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The sixth edition of this book devotes considerable attention to the 2008 global financial crisis, the most severe financial crisis since the Great Depression of the 1930s. The 2008 crisis has demonstrated the need for increased regulation of banking activities, for the reduction of government deficits and public debt in developed economies such as the United States and some European countries, and for an increase in consumption and imports in some emerging economies such as China. However, there are striking disagreements among the developed and emerging economies in the Group of 20 (G20), and among major economists as to what policies should be adopted to hasten the recovery and prevent future crises. For example, the United States and many European countries proposed a global bank tax, but Canada, Australia, and emerging economies such as China, India, and Mexico opposed this. (The G20 decided that each state would form its own policy on this issue.) Although the G20 agreed to cut government deficits in half by 2013 and stabilize the public debt of countries by 2020, the United States, Japan, and India insisted that this timetable was an expectation rather than a firm deadline. Whereas European countries wanted to cut back deficits and debts to increase investor confidence, the U.S. administration believed it was necessary to continue stimulating the global economy to prevent a return of recessionary conditions. Noted economic scholars also disagreed about policy priorities. Whereas Niall Ferguson and Kenneth Rogoff believed that the United States had to control its deficits and foreign debt, Paul Krugman argued that government stimulus was a more important priority.

The lack of consensus on how to deal with the global financial crisis also applies to many other major problems in the global political economy. Where we stand on issues often depends on where we sit, and our theoretical views can have a major effect on our policy prescriptions. As a result, this book places considerable emphasis on the role of theory and on the relationship between theory and practice. This book introduces undergraduate and beginning graduate students to the complex and important issues of international political economy (IPE). I wrote this book because of a conviction that students can understand the broader implications of IPE issues only by examining them in a theoretical context. Without the organizing framework of theory, it is difficult to make sense of the growing body of facts and statistics in the global political economy. Theory helps us identify a degree of order in the complex world of IPE and enables us to go beyond description and engage in causal explanations and modest predictions. Our theoretical perspective also affects how we perceive and interpret issues. Thus, the text takes a comprehensive approach by applying the theory to all the major issue areas in IPE. This approach will help instructors draw connections between theory and practice for the students. The book focuses on three major themes: globalization, North–North relations
(among developed countries), and North–South relations (among developed and developing countries). The book also discusses the transition economies of China, Eastern Europe, and the former Soviet Union (FSU) countries, which are becoming increasingly integrated in the capitalist global political economy.

Although globalization is a major theme of the text, I do not claim that it is leading to a world society or world government. Indeed, considerable space is devoted to the discussion of regional blocs and organizations such as the European Union (EU) and the North American Free Trade Agreement, and Chapter 8 focuses specifically on the subject of regionalism. Furthermore, the interconnections between economic and security issues, and domestic and international issues are also discussed.

**NEW TO THIS EDITION**

The most significant revisions in this edition include the following:

- Discussion of the 2008 global financial crisis is updated and examined in greater detail throughout the text, and especially in Chapter 11.
- The role of oil, gas, and other energy resources in the global political economy is discussed in Chapters 3, 5, 7, and 9.
- A list of key terms is presented at the end of Chapters 1 to 11 and the Glossary has been expanded. The Glossary contains the definitions of each key term.
- The discussion of trade regionalism in Chapter 8 has been updated to include assessments of the positive and negative results of the North American Free Trade Agreement (NAFTA). In Chapters 6 and 8 the possible effects of the 2008 global financial crisis on the future of the European Union (EU) and the euro is discussed.
- Chapters 3 to 5 on the theoretical perspectives have all been revised to clarify the concepts and theories. Chapter 5 on the critical perspectives contains extensive revisions on neo-Gramscian analysis, constructivism, and environmentalism.
- More attention is given to the growing influence of emerging economies such as China, India, Brazil, Russia, Mexico, South Korea, and South Africa, and to the imbalance in trade relations between the United States and China.

The chapters in the text have all been revised to reflect the changes in the theory and practice of IPE. Chapter 2 on the institutional framework points to the growing role of emerging economies in the formal and informal institutions. For example, the Group of 20 (developed and emerging economies) has replaced the Group of 8 (developed economies plus Russia) as the main informal forum for discussing global economic issues. Chapters 3–5 on the theoretical perspectives have been revised to clarify the concepts and theories. For example, concepts such as collective action problems and Pareto-deficient outcomes are now defined more clearly and are included in the Glossary. Chapter 5 on the critical perspectives contains extensively revised sections on neo-Gramscian
analysis, constructivism, and environmentalism; the section on environmental theories now draws linkages with the critical issue of oil and energy security.

The substantive chapters also contain major revisions. Chapter 6 on international monetary relations has more detailed analysis of the problems confronting the U.S. dollar and the euro as the two most widely used currencies. The chapter also discusses how government budget deficits, foreign debt, and the 2008 financial crisis have presented major confidence problems for both currencies and raised questions about the future of global monetary relations. Chapter 7 on global trade relations devotes more attention to the trade imbalances between the United States and China, and to the U.S. problem of balance-of-trade deficits with most of its major trading partners. The chapter also includes an updated discussion of problems with the World Trade Organization’s Doha Round, of China’s manipulation of its currency to give it unfair trade advantages, and of further delays in Russia’s admission to the World Trade Organization (WTO). Chapter 8 on trade regionalism adds a discussion of the European Union’s 2009 Lisbon Treaty and examines the effects of the 2008 financial crisis on the EU and the euro. The chapter also contains an updated discussion of the positive and negative results of the North American Free Trade Agreement.

Chapter 9 on multinational corporations (MNCs) now assesses the effect of oil, gas, and other energy resources on the bargaining leverage of MNCs and states. The chapter also adds a discussion of China as an “export platform” for many MNCs, a major factor in China’s growing monetary reserves. Furthermore, Chapter 9 updates the assessment of the United Nations, WTO, NAFTA, and Organization for Economic Cooperation and Development in foreign direct investment regulation. Chapter 10 has a revised and updated discussion of foreign aid, with emphasis on competing views of aid and on the prospects of achieving the “Millennium Development Goals.” This chapter also takes a more detailed look at the positive and negative aspects of export-led growth development strategies, and at pressures by the emerging economies for a greater role in IMF and World Bank decision making. Chapter 11 on debt and financial crises devotes more space to the causes of and possible solutions to the 2008 global financial crisis. The chapter also gives more attention to comparing the 2008 crisis with the 1980s foreign debt crisis and the 1990s East Asian financial crisis.

In sum, the sixth edition of this text is fully updated and contains many revisions that reflect the changes occurring in the global political economy and in the academic study of IPE.

FEATURES
This book has a number of distinguishing features which have been consistently maintained through the six editions. First is the book’s emphasis on the interaction between theory and practice. I believe that students understand theory better when they see its practical applications and that theory in turn
Preface

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gives meaning to the substantive IPE issues. Chapters 3–5 provide a comprehensive overview of the most important theoretical perspectives in IPE, and Chapters 6–11 examine monetary relations, global and regional trade, multinational corporations, international development, and foreign debt and financial crises. Most importantly, Chapters 6–11 include many references to the theoretical perspectives, and each of these chapters concludes with a boxed item on “Considering IPE Theory and Practice.” A second distinguishing feature is the book’s emphasis on the role of formal and informal institutions in IPE. As a result of globalization, there is a much greater need for global governance in IPE. However, it is becoming more difficult to manage the global economy, and institutions such as the International Monetary Fund (IMF), World Bank, WTO, G20 and G8, are subject to numerous criticisms. In some critical areas of IPE such as the relations between states and multinational corporations, there is a notable lack of global governance. Chapter 2 introduces the institutional framework for managing the global economy, and basic organizations such as the IMF, World Bank, and WTO are discussed throughout the book. Considerable emphasis is also given to the role of private actors such as multinational corporations, nongovernmental organizations, and civil society groups in global economic governance.

A third feature of this book is its emphasis on the historical evolution of issues. Some historical background is essential for a better understanding of contemporary IPE issues. For example, knowing the history of the informal General Agreement on Tariffs and Trade (GATT) helps explain why the major trading countries replaced it with the formal WTO in 1995, and knowing the history of the 1980s foreign debt crisis helps explain why some developing countries are still plagued with foreign debt problems. A fourth feature is this book’s treatment of North–South issues between developed and developing countries. In addition to devoting Chapters 10 and 11 mainly to North–South issues (international development, and the debt and financial crises), I integrate the discussion of North–North and North–South issues throughout the book. This reflects the fact that most developing countries are becoming increasingly integrated in the capitalist global economy, and that some Southern states such as China, India, and Brazil are becoming major economic actors. A fifth feature is the emphasis on regional as well as global relations in IPE. One of the most controversial issues in IPE today is the proliferation of regional trade agreements, and Chapter 8 is devoted to this subject; regionalism is also discussed in other chapters. A sixth feature is the emphasis on domestic–international interactions in IPE, for example, in Chapter 4 on liberalism and Chapter 7 on global trade. One effect of globalization is the blurring of boundaries between international and domestic relations. Seventh, this book discusses the broad range of IPE economic concepts as clearly as possible for students new to the subject, without oversimplifying them. To make the concepts more “user-friendly,” examples are often provided. Finally, to make the complexities of IPE understandable to students this book includes a number of study and research aids. At the end of the chapters are sections focusing on Questions, which alert students to aspects of the subject they should be
familiar with; Key Terms, which list the major terms and concepts covered in the chapters; and Further Reading, which directs students to some of the most important literature in the field. All of the key terms are defined in a Glossary at the end of the book, which students will find useful in writing papers and preparing for exams.

SUPPLEMENTS
Longman is pleased to offer several resources to qualified adopters of Global Political Economy and their students that will make teaching and learning from this book even more effective and enjoyable.

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With Passport, choose the resources you want from MyPoliSciKit and put links to them into your course management system. If there is assessment associated with those resources, it also can be uploaded, allowing the results to feed directly into your course management system’s gradebook. With over 150 MyPoliSciKit assets such as video case studies, mapping exercises, comparative exercises, simulations, podcasts, Financial Times newsfeeds, current events quizzes, politics blog, and much more, Passport is available for any Pearson introductory or upper-level political science book. Use ISBN 0-205-07413-8 to order Passport with this book. To learn more, please contact your Pearson representative.

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**The Penguin Dictionary Of International Relations (0-140-51397-3)**

This indispensable reference by Graham Evans and Jeffrey Newnham includes hundreds of cross-referenced entries on the enduring and emerging theories, concepts, and events that are shaping the academic discipline of international relations and today’s world politics. This is available at a discount when packaged with this book.

**Research And Writing In International Relations (0-205-06065-X)**

This is a brief and affordable guide that offers the step-by-step guidance and the essential resources needed to compose political science papers that go beyond description and into systematic and sophisticated inquiry. It provides current and detailed coverage on how to start research in the discipline’s major subfields. This text focuses on areas where students often need help—finding a topic, developing a question, reviewing the literature, designing research, and last, writing the paper. This is available at a discount when packaged with this book.

**ACKNOWLEDGMENTS**

I am grateful for the comments, advice, and support of a number of individuals in writing and revising this book. First, I want to thank Michael Webb of the University of Victoria for giving me extensive feedback and advice for most of the editions of the book. I also want to thank Mark Zacher of the University of British Columbia, and Benjamin Cohen of the University of California–Santa Barbara for providing helpful advice and comments. In addition, it is important
to note that the emphasis of this IPE text on international institutions and governance owes a great deal to the interest I developed in the subject years ago when the late Professor Harold K. Jacobson was my Ph.D. supervisor. I am also indebted to the following external reviewers, whose helpful comments contributed to the various editions of this book: Katherine Barbieri, University of South Carolina; Sherry L. Bennett, Rice University; Vicki Birchfield, Georgia Institute of Technology; Kurt Burch, University of Delaware; Jeffrey Cason, Middlebury College; Robert A. Daley, Albertson College; Vincent Ferraro, Mount Holyoke College; David N. Gibbs, University of Arizona; Vicki L. Golich, California State University–San Marcos; Robert Griffiths, University of North Carolina at Greensboro; Beverly G. Hawk, University of Alabama at Birmingham; Michael J. Hiscox, University of California–San Diego; Tobias Hoffman, College of William and Mary; Matthias Kaelberer, University of Northern Iowa; Quan Li, Florida State University; Waltraud Q. Morales, University of Central Florida; Thomas Oatley, University of North Carolina at Chapel Hill; James Quirk, Catholic University of America; Howard Richards, Earlham College; David E. Spiro, University of Arizona; Kenneth P. Thomas, University of Missouri–St. Louis; John Tuman, University of Nevada, Las Vegas; Robert S. Walters, University of Pittsburgh; Ming Wan, George Mason University; and Jin Zeng, Florida International University. In addition, thanks are due to several colleagues at Simon Fraser University, including James Busumtwi-Sam, Anil Hira, Stephen McBride, David Laycock, Sandra MacLean, Tsuyoshi Kawasaki, and Michael Howlett. I also want to thank Joel Fox for his assistance in preparing the tables and figures for this edition.

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THEODORE H. COHN
## Acronyms and Abbreviations

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<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ACP</td>
<td>African, Caribbean, and Pacific</td>
</tr>
<tr>
<td>ADD</td>
<td>antidumping duty</td>
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<tr>
<td>AFTA</td>
<td>ASEAN Free Trade Area</td>
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<tr>
<td>AID</td>
<td>Agency for International Development</td>
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<tr>
<td>AIDS</td>
<td>acquired immunodeficiency syndrome</td>
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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
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<tr>
<td>BITs</td>
<td>bilateral investment treaties</td>
</tr>
<tr>
<td>BRIC</td>
<td>Brazil, Russia, India, and China</td>
</tr>
<tr>
<td>CACM</td>
<td>Central American Common Market</td>
</tr>
<tr>
<td>CAP</td>
<td>Common Agricultural Policy</td>
</tr>
<tr>
<td>CARICOM</td>
<td>Caribbean Community and Common Market</td>
</tr>
<tr>
<td>CDF</td>
<td>Comprehensive Development Framework</td>
</tr>
<tr>
<td>CEECs</td>
<td>Central and Eastern European countries</td>
</tr>
<tr>
<td>CFIUS</td>
<td>Committee on Foreign Investment in the United States</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
</tr>
<tr>
<td>CMEA</td>
<td>Council for Mutual Economic Assistance</td>
</tr>
<tr>
<td>COCOM</td>
<td>Coordinating Committee</td>
</tr>
<tr>
<td>CPE</td>
<td>centrally planned economy</td>
</tr>
<tr>
<td>CRTA</td>
<td>Committee on Regional Trade Agreements</td>
</tr>
<tr>
<td>CU</td>
<td>customs union</td>
</tr>
<tr>
<td>CUSFTA</td>
<td>Canada–U.S. Free Trade Agreement</td>
</tr>
<tr>
<td>CVD</td>
<td>countervailing duty</td>
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<td>DC</td>
<td>developed country</td>
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<tr>
<td>DISC</td>
<td>Domestic International Sales Corporation</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>EC</td>
<td>European Community</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>ECSO</td>
<td>European Coal and Steel Community</td>
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<td>ECU</td>
<td>European currency unit</td>
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<td>EDF</td>
<td>European Development Fund</td>
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<td>EFTA</td>
<td>European Free Trade Association</td>
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<td>EMS</td>
<td>European Monetary System</td>
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<td>EMU</td>
<td>European Economic and Monetary Union</td>
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<td>ERM</td>
<td>exchange-rate mechanism</td>
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<td>EU</td>
<td>European Union</td>
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<td>Euratom</td>
<td>European Atomic Energy Community</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>FIRA</td>
<td>Foreign Investment Review Agency</td>
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<td>FSU</td>
<td>former Soviet Union</td>
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<td>FTA</td>
<td>free trade area</td>
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<td>G5</td>
<td>Group of Five</td>
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<td>Group of Seven</td>
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<td>G77</td>
<td>Group of 77</td>
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<td>GAB</td>
<td>General Arrangements to Borrow</td>
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<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GNI</td>
<td>gross national income</td>
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<td>GNP</td>
<td>gross national product</td>
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<td>GSP</td>
<td>generalized system of preferences</td>
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<td>HDI</td>
<td>human development index</td>
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<td>HIPIC</td>
<td>heavily indebted poor countries</td>
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<td>HIV</td>
<td>human immunodeficiency virus</td>
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<td>IBRD</td>
<td>International Bank for Reconstruction and Development (World Bank)</td>
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<td>ICSID</td>
<td>International Centre for Settlement of Investment Disputes</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IDB</td>
<td>Inter-American Development Bank</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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IMF: International Monetary Fund
IO: international organization
IPE: international political economy
IR: international relations
ISI: import substitution industrialization
ITO: International Trade Organization
KIEO: keystone international economic organization
LAFTA: Latin American Free Trade Association
LDC: less-developed country
LIC: low-income country
LLDC: least developed country
M&As: mergers and acquisitions
MAI: Multilateral Agreement on Investment
MDG: Millennium Development Goals
MDRI: Multilateral Debt Relief Initiative
Mercosur: Southern Common Market Treaty
MFA: Multi-Fiber Arrangement
MFN: most favored nation
MIC: middle-income country
MIGA: Multilateral Investment Guarantee Agency
MNC: multinational corporation
MTN: multilateral trade negotiation
NAFTA: North American Free Trade Agreement
NATO: North Atlantic Treaty Organization
NEM: New Economic Mechanism
NEP: National Energy Program
NGO: nongovernmental organization
NIE: newly industrializing economy
NIEO: New International Economic Order
NTB: nontariff barrier
OBM: obsolescing bargain model
ODA: official development assistance
ODF: official development finance
OECD: Organization for Economic Cooperation and Development
OEEC: Organization for European Economic Cooperation
OPEC: Organization of Petroleum Exporting Countries
PPP: purchasing power parity
PRC: People’s Republic of China
PRSPs: Poverty Reduction Strategy Papers
R&D: research and development
RTA: regional trade agreement
RTAA: Reciprocal Trade Agreements Act
SAL: structural adjustment loan
SAP: structural adjustment program
SDRs: special drawing rights
SDT: special and differential treatment
SEA: Single European Act
STABEX: Stabilization of Export Earnings
TAN: transnational advocacy network
TFN: transnational feminist network
TOA: Treaty of Asunción
TRIMs: Trade-Related Investment Measures
TRIPs: Trade-Related Intellectual Property Rights
UN: United Nations
UNCTAD: United Nations Conference on Trade and Development
UNCTC: United Nations Center on Transnational Corporations
UNDP: United Nations Development Program
USTR: U.S. Trade Representative
WEF: World Economic Forum
WTO: World Trade Organization
Introduction and Overview

