WTO does do is highlight the tensions between politics and economics. The political decisions by the United States to save dolphins and decrease pollution from gasoline have come in conflict with the economic philosophy of free trade. For now, the economic side seems to have triumphed in most cases, leading several groups to protest at WTO meetings (these protests will be discussed in Chapter 14), but the tension between politics and economics continues to be at the heart of the international political economy.

SUMMARY

- The study of the international political economy concerns the relationships and tension between political units and values and economics and market relations. Alternative economic philosophies, such as economic liberalism and mercantilism, offer different perspectives on the nature of these relationships.
- The international economic system set up in the non-Communist industrialized world after the Second World War was based on the economic liberal perspective, which stresses the free market system as a coordinator of greater wealth for all and free trade. The role of governments, according to this perspective, is best limited to provider of collective goods. Economic liberals disagree with mercantilists, who put the national interests of the state before economic wealth and favor protectionist politics when national interests are at stake and to maintain a positive balance of trade.
- The international economic system after World War II was centered around three principal organizations: the IMF, the World Bank, and the GATT. That system, based to an important extent on fixed exchange rates and free trade, worked well for the industrialized countries until the 1970s. In 1971, the United States put an end to the system in which gold and dollars were perfectly convertible at the rate of U.S. $35 per ounce of gold. The first OPEC increase in the price of oil in 1973 was another shock to the international system and helped produce a combination of high inflation and slow growth throughout the rest of the 1970s. When OPEC increased the price of oil again in 1979, the second oil shock helped throw the industrialized world into a recession. In 1982, it brought the United States the deepest recession it had experienced since World War II, and many predicted the decline of the United States as an economic hegemon. Economic growth in the 1990s, coupled with economic crises in countries like Japan, means that the United States remained the leading economy by many measures.
- The end of the twentieth century witnessed a rapidly changing and largely unstable international economy. Difficulties experienced by

former Communist states and financial crises in Asia and elsewhere have made many long for the stability of the Bretton Woods system. The Bretton Woods institutions—the World Bank, the IMF, and now the WTO—remain the only global efforts to coordinate economics across state borders, although their effectiveness and policies are often debated.

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