Many personal decisions we make have economic importance for us, whether we are choosing a career, purchasing goods, or investing in stocks. Collective political decisions also affect us economically. For example, governments play a major role in establishing tax rates; welfare payments; and economic, social, and environmental goals. As global interdependence has increased, the decisions of multinational corporations (MNCs) and international organizations (IOs) such as the World Trade Organization (WTO) also have a greater economic impact on us. Thus, international political economy (IPE) is an important area of study. Chapter 1 introduces the subject of IPE, the IPE theoretical perspectives, and the main themes of this book. Chapter 2 provides an overview of global economic relations before World War II and the postwar institutional framework developed to manage the global economy. For ease of reference, all terms defined in the glossary are in **bold print** when they are first described in detail.
We begin this introductory chapter with a brief discussion of the 2008 global financial crisis, because it is affecting all the major substantive issue areas we examine in this book ranging from monetary relations to trade, multinational corporations, and international development. The different accounts of the causes of the crisis also demonstrate how our theoretical views affect our interpretation of international events, and this book places strong emphasis on the role of theorizing in IPE.

Financial crises have occurred over the years, and the world has become more susceptible to them with the growth of financial market liberalization since the 1970s. However, the 2008 financial meltdown was the worst financial crisis since the Great Depression of the 1930s, and it also resulted in a social crisis. Problems included a significant increase in unemployment rates and major reductions in the value of pension funds.\(^1\) The most immediate cause of the crisis was a subprime mortgage crisis in the U.S. housing market. Subprime mortgages are granted to people who do not qualify for regular mortgages at market interest rates because of their low incomes, poor credit ratings, or poor employment prospects. In the 1990s, U.S. mortgage lenders provided low interest rates to entice people with poor credit ratings to borrow in the subprime market, and this led to a dramatic increase in U.S. home ownership. The increased demand for houses led to a building boom, which eventually resulted in an oversupply of houses and reduced U.S. housing prices in mid-2006. Mortgages were also coming up for renewal at higher interest rates that subprime borrowers could not pay, and they had to default on their loans. Because of the decline in housing prices, the scores of subprime borrowers ended up owing more than the value of their houses. Thus began the subprime mortgage crisis. The U.S. crisis became a global financial crisis in 2008, because the subprime mortgages had been repackaged and sold to investors around the world.
Although the U.S. subprime mortgage crisis was the most immediate cause of the global financial crisis, two underlying causes were the inadequate regulation of banks and other financial institutions, and the imbalance in financial relations between borrowers and savers. Some analysts argue that U.S. monetary and fiscal policies have allowed Americans to borrow too much and live beyond their means, while others believe that excess savings in China and other East Asian countries have enabled these countries to buy U.S. Treasury bonds and finance U.S. overspending. In reality, imbalances created by excesses in both U.S. borrowing and East Asian savings contributed to the financial crisis. This book, therefore, emphasizes the importance of examining a diversity of theories in interpreting IPE issues and events. Although the most detailed examination of the 2008 global financial crisis is in Chapter 11, we discuss the implications of the crisis for various aspects of IPE throughout this edition of the book.

The study of IPE requires factual knowledge in a wide range of areas such as trade, monetary relations, foreign investment, and development. However, people interpret the “facts” quite differently depending on whether they view them “from a bank office in Zurich, a maquiladora [border factory] in Mexico, a shantytown in Peru, a rice paddy in Sri Lanka... or a trade office in Washington, DC.”² Our interpretation of the facts also depends on our theoretical views, and the only choice is whether these views are implicit or whether we explicitly examine the theories we use to interpret issues and events. Our theoretical views also determine what facts we consider important. For example, realist theorists focus on the power relations among developed countries (DCs) in the North, while many critical theorists argue that the North’s exploitation of less-developed countries (LDCs) in the South is a more pressing issue. Although people tend to interact with those who share their views, this book focuses on a range of competing theoretical perspectives, because the study of IPE is “far too important and multifaceted to leave to one analytic or methodological perspective alone.”³ This book also emphasizes the interaction between theory and practice: Theory shapes our practice of IPE, and practical experience leads us to reassess our theories. Before introducing the main theoretical perspectives and themes of this book, we address the question “what is IPE?”

**WHAT IS INTERNATIONAL POLITICAL ECONOMY?**

IPE is concerned with the interaction between the state, a sovereign territorial unit, and the market, a coordinating mechanism where buyers and sellers exchange goods and services at prices determined by supply and demand. We normally associate the state with the political pursuit of power, and the market with the economic pursuit of wealth. However, the state also has an interest in accumulating wealth, and the market is not totally removed from power considerations. An inherent tension exists between the state and the market because the market’s association with
economic openness and the removal of state barriers poses a threat to state sovereignty. For example, the 1988 Canada–U.S. Free Trade Agreement (CUSFTA) established an open market between the two countries, which some Canadians considered a threat to their national sovereignty in energy, foreign investment, and cultural industries. When the North American Free Trade Agreement (NAFTA) replaced CUSFTA in 1994, Mexicans were concerned that it would encroach on their sovereignty in energy and agriculture, and many Americans feared that NAFTA would limit their control over employment and the environment. Despite the tension between states and markets, they also have a complementary relationship. Domestically, states protect private property rights and provide infrastructure such as transportation and communications required for market transactions. Internationally, states form agreements and organizations to promote economic openness and stability; and wealthier states with larger markets often have more military and political power. As interdependence has increased, states have been drawn into the competitive forces of the world economy. Thus, competition states seek to increase their competitiveness by restructuring industry, deregulating financial markets, and supporting research and development (R&D) in high-technology sectors. As we discuss, the rapid economic growth of Japan and the East Asian newly industrializing economies (NIEs) from the 1960s to 1980s was related to their symbiotic relationship with the competitive marketplace.

Although most scholars treat state–market interactions as the core IPE issue, they are also interested in other types of relationships. Primary among these is the interaction between the state and the multinational corporation (MNC), a central nonstate actor. In 2009, there were about 82,000 MNCs with 810,000 foreign affiliates. The exports by foreign affiliates of MNCs account for about a third of total world exports of goods and services, and they employ about 77 million people. As is the case with states and markets, state–MNC relations are marked by both cooperation and conflict (see Chapter 9). Whether we focus on state–market or state–MNC relations, IPE is interdisciplinary and draws on contributions from political scientists, economists, sociologists, anthropologists, historians, and geographers. In their effort to cross disciplinary boundaries, IPE theorists criticize some economists for economism (i.e., for focusing too much on economics and too little on politics) and some political scientists for politicism (i.e., for devoting too much attention to politics and too little to economics). In addition to doing interdisciplinary research, IPE scholars must also devote considerable attention to domestic–international linkages. Whereas domestic groups generally leave decision making on international security matters to the government “experts,” they demand a greater role in international economic decisions because they view trade and foreign investment as “bread and butter issues” that affect their economic welfare. In sum, IPE scholars have the daunting task of focusing on both international and domestic relations and of crossing disciplinary boundaries.
THE IPE THEORETICAL PERSPECTIVES

Many students tend to avoid “theory,” but without it we cannot assess the broader implications of our statistical and factual studies. (We discuss the purpose of theory in more detail in the introduction to Part II.) IPE has been marked by a growing diversity of theories, and some critics point to our failure to develop an all-embracing theory to explain events. However, the existence of different theoretical perspectives should not be viewed as a weakness. Social science theory “is always for someone and for some purpose,” and the IPE theoretical perspectives will never be entirely compatible because they are based on different sets of values. When IPE emerged as a major field of study in the 1970s, the three dominant perspectives were realism (or economic nationalism), liberalism, and Marxism, and IPE theorists tended to view them as separate “ideologies.” This book adopts a more updated approach to IPE theory in several respects. First, we do not view the IPE perspectives as separate ideologies, and we examine how they overlap and influence each other over time. Second, we view Marxism as less important today and supplement the third perspective with several “critical” perspectives. Some theorists question the value of using this typology for examining IPE theory today, but we believe it is still useful because liberalism and realism continue to be the two mainstream perspectives with the most influence on the practice of IPE. Chapters 3 and 4 of this book focus on realism and liberalism, and Chapter 5 examines several perspectives that are critical of the two mainstream IPE perspectives.

Realists consider the state to be the principal actor in international relations (IR). IR is a “self-help” system without a centralized authority in which states must build up their power or form alliances to prevent being dominated by others. Thus, realists tend to see IR as a zero-sum game, in which one state’s gain is another state’s loss, and they focus on relative gains or the gains a state achieves in relation to the gains of other states. In IPE each state tries to manipulate the market to capture relative gains. Although realism traditionally has been the most important IR perspective, liberalism is the most important IPE perspective. To avoid confusion, we should note that the term liberal is used differently in IPE and in U.S. domestic politics. In the United States, “liberals” support greater government involvement in the market to prevent inequalities and stimulate growth, while “conservatives” support free markets and minimal government intervention. Orthodox liberals in IPE are more akin to U.S. conservatives, because they favor free markets, private property rights, and only a limited government role in economic activities. However, Keynesian liberals are more accepting of government intervention (see Chapter 4). Liberals are more optimistic than realists about the prospects for cooperation among states, and they believe that international institutions can help promote cooperation. Thus, liberals view economic relationships as a positive-sum game, in which all states benefit, even if they do not benefit equally.

Chapter 5 of this book discusses four critical perspectives that question the mainstream liberal and realist views of the world, and see the mainstream as favoring some groups or issues and marginalizing others. The historical
materialist perspective encompasses the largest group of critical theories. Stemming partly from Marxism, historical materialism is “historical” because it examines structural change over time, with an emphasis on class and sometimes North–South struggles. The perspective is “materialist” because it examines the role of material factors, especially economic factors, in shaping society.\textsuperscript{11} The current system is marked by the dominance of capitalism, with the capitalist class (the bourgeoisie) exploiting the workers (the proletariat). In addition to historical materialism, Chapter 5 also discusses three other critical perspectives: constructivism, feminism, and environmentalism.

Although the realist, liberal, and critical perspectives provide us with alternative lenses for viewing IPE issues (such as trade and monetary relations), the margins separating these perspectives have become blurred as they have evolved and influenced each other over time. Hybrid theories and approaches such as regime theory, hegemonic stability theory, and constructivism are also linked with more than one perspective. Furthermore, the literature examining the relationship between domestic institutions and IPE does not fit easily into a single perspective. In addition to the main theoretical perspectives, this book discusses the hybrid theories and approaches, and domestic–international interactions.

**PURPOSES AND THEMES OF THIS BOOK**

This book provides a comprehensive approach to the study of IPE. Part II discusses the theoretical perspectives, and Part III examines substantive issues including monetary relations, global and regional trade, investment, development, and foreign debt and financial crises. We provide historical background and also focus on current developments such as the global financial crisis; the growing influence of emerging powers including China, India, and Brazil; the effect of environmental changes; and the role of oil and other energy resources in the global political economy. To understand the broader implications of these issues, the chapters in Part III direct the reader to the interaction between theory and practice. To help draw connections between theory and the substantive issues, this book focuses on three major themes: globalization, North–North relations, and North–South relations.

**Globalization**

The first theme of this book is globalization, which involves the broadening and deepening of interdependence among peoples and states. Broadening refers to the extension of geographic linkages to encompass virtually all major societies and states, so that policies and events in one part of the world can have a significant impact on distant locations. Deepening refers to the greater frequency and intensity of state and societal interactions. Although the state continues to be the most important actor in IR, modern telecommunications and transportation have increased connections among people with less regard to territorial boundaries. Thus, states are confronting a more complex
environment in which international organizations (IOs), MNCs, and non-governmental organizations (NGOs) have important roles. Theorists do not define globalization in a consistent manner, and they have differing views regarding the causes and effects of globalization. Whereas some theorists argue that globalization stems from technological advances, others emphasize the role of the state, the capitalist mode of production, and cultural and social-psychological factors. We discuss the different definitions of globalization here, and focus on the causes and effects of globalization in Chapters 3–5.

At one end of the spectrum are extreme or hyper-globalists, who believe that globalization involves the creation of a “borderless world” in which MNCs lose their national identities, and regional and global markets replace national economies. For example, Kenichi Ohmae asserts in *The End of the Nation-State* that “traditional nation states have become unnatural, even impossible, business units in a global economy.” When there is no longer state interference, Ohmae argues, MNC decisions and consumer choices will result in the rational allocation of global resources. We devote more attention to the views of internationalists and moderate globalists than to hyper-globalists, because there is little evidence that globalization is causing the state to wither away. Internationalists are at the other end of the spectrum from hyper-globalists. Although they recognize that interdependence is increasing and that nonstate actors have a role in IPE, they believe that the world is no more “global” than it was in the nineteenth century. The international economy in the view of internationalists “is still fundamentally characterized by exchange between relatively distinct and national economies.” Although some internationalists acknowledge that globalization today may be different because of the greater speed and volume of transactions, they see globalization mainly as an economic phenomenon and argue that “in most areas of world politics . . . states are still the principal authorities.” Internationalists view the disastrous events of September 11, 2001, and the subsequent U.S. turn toward unilateralism as evidence that globalization has produced no significant change, and that violence, geopolitics, and the national interest continue to be central concerns.

Moderate globalists take a position between hyper-globalists and internationalists. Although they reject the hyper-globalist view that the state is no longer a viable actor, they differentiate *international* relations among states from *global* relations that take place without regard to territorial boundaries. Global linkages in finance, trade, investment, and communications have existed in the past, but they now occur more frequently, intensely, and on a wider scale. For example, the Internet provides instantaneous linkages around the world; MNCs control economic resources greater than those of many states; and global problems such as ozone depletion, climate change, money laundering, and market volatility are increasing. Although states continue to be important, they must share the stage with private actors such as MNCs and NGOs, and with systems of transnational, global, and regional governance. Nevertheless, the world is *globalizing*, rather than fully *globalized*, and territorial and supraterritorial relations coexist.
This book provides evidence that both the internationalist and moderate globalist positions have some validity, depending on the issue areas and countries being studied. Relying on these two approaches, we briefly discuss some important points about globalization:

- **Globalization is not a uniform process throughout the world.** Its effects are more evident in major urban centers than in rural areas, remote islands, and the poorest countries.
- **Globalization is not causing the state to wither away.** Although the state’s autonomy is eroding in some important respects, states are adopting new and more complex functions to deal with an interdependent world and they continue to have choices in the policies they adopt.\(^{19}\)
- **Globalization can result in fragmentation and conflict as well as unity and cooperation;** for example, the formation of regional economic blocs in Europe, North America, and East Asia is associated with an increase in global *competitiveness*. Although competitiveness is a “contested concept” with various meanings, this book shows that it causes states to be concerned with their relative positions in the global economy.\(^{20}\)
- **Interdependence and globalization are not unique to the present-day world,** and it is possible that international events could reverse the current moves toward globalization. For example, there was a high degree of interdependence in trade and foreign investment before World War I which declined during the interwar period and began to increase again after World War II.

Despite the historical fluctuations, globalization is more encompassing today than it was at any time in the past. With advances in technology, communications, and transportation, state activities are being internationalized to a degree not previously experienced. Global interdependence today is also qualitatively different than previously. Although a number of corporations globalized their activities during the nineteenth century, the role of MNCs in generating foreign investment, trade, and technology is a modern-day phenomenon.\(^{21}\) The geographic reach of the capitalist economic system is also encompassing the entire globe, with LDCs and the transition economies of Eastern Europe and the former Soviet Union (FSU) becoming more involved in the global economy. For the first time, membership in the International Monetary Fund (IMF), World Bank, and WTO is becoming truly global.\(^{22}\) This book examines the implications of these changes and the differing views as to whether globalization is a positive or negative process.

**North–North Relations**

The second theme of this book concerns relations among economically developed countries in the North. The DCs in Western Europe, North America, and Japan are the only group of states with the wealth and power to look
after international management of the global economy. Thus, international management has been primarily a North–North issue, even though emerging LDCs in the South such as China, India, and Brazil are posing a growing challenge to Northern management. This book discusses two factors that contribute to international economic management: hegemony and international institutions.

The United States was the undisputed leader or hegemon in the early post–World War II period because of its economic and military power. An important measure of economic power is the gross domestic product (GDP), the total value of goods and services produced within a country's borders during a given year. The GDP records income in terms of where it is earned rather than who owns the factors of production. Thus, a country's GDP includes the interest and profits domestic and foreign companies and individuals earn in the country; it does not include income the country's residents earn abroad. In contrast to the GDP, the gross national product (GNP) records income according to who owns the factors of production rather than where the income is earned. Thus, the GNP is the total value of goods and services produced by domestically owned factors of production in a given year. GNP is derived by adding the income a country's residents earn from foreign activity to the GDP and subtracting the income foreigners earn from activity in the country. For example, the income a U.S. resident earns in France is part of the U.S. GNP but not the U.S. GDP; this income by contrast is included in the French GDP but not in the French GNP. A number of states and IOs now use a third indicator of total output, the gross national income (GNI), instead of the GNP. In practical terms, the GNI is equal to the GNP—it simply measures the income produced by the GNP rather than the value of the product itself. This book usually uses the GDP, because most countries use the GDP as their main measure of national economic activity. However, a country's GDP and GNI (or GNP) normally do not differ greatly, and we use all of these measures, depending on the source of the data. Whether we use the GDP or GNI, the United States was clearly the economic hegemon after World War II. During the war the U.S. GDP had increased by about 50 percent, whereas Western European states had lost one-quarter of their GDPs on average and the Soviet Union and Japanese economies were severely damaged. In 1950, the U.S. GDP was about 3 times larger than the Soviet Union's, 5 times larger than Britain's, and 20 times larger than Japan's. Western Europe and Japan were also highly dependent on U.S. aid and foreign investment for their postwar reconstruction.

During the 1960s, the United States’ relative economic position vis-à-vis other DCs began to decline as Western Europe and Japan recovered from the war. The extent of the U.S. economic decline and the possibilities for U.S. hegemonic renewal are matters of intense debate, partly because IR theorists often focus on different aspects of hegemony. In the security area, for example, U.S. hegemony has clearly increased since the breakup of the Soviet bloc and Soviet Union. However, most would agree that the relative economic power of the United States has declined since the end of World War II. In 1971, the
United States shifted from having annual balance-of-trade surpluses to having balance-of-trade deficits (i.e., imports greater than exports), the United States has become a major recipient as well as a source of foreign direct investment, and there has been a considerable loss of confidence in the U.S. dollar as the top international currency. The United States remains a major force in the global economy, and in 2004 it accounted for about 25 percent of world GDP. However, this book discusses the fact that the relative U.S. economic decline has resulted in a gradual shift from unilateral U.S. to collective management of the global economy.

Another factor in global economic management is the role of international institutions. Under U.S. and British leadership, three international economic organizations were established in the 1940s to help manage the global economy: the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD or World Bank), and the General Agreement on Tariffs and Trade (GATT). The DCs were the dominant economic powers in these organizations, and they also created some smaller institutions largely limited to DC membership, including the Organization for Economic Cooperation and Development (OECD) and the Group of Seven (G7)/Group of Eight (G8). In 1995 the WTO replaced the GATT as the main global trade organization. This book examines the role of these institutions in managing the global economy.

Despite the joint efforts of DCs to manage the global economy, they also have some significant differences. Three major economic blocs have emerged in Europe, North America, and East Asia with the decline of U.S. economic hegemony and the end of the Cold War. The competitiveness among these three blocs has major consequences for the future of the global economy because they encompass much of the world’s economic, technological, scientific, and military power. Differences over security issues such as the 2003 U.S.-led war against Iraq have further exacerbated the divisions among DCs on economic issues. Thus, the second theme of this text concerns the linkages and divisions among the DCs of the North.

North–South Relations
The third theme of this book concerns North–South relations. The South includes almost all the countries of Latin America and the Caribbean, Asia and Oceania, and Africa and the Middle East. These countries are mainly LDCs with colonial histories and lower levels of economic and social development. In 1950 the South accounted for almost 65 percent of the total world population, and by 1996 this figure had climbed to almost 80 percent of the world total. A number of former Communist states in Eastern Europe and the FSU are now receiving foreign debt and development financing from the DCs and are, in effect, also a part of the South. When we speak of the world, we therefore must give a great deal of attention to the South.

LDCs generally have lower per capita incomes, inadequate infrastructure (e.g., transportation and communications), and limited access to modern
technology. Many LDCs also have lower levels of social development such as inadequate educational facilities, health and sanitary facilities, and literacy rates. Assessing political development in a country is a difficult and contentious issue; but LDCs are more likely than DCs to have unstable and authoritarian governments. LDCs also have less influence in most international economic organizations such as the IMF, World Bank, and WTO. It is important to note that many IOs and development theorists prefer the term developing countries to LDCs because they believe the LDC term suggests that these countries are inferior or are expected to follow the same path to development as the DCs. However, LDC is used as an abbreviation in this book simply to indicate that these countries are economically less developed. LDCs may have histories and cultures as rich or richer than those of DCs, and they may follow different paths to development.

As this book shows, LDCs in fact have become a highly diverse group of countries with major differences in income and economic development. Some analysts, therefore, question whether it is still meaningful to speak of the South or LDCs as a single group. On the one hand, the East Asian NIEs—South Korea, Taiwan, Singapore, and Hong Kong—have relatively high per capita incomes and literacy rates and are quite competitive with DCs in some areas. Some of the larger LDCs and transition economies such as the BRIC economies—Brazil, Russia, India, and China—also have a growing degree of political and economic influence. On the other hand, the UN list of 49 least developed countries (LLDCs)—mainly in Sub-Saharan Africa and Central Asia—have extremely low per capita incomes, literacy rates, and shares of manufacturing. One analyst argues that 4 billion of the 5 billion people in LDCs today live in countries that are in fact developing. However, the “bottom billion” people in the world—most of whom are in LLDCs—are caught in a “development trap” and falling further behind.

Despite the South's economic disparities, we can generalize about LDC development problems because a major characteristic of the global economy is the inequality in wealth and power between DCs in the North and most LDCs in the South. Although China recently surpassed Japan as the world's second largest national economy (in terms of GDP) after the United States, the per capita GDP of DCs such as Japan, the United States, and Germany still exceeds the per capita GDPs of China and the other BRIC economies by a wide margin (see Chapter 2). A number of LDCs have been developing, but most have been frustrated in their efforts to exert more influence and close the economic gap with the North. Furthermore, the East Asian success stories are unusual in several respects. Singapore and Hong Kong are so small geographically that they are more akin to city-states, Hong Kong was a British crown colony before being incorporated into mainland China, and Taiwan and South Korea are contested territories. Although China, India, Brazil, and Russia have growing economic and political influence, they have major problems to overcome; even the East Asian NIEs have been vulnerable to financial crises (see Chapters 10 and 11). Thus, in 2005 the United Nations Development Program reported that
convergence is a relative concept. Absolute income inequalities between rich and poor countries are increasing even when developing countries have higher growth rates—precisely because the initial income gaps are so large. . . . If average incomes grow by 3 percent in Sub-Saharan Africa and in high-income Europe, for example, the absolute change will be an extra $51 per person in Africa and an extra $854 per person in Europe.  

This book explores the strategies LDCs have employed to promote economic development and increase their influence.

Although we focus mainly on inequalities between the North and the South, the global economy is also marked by differences of wealth and power within states. Brazil has one of the largest income gaps among LDCs, with the per capita income of the richest 10 percent of the population 32 times higher than that of the poorest 40 percent. As Chapter 10 discusses, some groups within LDCs such as women and children are especially disadvantaged. (Disparities in wealth are of course also present within DCs.) This book discusses the effects of changes in the global economy on inequalities between rich and poor both among and within states. We also devote space to the transition economies that have been liberalizing since the breakup of the Soviet bloc and Soviet Union. However, East–West relations are not a major theme of this book, because the Cold War has virtually ended and the transition economies are becoming more integrated in the capitalist global economy. Chapters 3–5 show that IPE theorists have different interpretations of the main themes in this book. In regard to globalization, realists emphasize the centrality of the state; liberals believe that globalization is an important and beneficial process; and historical materialists also view globalization as significant but as having negative consequences for poorer people; LDCs; and those marginalized because of gender, race, and ethnicity. In regard to North–North relations, liberals are more inclined than realists or critical theorists to see international institutions as having a positive role in promoting international economic cooperation. In regard to North–South and gender-based relations, critical theorists place more emphasis than liberals or realists on inequalities and exploitation.

FOCUS OF THIS BOOK

This book introduces undergraduate and graduate students to the study of IPE, and we have already discussed some of its distinguishing features. First, it provides an in-depth background to IPE theory, current IPE issues in historical perspective, and the interplay between theory and practice. Without the organizing framework of theory, discussions about trade, foreign investment, and development simply become a series of disparate facts. Although we devote considerable attention to the mainstream perspectives of liberalism and realism, we do not accept the view that the breakup of the Soviet bloc marked an “end of history” leading to “the universalization of Western liberal democracy as the final form of human government.”  

Thus, we also examine several
major critical perspectives. Second, we focus on three themes relating to globalization, North–North relations, and North–South relations. Third, we emphasize the role of global organizations such as the WTO, IMF, and World Bank, and regional organizations such as the European Union (EU), NAFTA, and Mercosur (the Southern Common Market Treaty). Early scholarship on international organization had a strong idealistic and legal focus on the bodies and rules of the League of Nations and United Nations, and post–World War II realists pointed out that these studies did not deal with the real world of power politics. In recent years, scholars have recognized the need to study IOs as part of international politics, and we examine the limitations as well as the strengths of international economic organizations.\textsuperscript{33} IOs are to a large degree creatures of the states that created them, and they are having difficulty managing the international economy in an age of globalization; for example, the daily flows of foreign exchange on global markets are much greater than the total resources of the United Nations, World Bank, and IMF. Despite their limitations, IOs are important forums for negotiation that assist in upholding the principles, norms, and rules of the global economy.

Fourth, this book emphasizes regional as well as global relations in IPE. The current trends toward regionalism inevitably affect the management of the global economy, and this book devotes Chapter 8 to regionalism and globalism in trade. With the formation of NAFTA, “the trade and economic relations of the two largest markets in world trade—the European Community and the United States—are increasingly conditioned by regional agreements.”\textsuperscript{34} LDCs have also established regional trade agreements (RTAs), and two of the largest South American countries, Brazil and Argentina, are members of Mercosur. Major countries in East Asia such as China, Japan, and South Korea are also engaging in regional cooperation often on an informal basis without formal agreements. Furthermore, countries ranging from the United States to Japan, Singapore, and Mexico are negotiating a number of bilateral free-trade agreements. Although liberal economists believe that RTAs such as the EU and NAFTA may be “stepping stones” to global free trade, they fear that many smaller bilateral RTAs could impede global trade liberalization. Chapter 8 discusses the debate on this issue, and other chapters examine regional trends in monetary relations, foreign investment, and international development. Of particular interest is the relationship between regionalism and globalism in IPE.

Fifth, this book focuses on North–South issues and integrates the North–North and North–South discussions as much as possible for several reasons. The IPE theoretical perspectives should be assessed in terms of their approach to all countries, and Chapters 3–5, therefore, discuss each perspective’s approach to North–South as well as North–North relations. Part III also integrates the discussion of North–North and North–South relations because globalization in trade, foreign investment, and monetary relations is affecting the entire world. Two chapters are devoted mainly to the South: Chapter 10 examines LDC strategies to promote economic development, and Chapter 11 on foreign debt and financial crises focuses mainly on LDCs, but also discusses the North and the former Soviet bloc countries. Sixth, this book discusses
Eastern Europe, the FSU, and China, which are in transition from centrally planned to market economies. They are establishing closer economic ties with the DCs and becoming more active members of international economic organizations. Seventh, this book examines the challenges civil society groups and NGOs are posing to globalization and the policies of the IMF, World Bank, and WTO. Finally, this book devotes considerable attention to contemporary changes in IPE, such as the growing influence of China, India, and Brazil as emerging economies and the challenge they present to the United States and other developed countries; and the effects of the global financial crisis and environmental changes on the prospects for growth in the global political economy.

Chapter 2 provides an overview of the history and institutions of the post-war international economic order; Chapters 3–5 discuss the basic assumptions and historical evolution of the IPE theoretical perspectives; and Chapters 6–11 cover monetary relations, global trade, trade regionalism, MNCs, international development, and foreign debt and financial crises. To assist students in understanding the issues and concepts, Chapters 1–11 have sections such as Questions and Key Terms, and Chapters 1–12 have suggestions for further reading.

**QUESTIONS**

1. What is IPE, and why do IPE scholars criticize some economists and political scientists? What is the relationship between “the state” and “the market”?
2. What is the 2008 global financial crisis, and what are some of its causes?
3. What is the importance of theory, and what are some of the main theoretical perspectives in IPE?
4. What are the hyper-globalist, moderate globalist, and internationalist views of globalization? Which group’s views do you find most convincing, and why?
5. Why has the North been so important in the management of the global economy? Do you think that the South is gaining in influence?
6. What are the East Asian NIEs, the BRIC economies, and the LLDCs? What do these groups tell us about economic disparities within the South?

**KEY TERMS**

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<td>economism</td>
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<td>gross national income</td>
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<td>market</td>
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<td>state</td>
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<td>internationalists</td>
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**FURTHER READING**


NOTES


22. Russia is not yet a WTO member.


Managing the Global Economy Since World War II: The Institutional Framework

In July 1944, delegates from 44 countries convened the Bretton Woods Conference, and within 22 days they endorsed a framework for international economic cooperation after World War II. Two international economic organizations resulted from the Bretton Woods Conference—the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD) or World Bank—and in 1948 the General Agreement on Tariffs and Trade (GATT) became the main global trade organization. These organizations were part of a complex institutional framework to help manage the postwar global economy. Although the Bretton Woods negotiations were “the first successful attempt . . . by a large group of nations to shape and control their economic relations,” only a small number of states had a critical role in the process. The three years of prenegotiations before Bretton Woods and the conference itself were “very much an Anglo-American affair, with Canada playing a useful mediating role,” and the chief conference planners were Harry Dexter White of the U.S. Treasury and John Maynard Keynes of Britain. Although French delegates were at the conference, France was still occupied by Germany; and Germany, Italy, and Japan as enemy states were not represented. Despite some basic differences of outlook, the Western DCs generally agreed on the postwar institutional order. Above all, they wanted to avoid a repetition of the interwar period experiences, when exchange controls and trade protectionism contributed to the 1930s Great Depression and World War II.

After providing some background on economic relations before World War II, this chapter introduces the postwar institutional framework that the North developed to manage the global economy. The chapter also focuses on two other groups of states that played only a limited role in establishing the postwar
economic order and at times sought to form an alternative order: the South and
the former East bloc led by the Soviet Union. Although 27 LDCs (19 of them
Latin American) were at the Bretton Woods Conference, their role was
marginal, and for many years the South had little influence in most postwar
economic institutions. The Soviet Union also played only a limited role in the
Bretton Woods Conference, and it refused to sign the final agreements. Instead
of joining the IMF, World Bank, and GATT, the Soviets established their own
economic institutions. This book examines how globalization has contributed
to the gradual integration of the South and the former East bloc with the liberal
economic order. We also discuss the challenges some major Southern states are
posing to the North’s dominance, especially since the 2008 global financial
crisis. Finally, this chapter discusses the role of nongovernmental actors
(business groups and NGOs) in the liberal economic order.

GLOBAL ECONOMIC RELATIONS BEFORE
WORLD WAR II

This section introduces some general historical benchmarks before World War II,
and Chapters 6–11 provide historical background on each issue area such as
trade and monetary relations.

The Mercantilist Period

The origins of IPE are closely associated with the development of modern
European states and their global markets. The modern European state gained
official recognition at the 1648 Treaty of Westphalia, which marked the defeat of
the Catholic Hapsburg countries by mostly Protestant countries in Northern
Europe. The Peace of Westphalia upheld state sovereignty and territorial integrity
by institutionalizing changes to prevent external religious and secular authorities
(e.g., the Pope, Holy Roman Emperor, and other states) from interfering in a
state’s internal affairs. A major factor enabling the state to establish its authority
vis-à-vis internal and external forces was the development of mercantilism. Adam
Smith, an eighteenth-century liberal economist who was highly critical of the
mercantilists, first used the term in reference to much of the economic thought
and practice in Europe from about 1500 to 1750. Mercantilists were acutely
aware of the linkage between politics and economics, viewing both power and
wealth as essential goals of national policy. The mercantilist states could use their
wealth to build up their armed forces, hire mercenaries, and influence their
enemies and allies. Thus, they accumulated gold and silver by seeking trade
advantages over others in the following ways: They increased their exports and
decreased their imports of manufactured goods, restricted raw material and
technology exports to prevent others from developing manufacturing capabili-
ties, and imported raw materials they needed to reduce costs for their own
manufacturers. Colonialism was central to mercantilism, because the colonies
provided the metropole with raw materials and served as markets for its manu-
factures; thus, manufacturing in the colonies was usually prohibited. Although Smith criticized mercantilists for following beggar-thy-neighbor policies that would lead to conflict, their emphasis on national power helped establish state authority and territorial unification. The European state system in turn contributed to the development of the global political economy.

Although sovereignty in principle gives states supreme authority within their own territory, there is a pecking order in which some states are more powerful than others. Chapter 3 of this book discusses hegemonic stability theory, which deals with the role of dominant or hegemonic powers in leading the international system. Some scholars have examined the role of “world powers” such as Portugal, Spain, the Netherlands, and Britain during the mercantilist period, but there is considerable debate as to whether these states were dominant enough to be hegemonic. Most hegemonic stability theorists refer to only two global hegemonic periods, both of them after the mercantilist period: under Britain in the nineteenth century and the United States in the twentieth century.

The Industrial Revolution and British Hegemony

*Mercantilism,* as the term is used in this book, is a preindustrial doctrine. The Industrial Revolution began in about 1780, affected only some manufactures and means of production, and initially progressed from region to region rather than involving entire countries. However, Britain became the hegemonic power in the nineteenth century as it was the first state to industrialize. By 1860 Britain accounted for about 37 percent of European industrial production, 20 percent of world industrial production, and 80 percent of newer technology industries. In view of its competitive edge, Britain shifted from mercantilist policies toward free trade: It removed most of its industrial trade restrictions by the 1830s, and in 1846 it repealed its *Corn Laws,* which had restricted agricultural imports. Britain’s decision to liberalize agricultural trade stemmed from both domestic and external factors. Domestically, industrial groups gained seats in the British Parliament at the expense of landed agricultural groups through legislative and demographic changes, and the agricultural elite could no longer prevent the repeal of the *Corn Laws.* Externally, Britain opened its markets to agricultural and raw material imports so that other countries would accept its manufactured goods. The division of labor served Britain’s hegemonic interests in promoting its industrial exports. Other states oriented their production in line with Britain’s preferences because it was the largest market for their exports. Moreover, Britain’s policies contributed to an extended period of free trade during the nineteenth century, and the 1860 *Cobden–Chevalier Treaty* between Britain and France resulted in a network of treaties lowering tariffs throughout Europe.

The Decline of British Hegemony and World War I

The growth of trade became slower in the late nineteenth century because of depressed economic conditions, industrial protectionism on the European continent, and a decline of British hegemony. A decrease in Britain’s productivity
relative to the United States and Germany made it less competitive in trade and less able to serve as a market for other countries’ exports. Banks and the state (including U.S. state governments) helped promote U.S. and German productivity through investment in industrial production and infrastructure such as railroads and canals, and the two countries built up their infant industries through protectionist policies that limited imports. Whereas Britain’s share of world trade fell from 24 percent in 1870 to 14.1 percent in 1913, Germany’s share rose from 9.7 to 12.2 percent and the U.S. share rose from 8.8 to 11.1 percent. On the eve of World War I, the United States had become the largest industrial power, accounting for about 32 percent of world industrial output. However, Britain continued to dominate in international finance. The city of London was the main center of the international financial system, the British pound was the key international currency, and in 1913 Britain accounted for about 43 percent of the world’s foreign investment. While Britain’s foreign liabilities increased during World War I, the United States emerged as a net creditor; thus financial preeminence finally shifted from London to New York after the war.

The Interwar Period

The United States emerged from World War I as the world’s largest industrial power and the only major net creditor. Although it lent about $10 billion to cash-short countries during the 1920s, some U.S. policies did not facilitate a return to an open, liberal economy. For example, the United States initially insisted that its close allies Britain and France repay all their war debts, and it imposed import barriers that made it difficult for Europeans to gain revenue from exports. The 1922 Fordney–McCumber Act raised U.S. customs duties, and when the U.S. economy moved into depression after the 1929 stock market crash, the 1930 Smoot–Hawley Act increased U.S. tariffs to their highest level in the twentieth century. European states retaliated with their own import restrictions, and world trade declined from $35 billion in 1929 to $12 billion in 1933. Hegemonic stability theorists argue that the lack of a global hegemon prevented the development of an open, stable international economy in the interwar period. Whereas Britain was the global hegemon in the nineteenth century, during the interwar period Britain was no longer able, and the United States was not yet willing, to assume the hegemon’s role. (Chapter 3 assesses the validity of hegemonic stability theory.) Other theorists argue that domestic U.S. politics lead to the economic disarray. The U.S. Constitution gives Congress the authority to regulate foreign commerce, but as a large unwieldy body, Congress could not resist constituent demands for protectionism from special interests. Thus, U.S. tariffs increased because of domestic politics despite the growing economic power of the United States.

In efforts to reverse the damage caused by the Smoot–Hawley tariff, the U.S. Congress passed the Reciprocal Trade Agreements Act (RTAA) in 1934. The RTAA delegated tariff-setting authority to the president, who could resist special interest pressures and negotiate tariff reductions more effectively than Congress. However, the RTAA reflected a conviction that the reduction of
tariffs through bilateral bargaining would help restore U.S. export markets, and “protection at home remained an important goal of American trade strategy.” Although the RTAA agreements resulted in a substantial reduction of some tariffs, tariff rates were so high in the early 1930s that the agreements were not sufficient to stem the forces of protectionism.

The Institutional Framework Before World War II
Most IOs formed from 1815 to 1914 were designed to utilize technological innovations and promote economic regulation and commerce mainly among European states. For example, the Central Commission for the Navigation of the Rhine was formed in 1815 to gain commercial advantages from the development of the steamship, the International Telegraph Union was established in 1865 to benefit from the invention of the telegraph, and the Universal Postal Union was created in 1874 to promote speedy and efficient postal deliveries. The first financial IO, the Bank for International Settlements (BIS), was established in Basle, Switzerland in 1930 to oversee the settlement of German reparations after World War I, but its main purpose was to promote cooperation among central banks (see Chapter 6). Other than the BIS, economic IOs in the interwar period were mainly concerned with developing international standards for facilities, equipment, and installations required for the functioning of the global economy. These organizations were not able to deal with major economic problems such as the Great Depression. As economic differences increased in the 1920s–1930s, several international conferences were convened to confront the trade and financial problems. For example, a 1922 conference in Genoa, Italy, pressured central banks to manage currency exchange rates and use currencies that were convertible into gold. However, these conferences failed to resolve the problems of war reparations and debt, disorderly currency exchange conditions, and a decline in world trade. In 1936, Britain, the United States, and France finally reached an agreement that recognized international responsibility for exchange rates. This experience emphasized the need for international bodies to promote open and stable economic relations after World War II and as a result the IMF, World Bank, and GATT were formed.

THE FUNCTIONS OF THE IMF, WORLD BANK, AND GATT
The United States emerged as a more mature power after World War II, both willing and able to lead. Under U.S. leadership, the North established institutions to develop a liberal economic order and prevent a recurrence of the interwar problems. As the hegemonic power, the United States had the most influence over the formation of the new institutions; however John Maynard Keynes, a British economist, also had an important role. Although some writers refer to the IMF, World Bank, and GATT as the Bretton Woods institutions, GATT was formed several years after the Bretton Woods Conference. We refer to these IOs as keystone international economic organizations (KIEOs) because of their central role in monetary relations, development, and trade. The IMF was created to monitor a
The KIEOs and the United Nations

system of *pegged or fixed exchange rates*, in which each currency had an official exchange rate in relation to gold and the U.S. dollar. This system was designed to avoid the competitive devaluation of currencies that led to trade wars during the interwar period. *Devaluation* refers to a reduction in the official rate at which one currency is exchanged for another. States with balance-of-payments deficits (i.e., with more money leaving than entering the country) may devalue their currencies in efforts to increase their exports and decrease their imports. Thus, the IMF provided short-term loans to help states deal with temporary balance-of-payments deficits and maintain the fixed exchange rates of their currencies. In contrast to the IMF’s short-term loans, the IBRD or World Bank provided long-term loans for postwar reconstruction in Europe and economic development in LDCs to avoid the financing problems that developed after World War I. The GATT lowered tariffs in multilateral trade negotiations, established rules for conducting international trade, and developed procedures for settling trade disputes. These functions were designed to avoid the protectionist barriers of the interwar period.

The functions of the KIEOs evolved as events unfolded after World War II. For example, European reconstruction was a larger task than anticipated, and the United States established the European Recovery Program (or Marshall Plan) in 1948 to give bilateral aid to Western Europe. The World Bank therefore had only a minor role in European reconstruction, and shifted its loans to LDCs for economic development. The IMF lost one of its main functions when the fixed-exchange-rate system for currencies collapsed in the 1970s and was replaced by floating exchange rates. However, the IMF’s role increased again in the 1980s and 1990s when it became the lead international agency for the foreign debt and financial crises (see Chapter 11). GATT was formed under special circumstances that affected its evolution. After the Bretton Woods Conference, negotiations were held to create an international trade organization (ITO) comparable in strength to the IMF and World Bank. However, the U.S. Congress refused to support the formation of the ITO, and the “temporary” GATT which had initiated postwar trade negotiations became our global trade organization by default (see Chapter 7). States joining GATT were “contracting parties” rather than formal members because it was designed to be a provisional treaty (this book uses the term *GATT members* for the sake of brevity). Despite its humble origins, GATT was quite effective in liberalizing trade; but its dispute settlement system was weak, its regulations were often circumvented, and it was unable to deal with new areas of trade. Thus, the formal *World Trade Organization* (WTO) superseded the informal GATT as the main global trade organization in 1995. Unlike GATT, the WTO deals not only with trade in goods but also with trade in services, intellectual property rights, and trade-related investment measures (see Chapter 7).

**THE KIEOs AND THE UNITED NATIONS**

Figure 2.1 shows that the IMF and World Bank are *specialized agencies* and that the World Bank is in fact a World Bank group of five institutions (see Chapter 10). As specialized agencies, the IMF and World Bank are
The United Nations System

Principal Organs

**Trusteeship Council**
- Military Staff Committee
- Standing Committee and ad hoc bodies
- Peacekeeping Operations and Missions
- Counter-Terrorism Committee

**Security Council**
- International Criminal Tribunal for the former Yugoslavia (ICTY)
- International Criminal Tribunal for Rwanda (ICTR)

**General Assembly**
- Main committees
- Human Rights Council
- Other sessional committees
- Standing committees and ad hoc bodies
- Other subsidiary organs

**Subsidiary Bodies**
- Research and Training Institutes
  - UNICRI United Nations International Crime and Justice Research Institute
  - UNITAR United Nations Institute for Training and Research

- Other UN Entities
  - UNOPS United Nations Office for Project Services
  - UNU United Nations University

- Other UN Trust Funds
  - UNFIP United Nations Fund for International Partnerships
  - UNDEF United Nations Democracy Fund

- Programs and Funds
  - UNCTAD United Nations Conference on Trade and Development
  - ITC International Trade Centre (UNCTAD/WTO)
  - UNDCP United Nations Drug Control Programme
  - UNEP United Nations Environment Programme
  - UNICEF United Nations Children’s Fund
  - UNDP United Nations Development Programme
  - UNIFEM United Nations Volunteers
  - UNCDF United Nations Capital Development Fund
  - UNFPA United Nations Population Fund
  - UNHCR Office of the United Nations High Commissioner for Refugees
  - UNICEF United Nations Children’s Fund

**Research and Training Institutes**
- UNRISD United Nations Research Institute for Social Development
- UNIDIR United Nations Institute for Disarmament Research
- UN-INSTRAW United Nations International Research and Training Institute for the Advancement of Women

**Other UN Entities**
- UNRWA United Nations Relief and Works Agency for Palestine Refugees in the Near East
- UN-HABITAT United Nations Human Settlements Programme
- UNICEF United Nations Children’s Fund
- UNDP United Nations Development Programme
- UNIFEM United Nations Volunteers
- UNCDF United Nations Capital Development Fund
- UNFPA United Nations Population Fund
- UNHCR United Nations High Commissioner for Refugees
- UNICEF United Nations Children’s Fund
- WFP World Food Programme
- UNRWA United Nations Relief and Works Agency for Palestine Refugees in the Near East
- UN-HABITAT United Nations Human Settlements Programme

**NOTES:**
1. The UN Drug Control Programme is part of the UN Office on Drugs and Crime.
2. UNRWA and UNIDIR report only to the GA.
3. The United Nations Economic Commission for Latin America and the Caribbean (ECLAC) and the Chief Information Technology Officer report directly to the Secretary-General.
4. In an exceptional arrangement, the Under-Secretary-General for Field Support reports directly to the Under-Secretary-General for Peacekeeping Operations.
5. UNFIP is an autonomous trust fund operating under the leadership of the United Nations Deputy Secretary-General. UNDEF’s advisory board recommends funding proposals for approval by the Secretary-General.

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**FIGURE 2.1**
The United Nations System

autonomous organizations affiliated with the United Nations. Although they report on their activities to the Economic and Social Council (ECOSOC)—a principal UN organ—once a year, the United Nations has little authority over them. Indeed, the United Nations signed an agreement with the World Bank (and a similar one with the IMF), acknowledging that “it would be sound policy to refrain from making recommendations to the Bank with respect to particular loans or with respect to terms or conditions of financing.”20
The UN General Assembly has at times tried to influence World Bank lending decisions, but it has been largely unsuccessful. When the WTO was established in 1995, the members decided it should be a “related organization” rather than a specialized agency, so it does not even issue a yearly report to the ECOSOC (see Figure 2.1).

A major reason for the lack of UN leverage is that the IMF, World Bank, and WTO do not seek UN funds. In September 1995, the United Nations even indicated that it might deal with its deficits by borrowing money from the World Bank, but some major UN members vetoed this idea. The DCs have directed most of their funds for multilateral economic management to the IMF and World Bank because they prefer their weighted voting systems to the one-nation, one-vote system of many UN bodies (see Chapters 6 and 10). Despite the United Nations’ limited leverage, it has sometimes induced the KIEOs to revise their policies and adopt new programs. Examples include the UN role in the World Bank’s creation of a soft-loan agency (see Chapter 10), the IMF’s establishment of a compensatory financing facility (see Chapter 6), and the IMF and World Bank’s decision to introduce human and social dimensions in their lending programs. The World Bank has also cooperated with UN bodies in providing development assistance.

**THE POSTWAR ECONOMIC INSTITUTIONS AND CHANGING NORTH–SOUTH RELATIONS**

The North has had the dominant role in the postwar global economy and in most international economic institutions. However, some major Southern states have posed a challenge to this Northern dominance in recent years, especially since the 2008 global financial crisis. The North’s role in the global economy is marked by several characteristics:

- The United States has been the most powerful single state, but its economic hegemony is giving way to a triad composed of North America, Western Europe, and East Asia.
- The DC-led triad is responsible for the largest share of global economic transactions, including foreign investment, trade in manufactures and services, and capital flows.
- Countries within the triad have conducted most of their international economic transactions, such as foreign direct investment and intra-industrial trade, with each other.

Although the DCs have occupied the dominant position in the global economy, some developing and transition economies are increasing their economic power and challenging the DCs’ dominance. This book will focus on four groups that have posed the biggest challenge:

- The Organization of Petroleum Exporting Countries (OPEC) formed in 1960 is a group of LDC oil exporters that acts as a resource cartel to...
manipulate oil supplies and prices. OPEC posed a major challenge to DCs in the early 1970s when it limited oil supplies and drastically increased prices. Although OPEC’s influence declined in the 1980s and 1990s, its control over oil supplies has become more critical in recent years. The current members of OPEC are Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela.

- A small number of rapidly developing **newly industrializing economies** (NIEs) in East Asia and Latin America presented a growing competitive challenge to the North in the early 1980s. The most prominent NIEs include Hong Kong, Singapore, South Korea, Taiwan, Argentina, Brazil, and Mexico.

- The rapidly growing Brazil, Russia, India, and China economies—or **BRIC economies** as coined by a researcher with Goldman Sachs in 2001—pose a major challenge to the North. Most notably, China displaced Germany in 2009 as the world’s largest merchandise exporter, and has recently displaced Japan as the world’s second largest economy after the United States. Some economists predict that India’s economic growth will soon begin to outpace China’s.\(^\text{25}\)

- The **emerging market economies** are developing and transition economies that have adopted many elements of a free-market system and have achieved rapid economic growth. The emerging economies include many BRIC, NIE, and OPEC economies, and some other LDCs and transition economies.\(^\text{26}\)

The following discussion shows that although the North continues to have the most influence in the international economic organizations, the pressure for change is increasing, especially from the BRICs and other important emerging economies.

### The IMF, World Bank, and WTO

Most of the funding for IMF and World Bank loans comes from the North, and five DCs—the United States, Japan, Germany, Britain, and France—have had the most votes in these institutions. Although the WTO has a one-nation, one-vote system, the major trading nations, mainly DCs, are instrumental in setting the agenda for multilateral trade negotiations. Moreover, the North has had a dominant position in the bureaucracies of these institutions. By tacit agreement, the World Bank president has always been American, and the IMF managing director has always been European. All the GATT/WTO directors general have been from DCs except Supachai Panitchpakdi of Thailand, who was the WTO director general from 2002 to 2005. The South has also been underrepresented on the professional staffs of all three KIEOs, and most Communist states were not KIEO members from the 1940s to the 1970s.\(^\text{27}\) The KIEOs have made some moves to give the South more voice, especially since the 2008 global financial crisis. For example, the IMF agreed to quota
increases for emerging countries such as China, South Korea, Mexico, and Turkey; the World Bank shifted some voting power from smaller European countries to China, India, and Brazil, and as a result the Bank received the first general increase in its capital since 1988. Despite the changes for emerging economies, critics in NGOs such as Oxfam argue that the gains are “all but meaningless” for the poorest LDCs.  

The KIEOs are often credited with contributing “to almost unprecedented global economic growth and change over the past five decades.” However, the type of growth these institutions foster has closely followed the prescriptions of the North. The KIEOs support a liberal economic approach, which holds that the free flow of goods and capital throughout the world promotes prosperity. (Critical theorists by contrast argue that the liberal economic approach benefits some states and individuals at the expense of others.) In the 1950s and 1960s, the liberal economic order contributed to economic growth and stability for several reasons. First, the Cold War increased U.S. determination to cooperate economically with Western Europe and Japan; vigorous economic recovery was viewed as a prerequisite for a strong anti-Soviet alliance. Second, the United States as global hegemon helped establish principles and rules for the conduct of postwar trade, financial, and monetary relations, and the major DCs generally accepted U.S. leadership. Third, the KIEOs enabled governments to abide by international rules and obligations without jeopardizing domestic policy objectives such as full employment.  

In the 1970s, however, several changes began to pose serious problems for the KIEOs. First, the United States became less supportive of economic liberalism as its economic dominance declined; for example, U.S. protectionism increased after its balance of trade shifted to a deficit position in 1971. Europe and Japan also began to question U.S. leadership, and frictions among DCs increased with the decline of the Cold War. Second, the Arab OPEC countries limited the supply of oil after the October 1973 Middle East War, and oil prices increased by more than 400 percent; this disrupted the global economy and challenged the management capabilities of the KIEOs. Third, the KIEOs had difficulty managing the forces of globalization, because their economic resources “pale in comparison to daily market-driven foreign exchange cash flows,” and no IO regulates the MNCs and international banks which are major contributors to these capital flows. Finally, the growing membership of the KIEOs with the influx of LDCs and transition economies has sorely tested their management capabilities. By October 2010, the membership of the IMF, World Bank, and WTO had grown to 187, 187, and 153 states, respectively. This enlargement makes the KIEOs more broadly representative, but their large, diverse memberships can pose an obstacle to consultation, coordination, and decision making.  

The large memberships of the IMF, World Bank, and WTO have caused some analysts to argue that “they must be led by a much smaller core group
The Postwar Economic Institutions and Changing North–South Relations

Organization for Economic Cooperation and Development (Year of Admission)

<table>
<thead>
<tr>
<th>Country</th>
<th>Year of Admission</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>1971</td>
</tr>
<tr>
<td>Austria</td>
<td>1961</td>
</tr>
<tr>
<td>Belgium</td>
<td>1961</td>
</tr>
<tr>
<td>Canada</td>
<td>1961</td>
</tr>
<tr>
<td>Chile</td>
<td>2010</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1995</td>
</tr>
<tr>
<td>Denmark</td>
<td>1961</td>
</tr>
<tr>
<td>Finland</td>
<td>1969</td>
</tr>
<tr>
<td>France</td>
<td>1961</td>
</tr>
<tr>
<td>Germany</td>
<td>1961</td>
</tr>
<tr>
<td>Greece</td>
<td>1961</td>
</tr>
<tr>
<td>Hungary</td>
<td>1996</td>
</tr>
<tr>
<td>Iceland</td>
<td>1961</td>
</tr>
<tr>
<td>Ireland</td>
<td>1961</td>
</tr>
<tr>
<td>Israel</td>
<td>2010</td>
</tr>
<tr>
<td>Japan</td>
<td>1964</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1961</td>
</tr>
<tr>
<td>Mexico</td>
<td>1994</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1961</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1973</td>
</tr>
<tr>
<td>Norway</td>
<td>1961</td>
</tr>
<tr>
<td>Poland</td>
<td>1996</td>
</tr>
<tr>
<td>Portugal</td>
<td>1961</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>2000</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2010</td>
</tr>
<tr>
<td>South Korea</td>
<td>1996</td>
</tr>
<tr>
<td>Spain</td>
<td>1961</td>
</tr>
<tr>
<td>Sweden</td>
<td>1961</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1961</td>
</tr>
<tr>
<td>Turkey</td>
<td>1961</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1961</td>
</tr>
<tr>
<td>United States</td>
<td>1961</td>
</tr>
</tbody>
</table>

**Figure 2.2**

Groups of Developed Countries

whose weight confers on them the responsibility of leadership.” The decline of U.S. economic hegemony has also contributed to the need for collective leadership, and DCs often confer among themselves before seeking endorsement of their policies by the KIEOs. As Figure 2.2 shows, the smaller DC-led groups include the Organization for Economic Cooperation and Development (OECD), Group of 10 (G10), and Group of Seven (G7). Although the G7 superseded the Group of Five (G5) in 1986, we include the G5 because of its members’ influence in the IMF and World Bank. Whereas liberal economists believe that these groups promote economic leadership
and stability, critical theorists argue that they exclude LDCs from the decision-making process.

The OECD
The OECD, which is located in Paris, has 33 mainly DC members (see Figure 2.2). When the OECD was created in 1961, the United States viewed it as a forum where it “could sit down together on equal terms” with “the Europeans and other ‘industrial democracies’.” The OECD is committed to liberalizing international transactions such as trade and capital flows, and in this sense it has been an agent of globalization. The OECD also serves as a forum for the North to discuss members’ economic policies and promote policy coordination. In an age of globalization, a state’s domestic policies often have international consequences, and OECD members try to reach a consensus on domestic policies that will minimize conflict. The OECD usually operates through a system of mutual persuasion, in which members exert peer pressure on each other to meet their commitments.

The North also uses the OECD to develop a more unified position on issues in the IMF, World Bank, and WTO. For example, the OECD’s work on services trade helped the North legitimize the idea that the WTO should include rules for trade in services as well as goods. Although the OECD normally maintains a low profile, its efforts to negotiate a Multilateral Agreement on Investment (MAI) in the 1990s were highly controversial. The MAI would have provided much more protection for Northern investors than for Southern recipients, and the negotiations were suspended in 1998 because of divisions among OECD members and strong opposition by LDCs and civil society groups (see Chapter 9).

In earlier years, the DC economies in the OECD accounted for a vast share of world production, trade, and advances in science and technology. However, that share has been decreasing as emerging countries have been integrated into the global economy. This led to growing pressure on the OECD to include nonmembers in its work, and in 1992 the OECD decided to develop principles for participation and eventual membership of nonmembers to retain its influence. As Figure 2.2 shows, nine countries outside the industrial core group became OECD members after 1992: Mexico in 1994; the Czech Republic in 1995; Hungary, Poland, and South Korea in 1996; the Slovak Republic in 2000; and Chile, Slovenia, and Israel in 2010. The OECD is also involved in accession talks with Estonia and Russia, and has offered “enhanced engagement” to Brazil, China, India, Indonesia, and South Africa. Enhanced engagement has the potential to lead to future membership. Critics argue that further enlargement will jeopardize the OECD’s strength as an organization of like-minded members, that China and Russia do not meet the democratic requirements of OECD members, and that too much enlargement will turn the OECD into a mini United Nations. However, others question whether the OECD can retain its importance if it does not include the emerging economies.
The G10, G5, G7, G8, and G20

These groups are smaller and much more informal than the OECD. For a number of years the most influential groups (the G10, G5, G7, and G8) were largely comprised of DCs; but more recently the G20 (composed of DCs and emerging economies) has become much more important. The G10, which was formed in 1962, includes 11 countries: the United States, Japan, Germany, France, Britain, Italy, Canada, Belgium, the Netherlands, Sweden, and Switzerland (see Figure 2.2). In the early 1960s, the IMF lacked sufficient funding to meet its members’ borrowing requirements; therefore, the G10 countries established the General Arrangements to Borrow (GAB) to provide the IMF with supplementary loans if needed (see Chapter 6). This represented a shift from U.S. to collective management, because the G10 had to approve each IMF request for supplementary support. Although the OECD and G10 continued to coordinate DC economic policies, the main focus of policy coordination shifted in the 1970s to the G5 and G7, which had some special advantages.

- They were smaller informal groups without formal constitutions.
- They included the most powerful DCs in the global economy.
- Top political leaders with authority to implement agreements often attended their meetings.\(^3^8\)

The G5 included the finance ministers and central bank governors of the five largest DC economies with the most votes in the IMF and World Bank: the United States, Japan, Germany, France, and Britain (see Figure 2.2). The G5, which had informal discussions since its formation in 1967, began holding more formal summit meetings in 1975. Later, when Italy and then Canada were invited to attend, the G7 was created. The G7 summits resulted from the move toward collective leadership with the decline of U.S. economic hegemony, the growing interdependence among DCs, the 1973–1974 OPEC oil crisis, and the world economic recession. G7 members use the summits to reach a consensus on key issues at the highest political level. From 1975 to 1986, the G5 and G7 both continued to meet, but the G7 superseded the G5 in 1986. Presently, the G7 has two layers: At the top level are heads of state or government who meet in annual summits, and at the second level are finance ministers and central bank governors. In 1991 the G7 invited Russia to the summit to help it come to terms with its loss of superpower status and to encourage it to continue with economic and political reforms. Russia gradually became more involved, and the G7 became the **Group of Eight** (G8). However, Russia is more involved in political than economic discussions, and only the G7 countries’ finance ministers continue to meet to discuss economic issues.\(^3^9\)

Most analysts consider the G8 to be an informal forum of individual leaders rather than an institution. It has no constitution or legal status, no headquarters or formal meeting place, no formal rules of membership, and no means to enforce its decisions. The main G8 objectives are “to raise consciousness, set an agenda, create networks, prod other institutions to do things that they should be doing, and, in some cases to help create institutions.”\(^4^0\) Although the G8 has
been quite successful in some areas such as managing the end of the Cold War and addressing the issue of debt relief for LDCs, its influence has declined because of DC divisions with the demise of the Cold War and the difficulties in coping with globalization; for example, massive international capital flows interfere with the ability of G8 monetary authorities to influence currency markets.

Most importantly, G8 members had to confront the fact that, other than Russia, they did not include major emerging economies such as China, India, and Brazil. The DCs in the G7 accounted for about 65 percent of global output from 1965 to 2002, but by 2008 their share had fallen to 52 percent, and their share of global output is expected to fall to 37 percent by 2030 and to 25 percent by 2050. Thus, the **Group of 20 (G20)** was formed in 1999, and it became a permanent forum for informal dialogue among “systematically important” developed and emerging economies. As Table 2.1 shows, the G20 includes 19 countries and the European Union. The immediate motivation for creating the group was the East Asian financial crisis in the 1990s (see Chapters 10 and 11). As with the G7/G8, the G20 is not a decision-making body, has no charter or permanent staff, and does not take votes or make legally binding decisions. Instead, the G20 finance ministers and central bank governors try to reach a consensus on economic and financial issues, shape the international agenda, and lead by example. As this book discusses, the role of the emerging economies in the global economy is increasing, and it is not surprising that the G20 has become more important than the G7/G8. The countries in the G20 represent about two-thirds of the world’s population and 85 percent of the global GNP. The 2008 global financial crisis further increased the G20’s influence, and in September 2009 the major countries decided that the G20 should replace the G8 as the main forum for discussing global economic issues. Some DCs want the G8 members to continue to have global influence because the larger, more diverse G20 is vulnerable to divisions between the United States and China, and between regional groups (Europe, North America, and Asia). The G20 has clearly eclipsed the G8 as the main informal group dealing with global economic issues; but to this point the G20 has not been very effective in dealing with the economic problems related to the global financial crisis.

<table>
<thead>
<tr>
<th>Table 2.1: The Group of Twenty (G20)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
</tr>
<tr>
<td>Australia</td>
</tr>
<tr>
<td>Brazil</td>
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<tr>
<td>Canada</td>
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<tr>
<td>China</td>
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<tr>
<td>France</td>
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<tr>
<td>Germany</td>
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<tr>
<td>India</td>
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<tr>
<td>Indonesia</td>
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<tr>
<td>Italy</td>
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<tr>
<td>Japan</td>
</tr>
<tr>
<td>South Korea</td>
</tr>
<tr>
<td>Mexico</td>
</tr>
<tr>
<td>Russia</td>
</tr>
<tr>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>South Africa</td>
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<tr>
<td>Turkey</td>
</tr>
<tr>
<td>United Kingdom</td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>European Union</td>
</tr>
</tbody>
</table>
POSTWAR ECONOMIC INSTITUTIONS AND THE SOUTH

The G20 is more representative than the G8 because it includes a number of emerging economies from different geographic regions: Argentina, Brazil, China, India, Indonesia, Mexico, Saudi Arabia, South Africa, South Korea, and Turkey. However, these are “systematically important” economies, and there is no seat at the G20 for the poorest LDCs. It is important to be aware that poverty, disease, and hunger are prevalent in much of the world, and that a major gulf remains between the North and much of the South. The Bretton Woods system and its institutions are often credited with contributing “to almost unprecedented global economic growth and change over the past five decades.”

However, this economic growth has not been shared by all. We begin by looking at the South’s position vis-à-vis the North in general, and we then discuss the divisions within the South. The most common measure economists use to compare the economic development of states is per capita GDP or per capita income (a country’s GDP or GNI divided by its population). We use exchange rates, or the rates at which currencies are exchanged for one another, to convert per capita GDP figures in other currencies into the U.S. dollar (the key international currency). However, comparing countries’ per capita GDPs does not tell us fully about their standards of living because the exchange rate does not accurately reflect the purchasing power of the local currency in each country. Countries often have different price levels for comparable goods, and prices are generally lower in LDCs than in DCs. In comparing per capita GDPs, we therefore often convert the figures into purchasing power parity (PPP) based exchange rates. PPP rates are “the number of units of a country’s currency required to buy the same amount of goods and services in the domestic market as a United States dollar would buy in the United States.” For example, The Economist magazine has used a “Big Mac index” to compare PPP rates for hamburgers. If a Big Mac costs 2.75 euros in countries using the euro and $2.65 in the United States, the PPP exchange rate for Big Macs would be 2.75/2.65, or 1.0377. The PPP rate for different goods and services are weighted according to their importance in the economy. PPP exchange rates have limitations because they are based on price comparisons of “comparable items”; but the quality of these items may differ across countries. Nevertheless, they are more accurate in comparing living standards, and this book sometimes provides PPP-adjusted per capita GDP figures (e.g., see Table 2.2).

Even PPP-weighted figures are an imperfect indicator of well-being because they do not take account of income inequalities, leisure time, and quality of the environment. For example, a country where a relatively small number of people are extremely rich and most are extremely poor has less well-being than a country with the same per capita GDP that has less extreme wealth and poverty. Furthermore, PPP-adjusted per capita GDP figures only measure a country’s economic development. Since 1990 the United Nations Development Program (UNDP) has published a Human Development Report with a human development index (HDI) that measures social as well as economic development. The HDI includes three dimensions: a long life measured by life expectancy at birth, knowledge measured by adult literacy
### TABLE 2.2

Human Development Index (HDI), GDP per Capita, and GDP per Capita Rank Minus HDI Rank, 2007

<table>
<thead>
<tr>
<th>Country</th>
<th>HDI Value (and Rank)</th>
<th>GDP Per Capita (PPP* U.S.$)</th>
<th>GDP per Capita (PPP* U.S.$) rank minus HDI rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway</td>
<td>0.971 (1)</td>
<td>53,433</td>
<td>4</td>
</tr>
<tr>
<td>Canada</td>
<td>0.966 (4)</td>
<td>35,812</td>
<td>14</td>
</tr>
<tr>
<td>Japan</td>
<td>0.960 (10)</td>
<td>33,632</td>
<td>16</td>
</tr>
<tr>
<td>United States</td>
<td>0.956 (13)</td>
<td>45,592</td>
<td>−4</td>
</tr>
<tr>
<td>Germany</td>
<td>0.947 (22)</td>
<td>34,401</td>
<td>2</td>
</tr>
<tr>
<td>Korea, Republic of</td>
<td>0.937 (26)</td>
<td>24,801</td>
<td>9</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>0.903 (35)</td>
<td>54,626</td>
<td>−31</td>
</tr>
<tr>
<td>Poland</td>
<td>0.880 (41)</td>
<td>15,987</td>
<td>12</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.854 (53)</td>
<td>14,104</td>
<td>5</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>0.817 (71)</td>
<td>14,690</td>
<td>−16</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.813 (75)</td>
<td>9,567</td>
<td>4</td>
</tr>
<tr>
<td>China</td>
<td>0.772 (92)</td>
<td>5,383</td>
<td>10</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.734 (111)</td>
<td>3,712</td>
<td>10</td>
</tr>
<tr>
<td>Botswana</td>
<td>0.694 (125)</td>
<td>13,604</td>
<td>−65</td>
</tr>
<tr>
<td>South Africa</td>
<td>0.683 (129)</td>
<td>9,757</td>
<td>−51</td>
</tr>
<tr>
<td>India</td>
<td>0.612 (134)</td>
<td>2,753</td>
<td>−6</td>
</tr>
<tr>
<td>Pakistan</td>
<td>0.572 (141)</td>
<td>2,496</td>
<td>−9</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>0.543 (146)</td>
<td>1,241</td>
<td>9</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>0.414 (171)</td>
<td>779</td>
<td>0</td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>0.365 (180)</td>
<td>679</td>
<td>−5</td>
</tr>
<tr>
<td>Niger</td>
<td>0.340 (182)</td>
<td>627</td>
<td>−6</td>
</tr>
</tbody>
</table>

*Purchasing power parity


rates and school enrollments, and a decent standard of living measured by PPP-adjusted per capita GDPS. A major problem with the HDI is collecting data; for example, the 2009 Human Development Report does not provide an HDI for 12 UN member states (all LDCs) because of a lack of reliable data, and the report’s statistics are incomplete for a number of other LDCs.46

Table 2.2 compares HDI values and per capita GDPS for a number of countries during 2007. The first column lists each country’s HDI value and rank, the second lists its PPP-adjusted per capita GDP, and the third lists its per capita GDP rank minus its HDI rank. For example, in 2007 Norway ranked first (of 182 countries) in HDI and fifth in GDP per capita, so its figure in the third column is (5–1) or plus 4; the United States ranked thirteenth in HDI and ninth in GDP per capita, so its figure in the third column is (9–13) or minus 4. Some countries have
HDI rankings that are much lower than their per capita GDP rankings. For example, Table 2.2 shows that the HDI rankings for Botswana and South Africa were lower than their per capita GDP rankings by 65 and 51, respectively. Lower HDI rankings relative to per capita GDP in Africa often result from the high incidence of HIV/AIDS (human immunodeficiency virus/acquired immunodeficiency syndrome). For example, Botswana has an adult HIV prevalence estimated at 23.9 percent, the second highest in the world after Swaziland. Life expectancy in Botswana fell from 65 years in 1990–1995 to less than 40 years in 2000–2005.47

Two other countries in Table 2.2, Norway and the United Arab Emirates (UAE), are oil-rich countries. However, the UAE’s HDI rank is well below its GDP per capita rank (minus 31 in column 3), while Norway ranks first in HDI. Norway is a developed country in which health care, education, and other social benefits are widespread throughout the population. The UAE has been able to transform itself from seven small impoverished desert principalities to a relatively modern state, but the benefits have been less widespread among the population. Although the UAE has a high mean per capita GDP, it is skewed—not only toward UAE nationals over foreign laborers, but also toward Abu Dhabi and Dubai over the other principalities. The society also sometimes discourages women from meeting their economic potential.48 Russia’s HDI rank is also well below its per capita GDP rank (minus 16). Although Russia’s economic standing has increased greatly in recent years because of its energy wealth, it has been undergoing a “mortality crisis” in human terms. Life expectancy for Russian men was 59 years in 2003, down from 65 years in the mid-1960s. Russians have high rates of cardiovascular disease, tuberculosis, HIV/AIDS, and homicide and suicide. Scholars often attribute Russia’s high mortality rates to instability caused by transition from Communism to a free market system, but this is not the case in transition economies such as Poland, where life expectancy has been increasing.49

Despite the disparities between the HDI and per capita GDP rankings, Table 2.2 shows that both HDIs and per capita GDPs tend to be higher for DCs than LDCs. The five DCs on the list (Norway, Canada, Japan, the United States, and Germany) have the highest HDIs as well as per capita GDPs; and the six LDCs with the lowest per capita GDPs on the list (India, Pakistan, Bangladesh, Ethiopia, Sierra Leone, and Niger) also have the lowest HDI values on the list. This is not surprising, because the poorest LDCs are less able to provide health care and education to their population. However, it is important to note that HDI values also have limitations in measuring well-being. For example, the HDI does not measure political aspects of human rights such as free speech and elections. Table 2.2 shows that China’s HDI rank exceeds its per capita GDP rank (by 10), whereas India’s HDI rank is lower than its per capita GDP rank (by 6); these figures do not reflect the fact that India has a more democratic political system than China. The HDI ranking also is not always a good predictor of the future. Although Iceland ranked third in HDI in 2007, it was one of the countries most severely affected by the 2008 global financial crisis! Despite its shortcomings, the HDI is important because it takes account of social as well as economic aspects of development.
In some respects, conditions of LDCs have improved on average in recent years. For example, since 1990 life expectancy in the South has increased by two years, 3 million fewer children are dying annually, and 30 million fewer children are out of school. High income growth in China and India has been a powerful factor behind the improving LDC income poverty figures overall, but this tends to mask the lack of progress in a number of other countries. The most severe problems are in Sub-Saharan Africa, the only region where HDI scores have been decreasing. Sub-Saharan Africa’s problems stem from colonial experience, economic reversals, and the human costs of conflict, but the most important factor has been HIV/AIDS. Three million people died from AIDS in 2005 alone, and more than 39 million are infected with HIV. The following statistics provide stark examples of the North–South socioeconomic gap:

- Forty percent of the world’s population lives on less than $2 a day and accounts for only 5 percent of global income. The richest 10 percent of the world’s population by contrast accounts for 54 percent of global income.
- Ninety percent of the people in OECD countries are in the top 20 percent of the global income distribution.
- The average life expectancy gap between low- and high-income countries is about 19 years. Japan’s life expectancy is 35 years longer than Burkina Faso’s, and the United States’ is 14 years longer than India’s.
- Almost all child deaths occur in the South, while most of the funds to prevent child deaths are spent in the North.

Although the North–South gap is the most important division, there are also major differences within the South. Table 2.3 shows that Latin America, East Asia, and the Arab states score higher in terms of most socioeconomic indicators than South Asia and Sub-Saharan Africa. For example, in 2007 the HDI index ranged from 0.821 in Latin America and the Caribbean to 0.514 in Sub-Saharan Africa; life expectancy ranged from 73.4 years in Latin America and the Caribbean to 51.5 years in Sub-Saharan Africa; the adult literacy rate ranged from 92.7 percent in East Asia and the Pacific to 62.9 percent in Sub-Saharan Africa; and the PPP-adjusted GDP per capita ranged from $10,007 in Latin America and the Caribbean to $2,031 in Sub-Saharan Africa. Although Latin America and the Caribbean had the highest GDP per capita on average, the East Asian NIEs had higher incomes than any Latin American state in 2007. For example, the per capita GDPs for Singapore; Hong Kong, China; and South Korea were $49,704, $42,306, and $24,801, respectively. This compared with per capita GDPs for Mexico, Chile, and Argentina of $14,104, $13,880, and $13,238, respectively. Table 2.3 also shows that East Asia and the Pacific have had higher annual GDP per capita growth rates (6.1 and 5.8 percent) than other LDC regions. Chapters 10 and 11 discuss the reasons for the economic prosperity of the East Asian NIEs. In marked contrast to East Asia and Latin America is Sub-Saharan Africa, which scores lowest in HDI value, GDP per capita, GDP per capita growth rate, life expectancy, and adult literacy (see Table 2.3).
In 1971 the United Nations compiled a list of 24 least developed countries (LLDCs), which has now grown to 49 countries. The United Nations describes the LLDCs as having low per capita incomes; weak human assets (i.e., nutrition, health, school enrollment, and adult literacy); and high economic vulnerability (i.e., instability of production and exports, exposure to shocks, and economic smallness and remoteness). Thirty-four of the 49 LLDCs are in Africa; the others are in Asia and in islands in the Pacific and the Caribbean. The LLDCs as a group had fairly strong economic growth from 2002 to 2007, but that is currently in jeopardy. With the 2008 global financial crisis, LLDCs have lost export revenue because of declining commodity prices and have found it more difficult to attract external finance. LLDCs as a group also have high levels of indebtedness, amounting to 42 percent of their GNI. The DCs have indicated that their foreign aid, or official development assistance (ODA), to LLDCs will not decline, but historical trends show that donor countries tend to shift their funds from aid-giving to domestic budgetary priorities in response to financial crises. LLDCs also depend on remittances, or the transfer of money from foreign workers to family members and others in their home countries. This basic source of supplementary income in LLDCs is also under threat because of the financial crisis. Thus, the 2009 United Nations Least Developed Countries Report warns that the LLDCs are likely to be the major victims of the global financial crisis.51

### TABLE 2.3

<table>
<thead>
<tr>
<th>Human Development Indicators</th>
<th>GDP per Capita (PPP(^a) U.S.)</th>
<th>GDP per Capita Annual Growth Rate</th>
<th>Life Expectancy at Birth (years)</th>
<th>Adult Literacy Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America and Caribbean</td>
<td>0.821</td>
<td>10,077</td>
<td>0.7</td>
<td>1.2</td>
</tr>
<tr>
<td>East Asia and Pacific States</td>
<td>0.770</td>
<td>5,733</td>
<td>6.1</td>
<td>5.8</td>
</tr>
<tr>
<td>Arab States</td>
<td>0.719</td>
<td>8,202</td>
<td>0.7</td>
<td>2.3</td>
</tr>
<tr>
<td>South Asia</td>
<td>0.612</td>
<td>2,905</td>
<td>2.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>0.514</td>
<td>2,031</td>
<td>−0.5</td>
<td>0.5</td>
</tr>
</tbody>
</table>

\(^a\)Purchasing power parity
\(^b\)Data refer to national literacy estimates from surveys conducted between 1999 and 2007.

It is also important to consider inequities within states. Statistics show that within-country income inequality declined from the 1950s to 1970s in most DCs, LDCs, and centrally planned economies (CPEs). However, this decline slowed beginning in the 1980s, and income inequality has been increasing in many states in recent years. Within-country inequities stem from differences in educational opportunities, gender, race and ethnicity, and region of birth. For example, there are persistent gender gaps in access to education, employment, and equitable pay for work. Women account for about two-thirds of adult illiteracy today. Although the number of women in the workforce has increased in LDCs, they usually have lower pay and poorer working conditions. Some areas such as rural China and northwest India have significantly more boy than girl infants because of sex-selective abortion and differential care after birth. Although this book discusses within-country inequities and inequities among LDCs, it gives more emphasis to North–South inequities. Some LDCs have improved their socioeconomic positions, but many have been frustrated in their efforts to promote development and exert more influence. Because most LDCs are in a weak position individually, only collective action provides some opportunity to extract concessions from the North. From the South’s perspective, some KIEO policies pose major obstacles to economic development. This chapter briefly discusses the United Nations Conference on Trade and Development (UNCTAD), which gives priority to the interests of LDCs (see Chapter 7).

In the 1960s many LDCs gained political independence, and the number of African and Asian states in the United Nations increased from 10 in 1955 to 55 in 1966. In 1964, the 77 LDCs in the United Nations from Africa, Asia, and Latin America (“the Third World”) met to express their dissatisfaction with the KIEOs, and this LDC caucus, which now has 130 members, is still referred to as the Group of 77 (G77). The G77 was highly critical of GATT, which it viewed as a rich countries’ club, and it was instrumental in organizing the first United Nations Conference on Trade and Development, or UNCTAD I, in March 1964. UNCTAD subsequently became a permanent forum or conference under the UN General Assembly, with facilities to do research and policy analysis (see Figure 2.1). Unlike the KIEOs, UNCTAD depends on UN funds for its operating budget and its technical cooperation activities. Although all UN members are in UNCTAD, its secretariat openly supports LDC interests, and the UNCTAD secretary general has always been from the South. UNCTAD established some international commodity agreements and has induced the GATT/WTO to give more priority to Southern trade interests (see Chapter 7). However, the DCs refused to accept UNCTAD as a major forum for trade negotiations, and the WTO continues to be the unrivaled global trade organization. UNCTAD acts mainly as a pressure group for Southern interests and as a source of technical expertise. For example UNCTAD has assisted LDCs with the complex process of joining the WTO. In recent years, UNCTAD’s critical approach has been replaced by a greater acceptance of orthodox liberalism, but the 2008 global financial
Postwar Economic Institutions and the Centrally Planned Economies

All states can become members of the IMF, World Bank, and WTO, which are universal membership organizations. However, the CPEs of Eastern Europe, the Soviet Union, and China were nonmembers or had a very limited role for many years. At the end of World War II, the United Nations focused mainly on political security and the KIEOs focused on economic cooperation, but there are of course close linkages between political and economic issues. The U.S. negotiator Harry Dexter White thought that universalism would create a more secure environment, and his 1942 draft Bretton Woods plan asserted that to exclude “Russia would be an egregious error. Russia, despite her socialist economy could both contribute and profit by participation.” The West also expected the Eastern European states to become KIEO members. Although the Soviet Union feared capitalist encirclement, it participated in the Bretton Woods Conference and wanted financial aid to reconstruct its war-damaged economy. As the only Communist state at Bretton Woods (Poland and Czechoslovakia were not yet Communist), the Soviet Union was critical of IMF and World Bank voting procedures, rules on state-trading, and requirements that members provide detailed information. Although the West made limited concessions to the Soviet Union and it signed the Bretton Woods agreements, the Soviets continued to oppose the IMF and World Bank voting systems, the transfer of gold to U.S. territory, and the IMF conditions on its loans. Cold War issues also intruded (e.g., disputes over Berlin and the Soviet occupation of Eastern Europe), and the Soviet Union decided not to become a member of the KIEOs.

In 1947, the United States created the European Recovery Program or Marshall Plan to help Western Europe build up its foreign exchange reserves. Although U.S. secretary of state George C. Marshall invited the Soviet Union and Eastern Europe to participate, the Soviets refused and vetoed the idea of East European participation. They objected to the fact that the United States would have advisory authority over the internal budgets of Marshall Plan recipients, European states would have to cooperate with each other in using Marshall Plan aid, and most of the aid would be used to purchase U.S. exports. Only Western Europe participated in the Marshall Plan, and the Soviets established the Council for Mutual Economic Assistance (CMEA) in 1949 as a counterweight. Composed of the Soviet Union and Eastern European states other than Yugoslavia, CMEA solidified the East–West economic and political divisions. CMEA’s strategies to promote economic cooperation differed
sharply from the market-oriented Bretton Woods system. For example, CMEA emphasized central economic planning, nationalization of the factors of production such as capital and natural resources, the collectivization of agriculture, and insulation of the domestic economy from external influences. CMEA’s main goals were to reorient Eastern European trade away from the West and to solidify Soviet–East European economic linkages. However, CMEA performed poorly because it contributed to bilateralism, inward-looking policies, and a currency (the ruble) with unrealistic conversion rates that limited trade. U.S. as well as Soviet policies were responsible for the growing East–West economic rift. For example, the United States restricted trade with Communist countries and pressured its allies to participate in the Coordinating Committee (COCOM), which organized Western embargoes of strategic goods to the Soviet bloc. The liberal economic orientation of the KIEOs also contributed to the East–West split. Although the IBRD Articles of Agreement state that “only economic considerations shall be relevant” to the Bank’s decisions, the KIEOs in fact base their decisions on political and ideological as well as economic factors. The values of the KIEO professional staff members, who have received their education mainly in Western countries, affect the decision-making process.

In view of the East–West divisions, most linkages between Communist states and the KIEOs were severed. Czechoslovakia, Poland, Yugoslavia, China, and Cuba were founding members of the IMF and World Bank, but their membership ended or their status changed after they became Communist (the sole exception was Yugoslavia). As Table 2.4 shows, Poland withdrew from the IMF and World Bank in 1950 charging that they were controlled by the U.S. government, and the World Bank and IMF expelled Czechoslovakia in 1954 ostensibly for failing to pay its capital subscription. Yugoslavia, which was a special case because of its independence from the Soviet Union, was the only Eastern European state that remained in these institutions in the 1950s. Taiwan occupied the China seat in the IMF and World Bank after the People’s Republic of China took over the mainland in 1949, and Fidel Castro’s Cuba withdrew from the Bank in 1960 and the IMF in 1964. As for the GATT, Table 2.4 shows that China and Czechoslovakia were founding members in 1948, but the Chiang Kai-shek government (which had fled to Taiwan) withdrew from GATT in 1950, purportedly on behalf of China. Czechoslovakia remained in GATT, but its membership was inactive for many years. This was possible because of GATT’s status as an informal organization.

As nonmembers of the KIEOs, the Soviet bloc countries joined the South in supporting alternative organizations such as UNCTAD. However, the Eastern Europeans began to take notice of the KIEOs by the late 1960s because of their increased economic problems, their growing dependence on Western markets for their exports, and their efforts to gain more independence from the Soviet Union. Thus, Table 2.4 shows that Poland, Romania, and Hungary joined the KIEOs beginning in the late 1960s, and the People’s Republic of China replaced Taiwan in the IMF and World Bank in 1980. The most
## TABLE 2.4
Membership of Transition Economies in the Keystone International Economic Organizations

<table>
<thead>
<tr>
<th>Year</th>
<th>IMF</th>
<th>World Bank</th>
<th>GATT/WTO</th>
</tr>
</thead>
<tbody>
<tr>
<td>1946</td>
<td>Poland, Czechoslovakia, Yugoslavia, China (founding members of IMF/World Bank)</td>
<td></td>
<td>Czechoslovakia and China (founding members)</td>
</tr>
<tr>
<td>1948</td>
<td>Poland withdraws from IMF/World Bank</td>
<td></td>
<td>Republic of China (Taiwan) withdraws from GATT</td>
</tr>
<tr>
<td>1950</td>
<td>Poland withdraws from IMF/World Bank</td>
<td></td>
<td>Republic of China (Taiwan) withdraws from GATT</td>
</tr>
<tr>
<td>1954</td>
<td>Czechoslovakia ousted from IMF/World Bank</td>
<td></td>
<td>Yugoslavav</td>
</tr>
<tr>
<td>1966</td>
<td>Romania</td>
<td>Romania</td>
<td>Yugoslavav</td>
</tr>
<tr>
<td>1967</td>
<td>Poland</td>
<td></td>
<td>Poland</td>
</tr>
<tr>
<td>1971</td>
<td>Romania</td>
<td></td>
<td>Romania</td>
</tr>
<tr>
<td>1972</td>
<td>Romania</td>
<td>Romania</td>
<td>Poland</td>
</tr>
<tr>
<td>1973</td>
<td>Romania</td>
<td></td>
<td>Romania</td>
</tr>
<tr>
<td>1980</td>
<td>People’s Republic of China (replaces Taiwan in IMF/World Bank)</td>
<td></td>
<td>East Germany accedes to GATT due to German reunification</td>
</tr>
<tr>
<td>1982</td>
<td>Hungary</td>
<td>Hungary</td>
<td>East Germany accedes to GATT due to German reunification</td>
</tr>
<tr>
<td>1986</td>
<td>Poland</td>
<td>Poland</td>
<td>East Germany accedes to GATT due to German reunification</td>
</tr>
<tr>
<td>1990</td>
<td>Czech and Slovak Federal Republic Bulgaria</td>
<td>Bulgaria</td>
<td>Bulgaria, Czech Republic, Slovak Republic, Slovenia, Bosnia and Herzegovina, Czech Republic, Slovak Republic (IMF/World Bank)</td>
</tr>
<tr>
<td>1991</td>
<td>Albania, Lithuania</td>
<td>Albania, Czech Republic, Slovak Republic, Slovenia, Bosnia and Herzegovina, Czech Republic, Slovak Republic (IMF/World Bank)</td>
<td>Bulgaria, Czech Republic, Slovak Republic, Slovenia, Bosnia and Herzegovina, Czech Republic, Slovak Republic (IMF/World Bank)</td>
</tr>
<tr>
<td>1992–1997</td>
<td>Russian Federation, other FSU republics, Croatia, Slovenia, Macedonia, Bosnia and Herzegovina, Czech Republic, Slovak Republic (IMF/World Bank)</td>
<td>Bulgaria, Czech Republic, Slovak Republic, Slovenia, Bosnia and Herzegovina, Czech Republic, Slovak Republic (IMF/World Bank)</td>
<td>Bulgaria, Czech Republic, Slovak Republic, Slovenia, Bosnia and Herzegovina, Czech Republic, Slovak Republic (IMF/World Bank)</td>
</tr>
</tbody>
</table>
CHAPTER 2  Managing the Global Economy Since World War II

A dramatic change occurred in the early 1990s after the breakup of the Soviet Union, when Russia and other FSU republics joined the IMF and World Bank, and a number of former East bloc countries joined GATT. Other major changes occurred when China, Taiwan, and Ukraine became WTO members in 2001, 2002, and 2008, respectively. However, Russia has not yet become a WTO member. Later chapters discuss both the opportunities and difficulties presented by the transition economies’ membership in the KIEOs.

NONSTATE ACTORS

A wide range of nonstate actors have had a growing presence in the global political economy. Business firms, which often support the neoliberal globalization process, are the most influential nonstate actors in the global economy. They have established their own business institutions, influenced the policies of the KIEOs, and interacted with governments and IOs in the World Economic Forum (WEF). The WEF’s origins stem from the European Management Forum, a group of European business leaders that began meeting in Davos, Switzerland, in 1971 to help Europe reclaim some leadership of the international business community from the United States. The group gradually shifted to a global focus; changed its name to the WEF in 1987; and became a venue in which business executives, political leaders, and multilateral institutions discuss global economic, political, and social problems. The WEF’s core members are the top 1,200 global firms and banks in terms of global sales or capital. In addition to its

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**TABLE 2.4 (Continued)**

<table>
<thead>
<tr>
<th>Year</th>
<th>IMF/World Bank</th>
<th>GATT/WTO</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998–2001</td>
<td>Serbia/Montenegro (IMF/World Bank)</td>
<td>Kyrgyz Republic, Estonia, Croatia, Albania, Georgia, Latvia, Lithuania, Moldova, China</td>
</tr>
<tr>
<td>2002</td>
<td>Montenegro (IMF/World Bank; Serbia continues membership of former Serbia/Montenegro)</td>
<td>Chinese Taipei (Taiwan)</td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td>Armenia, Macedonia</td>
</tr>
<tr>
<td>2007</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td>Ukraine</td>
</tr>
</tbody>
</table>

FSU = Former Soviet Union republics

annual meeting in Davos, the WEF holds regional summits and issues influential publications such as the Global Competitiveness Report and the Global Information Technology Report. Although the WEF is a private institution with no publicly sanctioned authority, it has a public agenda and considerable influence in the public sphere. For example, the Mexican president initiated discussions at the WEF in 1990 that led to negotiation of the NAFTA. Many liberals believe that business entrepreneurs in the WEF are acting in the global public interest, and they note that the WEF’s founder (Klaus Schwab) adheres to a multistakeholder model that takes account of the interests of a wide range of private and public actors. Critical theorists by contrast argue that NGOs account for less than 2 percent of those at the Davos meetings, and that members of the WEF governing boards are “overwhelmingly male, predominantly white and substantially from the wealthiest nations of Europe, North America and Japan.”

In contrast to global business firms, NGOs and social movements focusing on labor, women, the environment, development, and human rights have been largely excluded from positions of power. These diverse groups are often categorized together as civil society, which can be defined as a wide range of nongovernmental, noncommercial groups that seek to either reinforce or alter existing norms, rules, and social structures. Scholars discuss three types of civil society orientations in terms of objectives and tactics: conformist, reformist, and transformist or rejectionist. Although much of the literature focuses on civil society protests aimed at the IMF, World Bank, WTO, and other symbols of neoliberal globalization, most civil society organizations (CSOs) are conformist CSOs “that seek to uphold and reinforce existing norms.” Conformist CSOs include many professional associations, business lobbies, philanthropic foundations, some research groups such as the Institute for International Economics and the Brookings Institution, and the WEF, which has official NGO consultative status with the United Nations. Reformist CSOs want the KIEOs to become more democratic, transparent, and open to participation by underrepresented groups, but they do not seek to replace the underlying structure of capitalism. Although reformists often engage in peaceful protest such as passive marches, they also interact with the KIEOs through lobbying, discussions, briefing sessions, and negotiations. Transformist or rejectionist CSOs seek “a comprehensive change of the social order (whether in a progressive or a reactionary fashion).” Leftist rejectionists adopt an anticapitalist position and see the KIEOs as unreforable. Although rejectionists employ a diversity of tactics, they are generally committed to confrontational and disruptive actions; extreme rejectionists such as anarchists may engage in property destruction, clashes with the police, and violence. Some scholars refer to rejectionists as “anti-globalizers” because they oppose international trade and financial integration, but others argue that rejectionists are not opposed to globalization per se; they oppose the current neoliberal form of globalization.

A major obstacle to scholarly analysis of civil society groups is that “civil society” is a vague term that is used in “many different theoretical, practical, and
historical contexts.” Some scholars view the term transnational advocacy networks (TANs) as more useful for analyzing the relations between NGOs and other actors. A TAN “includes those relevant actors working internationally on an issue, who are bound together by shared values, a common discourse, and dense exchanges of information and services.” TANs support value-laden causes and are especially important in areas such as the environment, women, infant health, and indigenous peoples. However, they are also involved with economic matters, and we will examine the position of TANs on trade, development, and foreign debt issues. TANs incorporate not only NGOs, but also social movements, the media, trade unions, consumer organizations, religious institutions, intellectuals, and various parts of international organizations and governments.

THE 2008 GLOBAL FINANCIAL CRISIS: A TURNING POINT?

This chapter has examined the institutional framework for managing the post-war global economy. Subsequent chapters discuss the role of the IMF, World Bank, WTO, OECD, UNCTAD, and informal groupings such as the G20 and G8 in greater detail. The DCs at the Bretton Woods Conference had faith in the ability of international institutions to promote economic stability and growth, and the three KIEOs have contributed to postwar prosperity. However, there is a hierarchy of states in the IMF, World Bank, and WTO, with the North having the most votes in the IMF and World Bank and the most influence over multilateral trade negotiations in the GATT/WTO. The South has had less power and wealth in the global political economy, and has tried to alter the KIEOs and establish alternative organizations such as UNCTAD. However, the South’s gains have been limited, and foreign debt and financial crises in the 1980s and 1990s induced many LDCs to become more closely integrated with the KIEOs (see Chapter 11). For many years the centrally planned economies did not participate in the KIEOs, and the Soviet Union established the CMEA as an alternative organization. However, these countries began to join the KIEOs because of growing economic problems and dependence on the West. The breakup of the Soviet bloc and Soviet Union sped up this integration process.

The KIEOs are therefore becoming universal membership organizations, but it is increasingly difficult for them to reach a consensus and manage global economic relations. A major change is that emerging economies such as China, India, Brazil, and Russia have been growing more rapidly than the United States, Europe, and Japan, and are less willing to accept the North’s leadership in the formal and informal international institutions. As we will discuss, the 2008 global financial crisis marked a turning point because emerging economies such as China, Brazil, and India are recovering from the crisis more rapidly than most DCs, and without the budgetary and debt burdens plaguing the United States, Britain, and a number of other DCs. In September 2009 the
G7 finance ministers (from the United States, Japan, Germany, Britain, France, Italy, and Canada) agreed to cede responsibility for steering the global economy to the G20 developed and emerging economies, and this was the first sign of a significant change in the global institutional framework. As an informal grouping, the G20 can deliberate and propose, but it cannot make decisions that bind the international community. However, since 2005, the G20 has discussed the issue of reforming the IMF and World Bank. G20 emerging economy members have argued that the selection of senior management of the IMF and World Bank should be based on merit, and that the process for selecting the IMF managing director (who has always been European) and the World Bank president (who has always been American) should be changed. The IMF and World Bank have accepted the idea that change in their governing bodies is necessary, and that some votes should be redistributed to emerging economies such as China, India, and Brazil. Although, some reform is now taking place, resistance from DCs, especially in Europe, is delaying the process. Furthermore, as mentioned, the LDCs in the G20 are larger emerging economies and there is no representation for the poorest countries, the 49 LLDCs. In sum, the 2008 global financial crisis has been somewhat of a turning point in giving emerging countries such as the BRIC economies more influence, which is slowly being translated into more voice in the IMF, World Bank, and WTO. However, the influence of the least developed, poorest countries in the South will continue to be extremely limited for the foreseeable future. This chapter has examined the role of the postwar institutions in promoting globalization, and the complexities globalization is presenting for their management capabilities. The next three chapters examine the IPE theoretical perspectives.

**QUESTIONS**

1. Why were the IMF, World Bank, and GATT/WTO created, and why are they called the “keystone international economic organizations”?
2. What is the role of smaller organizations and groups such as the OECD, G7/G8, and G20? Why was the G20 formed, and why is it displacing the G7/G8?
3. What are the advantages of using PPP-adjusted per capita GDP figures, and what are the shortcomings of the PPP-adjusted figures?
4. What is the human development index, and what are its strengths and weaknesses?
5. Why were the G77 and UNCTAD formed, and how successful have they been? Is the growing influence of the G20 likely to benefit all LDCs?
6. What are some of the most significant divisions within the South? What are OPEC, the NIEs, the BRIC economies, and the emerging economies? Do these groups have anything in common with the LLDCs?
7. How has the relationship changed between the former centrally planned economies and the KIEOs?
8. What is the World Economic Forum, and in what way does it contribute to a blurring of lines between “public” and “private” in the global political economy?
9. What are civil society groups, and how do they differ in terms of their tactics and goals? What are TANs?
KEY TERMS

Bank for International Settlements 22
Bretton Woods Conference 18
BRIC economies 27
civil society 43
General Agreement on Tariffs and Trade 18
Group of Five 29
Group of Seven 29
Group of Eight 31
Group of 10 29
Group of 20 32
Group of 77 38
emerging market economies 27
exchange rates 33
human development index 33
International Monetary Fund 18
newly industrializing economies 27
Organization of Petroleum Exporting Countries 26
Organization for Economic Cooperation and Development 29
purchasing power parity 33
transnational advocacy networks 44
United Nations Conference on Trade and Development 38
World Bank 18
World Economic Forum 42
World Trade Organization 23

FURTHER READING


A recent study on the many facets of the OECD is Rianne Mahon and Stephen McBride, eds., The OECD and Transnational Governance (Vancouver: University of British Columbia Press, 2008).


NOTES


15. Lake, Power, Protection, and Free Trade, p. 204.


44. For example, see “Big MacCurrencies,” The Economist, April 11, 1998, p. 58.


55. UNCTAD, The Least Developed Countries Report 2009, p. i.
Before turning to the theoretical perspectives, we briefly discuss the role of theory and methodology in the study of IPE. Theory helps us identify meaningful patterns and a degree of order in the complex world of IPE. Theory also enables us to go beyond description and provide causal explanations and modest predictions. For example, one scholar might hypothesize that free trade contributes to an increase in average real incomes, while another might hypothesize that free trade results in greater economic inequality. Some theorists use mathematical and statistical techniques to test their hypotheses, while others rely on historical or comparative studies that are qualitative (i.e., nonquantitative) in nature. Another group of theorists questions whether value-free theorizing is even possible, because the work of scholars is affected by the historical and cultural setting in which they operate (see the discussion of constructivism in Chapter 5). Despite these differences, most theorists agree that theory helps us deal with the wide array of IPE issues and events by focusing on some and disregarding others; but theorists from different perspectives do not agree on which issues and events are most and least important!¹

This book focuses mainly on substantive theories within the realist, liberal, and critical perspectives. In a seminal study of IPE, Robert Gilpin grouped the various theories into three competing “ideologies”: liberalism, nationalism, and Marxism.² Although we draw upon Gilpin’s work, this book alters the approach to theory in several important respects. First, the perspectives are not mutually exclusive ideologies; the margins between them are sometimes blurred, and they influence each other over time. Many IPE theories such as
hegemonic stability and regime theory are hybrids that draw on more than one perspective. Second, Marxism, the third perspective of IPE in Gilpin’s view, has declined in importance, particularly with the breakup of the Soviet bloc and the Soviet Union. To reflect the wide range of perspectives in IPE today, we focus on four different critical perspectives: historical materialism, which stems partly from Marxism, constructivism, feminism, and environmentalism. Third, there is a wide diversity of writings within each theoretical perspective. For example, Chapter 4 points to the different views that liberals such as John Maynard Keynes and Friedrich Hayek had regarding the relationship between the government and the market; and Chapter 5 highlights the diversity of views within the feminist and environmentalist perspectives.

Despite the diversity of views within liberalism, realism, and the critical perspectives, authors within each perspective generally agree on a core set of assumptions. Chapters 3–5 begin with a discussion of how the theoretical perspectives deal with four key questions: (1) What is the role of domestic actors? (2) What are the nature and purpose of international economic relations? (3) What is the relationship between politics and economics? (4) What are the causes and effects of globalization? The chapters then examine the historical development of the perspectives, with particular emphasis on the diversity of views within each perspective. Most importantly, the book emphasizes the fact that no single theoretical perspective explains all phenomena in IPE, and that the success of one theory is not necessarily tied to the failure of another. Different theoretical perspectives are useful for explaining various issues and events, and “our empirical task is to sort out under what condition each logic operates—including the recognition that they operate together in some circumstances.”

Although this book focuses mainly on substantive theories within the realist, liberal, and critical perspectives, we also devote some attention to rational choice and constructivism, the two most prominent methodologies or methods of theory construction used by IPE theorists. It is important to note that many IPE scholars do not explicitly identify their work with either rational choice or constructivism, and that a number of scholars implicitly draw on both methodologies. We discuss rational choice here because it is most closely associated with the mainstream liberal and realist assumptions that individuals and states are rational actors with specified interests. Constructivists by contrast see reality as being socially constructed. Although there are both critical and liberal versions of constructivism, we discuss constructivism in
Chapter 5 with the critical perspectives because even liberal constructivists are critical of the rationalist assumptions of many mainstream theorists.

Both supporters and opponents of rational choice analysis would agree that it is a highly influential method of theory construction. Indeed, one scholar has described rational choice as “the most powerful paradigm in the political science discipline, especially in the United States.”

While rational choice is the favored term of political scientists, economists prefer the term public choice. Rational choice theorists apply an economic model of human behavior to the social, political, and economic spheres, and develop propositions that simplify the real world and can be tested through quantitative methods. Although mathematical models are often central, they are not a necessary feature of rational choice. Rational choice theorists assume that individuals have goals and some freedom of choice and that they take actions they believe will help achieve their goals. Individuals are “utility maximizers,” who seek to maximize or optimize their self-interest by weighing the expected costs versus the expected benefits of their actions. For example, political leaders weigh the benefits and costs of adopting particular policies in terms of their re-election (i.e., political survival); and individuals weigh the benefits of voting (having some effect on the election results) against the costs (the effort involved in going to vote). Although the pure rational choice model posits that rational individuals obtain an optimal amount of information before making decisions, “rationality applies only to endeavor not to outcome; failure to achieve an objective because of ignorance or some other factor does not invalidate the premise that individuals act on the basis of a cost/benefit or means/ends calculation.”

Thus, most studies assume that individuals achieve satisfactory rather than optimal outcomes because of limitations in their knowledge and abilities. The actions available to individuals also have limits because people make choices under conditions of scarcity. For example, an individual may decide to rent a house because she is unable to purchase one. Although rational choice analysis is grounded in the liberal perspective, with its emphasis on the individual, some realists use it to explain the international behavior of states, and some critical theorists use it as well.

In a number of cases individuals may behave the way the rational choice model predicts; for example, politicians may support policies strongly favored by their constituents to increase their chances for re-election. However, rational choice analysis has been criticized on a number of grounds. Some critics argue that politicians may take actions that rational choice analysts would not consider “rational”; for example, they may oppose policies that go against their
ethical principles even if this decreases their chances for re-election. Some politicians may also feel obliged to honor prior commitments to support less popular policies, and this could also decrease their chances for re-election. Thus, the rational choice model does not explain all the choices of political actors. Critics also point out that rational choice analysis assumes that the actor is a rational, self-interested person who makes decisions without regard to historical and cultural context. It takes individual preferences as a “given” without judging the worthiness of the preferences or seeking to explain why an individual or state has some preferences rather than others. It simply assumes that a state or individual’s preferences reflect rational choices under conditions of scarcity. Some other IPE approaches such as constructivist theory take more account of historical and sociological factors (see Chapter 5). Constructivists seek to explain why actors have particular norms, values, beliefs, perceptions, and preferences, and how these affect actions and outcomes. This book examines several areas where rational choice is explicitly applied to the study of IPE. For example, Chapter 3 discusses public goods theory, and Chapter 4 discusses a type of game theory—prisoners’ dilemma. In game theory, two or more people interact, with each person acting according to the rational choice model (see Chapter 4).[9]

NOTES

Realism emphasizes power and the national interest, and directs more attention to political security than to economic issues. Liberalism, which is more concerned with economic issues, has therefore been the dominant perspective in IPE. We nevertheless begin with the realist perspective for several reasons. First, realism is the oldest school of thought in international relations (IR). Thucydides (ca. 471–400 B.C.E.) is often credited with being the first realist author and also with writing the first important work on IR—*The History of the Peloponnesian War*, on war between the Greek city-states. First, classical realism was the dominant approach to IR for so long that it “provides a good starting point and base line for comparison with competing models.” Second, realism is an important IPE perspective today because of debates about the decline of U.S. economic hegemony vis-à-vis emerging powers such as China, and about the relative merits of government involvement in the market. These issues have become more pressing since the 2008 global financial crisis.

Two major strains of realism are relevant to the study of IPE. The first strain, which largely neglects economics, was evident in the views of Niccolò Machiavelli (1420–1527), an Italian philosopher and diplomat who is best known for his work *The Prince*. Machiavelli saw little connection between economics and politics and thus wrote that “as I do not know how to reason either about the art of silk or about the art of wool, either about profits or about losses, it befits me to reason about the state.” Machiavelli also considered military strength to be more important than wealth in making war because “gold alone will not procure good soldiers, but good soldiers will always procure gold.” As this chapter discusses, American realist scholars after World War II, like Machiavelli, devoted little attention to economics. The second strain of realism, stemming from Thucydides and the mercantilists, is more attuned to economic–political linkages. In *The History of the Peloponnesian War*...
Basic Tenets of the Realist Perspective

The Role of the Individual, the State, and Societal Groups

Realists assert that the international system is “anarchic,” because there is no central authority above the state. Thus, IR is a self-help system in which each state must look after its own interests. Realists see the state as the principal actor in IR, and they emphasize the need to preserve national sovereignty. A state has internal sovereignty when it has a monopoly on the legitimate use of force within its territory, and it has external sovereignty when it is free of control by outside authorities. Some realists give priority to power and others to security, but both are necessary for the state to survive and pursue its national interest. Realists see the state as a unitary actor in IR, with subnational and transnational actors in a subsidiary position. Realists also describe states as rational actors that seek to maximize the benefits and minimize the costs of pursuing their objectives. States may settle for value-satisficing rather than value-maximizing decisions, because policy makers have misperceptions and may lack information and capabilities needed to make optimal choices. Nevertheless, the state in the realist view is basically a rational decision maker. The assumption that states are rational, unitary actors enables realists to be parsimonious theorists, who develop some elaborate theories with only a small number of concepts and variables.

The Nature and Purpose of International Economic Relations

In a self-help system such as IR, a security dilemma results because the actions a state takes to bolster its security may increase the fear and insecurity of others; thus, even if a state arms itself only for defensive purposes, this may raise fears and contribute to an arms race. In view of the security dilemma, realists see each state as being most concerned with relative gains, or its position vis-à-vis other states. Even if two states are “gaining absolutely in wealth, in political terms it is the effect of these gains on relative power positions which is of primary importance.” The realist emphasis on relative gains stems from their view that IR is a zero-sum game, in which one group’s gain equals another group’s loss. Liberals by contrast focus on absolute gains, in which each state seeks to maximize its own gains and is less concerned about the gains of others; thus, liberals see IR as a variable-sum game, in which groups...
may gain or lose together. Liberal and realist views of international institutions are a prime example of this difference in outlook. Whereas liberals see the IMF, World Bank, and WTO as organizations that benefit all states adhering to their liberal economic guidelines, realists see these IOs as “arenas for acting out power relationships” in which the most powerful states shape the rules to fit their national interests.9

Despite their concern with relative gains, realists focus on the redistribution of power within the capitalist system, whereas historical materialists believe that a more equitable distribution of power and wealth is not possible with unfettered capitalism. In the view of historical materialists, there are only two “modes of development in contemporary history: capitalist and redistributive,” and realism fits with liberalism in the capitalist mold.10

The Relationship Between Politics and Economics

Realists give priority to politics over economics and view “the economy as a creature of the state.”11 This was especially the case during the height of the Cold War when American realist scholars focused almost exclusively on political security issues and largely ignored economics (see discussion in this chapter). Realists also believe that the distribution of political power has a major effect on international economic relations. Thus, this chapter discusses “hegemonic stability theory,” which examines the effect of a predominant state (Britain in the nineteenth century and the United States in the twentieth century) on the global political economy.

The Causes and Effects of Globalization

Realists see globalization mainly as an economic process that does not affect the basic international political structure in which states are predominant. Globalization increases only when states permit it to increase, and the largest states can either open or close world markets to improve their power positions vis-à-vis weaker states. Thus, realists see

no evidence that globalization has systematically undermined state control. . . . Transnational activities have challenged state control in some areas, but these challenges are not manifestly more problematic than in the past.12

Whereas liberals see globalization as imposing pressure on states to adopt a single model of capitalism, realists argue that different national capitalisms can continue to exist in a world of separate states. For example, the state has a greater socioeconomic role in France, Scandinavia, Japan, and South Korea than it has had in the United States, Britain, and Canada.13 Some realists argue that globalization has enabling as well as constraining effects on the state. Thus, many states have “increased direct tax yields, maintained or expanded social spending, and devised more complex systems of trade and industrial governance in order to cope with deepening integration.”14
THE MERCANTILISTS

Adam Smith, the eighteenth-century liberal economist and philosopher, used the term mercantilism to refer to economic thought and practice that prevailed in Europe from about 1500 to 1750. As discussed in Chapter 2, mercantilism’s emphasis on national power played an important role in state building after the demise of feudalism. Mercantilists believed that a state could use its gold and silver to increase its power by building up its armed forces, hiring mercenaries, and influencing its enemies and allies. States therefore took all necessary measures to accumulate gold by increasing their exports and decreasing their imports. Because it is impossible for all states to have a balance-of-trade surplus, mercantilists viewed IR as a zero-sum game, in which relative gains were more important than absolute gains. In the late eighteenth century, critics argued that mercantilism encouraged states to encroach on individual freedom and engage in the continuous cycle of European wars. For example, Adam Smith asserted that mercantilism encouraged states to “beggar ... all their neighbours” and cause trade and commerce to become a “fertile source of discord and animosity.” These criticisms were highly effective, and liberal views of free trade became dominant in England for much of the nineteenth century. We should note that some authors use mercantilism as a general term in reference to realist thought and practice in IPE, and they refer to some states today as being “neomercantilist.” However, this book uses the term realism in reference to the IPE perspective, and the term mercantilism only in reference to the period when states sought to increase their national power in the sixteenth to eighteenth centuries.

REALISM AND THE INDUSTRIAL REVOLUTION

Mercantilism was a preindustrial doctrine, and the Industrial Revolution gave new impetus to realists who viewed industrialization as essential for a state’s military power, security, and economic self-sufficiency. Foremost among the realist thinkers at this time were Alexander Hamilton (1755–1804), the first U.S. secretary of the treasury, and Friedrich List (1789–1846), a German civil servant, professor, and politician who was imprisoned and exiled for his dissident political views. Hamilton’s 1791 Report on the Subject of Manufactures “contains the intellectual origins of modern economic nationalism and the classic defense of economic protectionism.” The report argued that the United States could preserve its independence and security only by promoting economic development through industrialization, government intervention, and protectionism. Industrialization was especially important because the “independence and security of a Country, appear to be materially connected with the prosperity of manufactures,” and U.S. government intervention was necessary to establish an industrial base because Britain had discouraged manufacturing in its colonies. To counter Britain’s industrial advantages, the U.S. government had to promote the use of foreign technology, capital, and skilled labor and adopt protectionist policies such as tariffs and quotas to bolster its fledgling industries.
List, who was influenced by Hamilton’s ideas, also emphasized the importance of manufacturing for a state’s economic development. In *The National System of Political Economy* (1841), List wrote that “a nation which exchanges agricultural products for foreign manufactured goods is an individual with one arm, which is supported by a foreign arm.” Thus, Germany and the United States could catch up with the British only by providing protection for their infant industries. Britain itself had attained manufacturing supremacy by adopting protectionist policies, and it did not turn to free trade until the nineteenth century to retain its lead in manufacturing; thus, Britain traded industrial products for U.S. wool and cotton. National unity was also important because a strong, unified state could impose external trade barriers, launch national projects such as railroads, and develop “human capital” (e.g., human skills, training, and enterprise). List argued that governments had responsibilities to educate their citizens because Britain’s leadership in manufacturing stemmed largely from its superior educational system.

In List’s view Adam Smith’s arguments favoring a division of labor and free trade overemphasized the existence of natural peace and harmony and underestimated the importance of national rivalries and conflict. At the same time, however, List integrated “the advances in economic thought produced by the liberal school” with his own brand of realism. Although List argued that protectionism could be used to promote industrialization, he criticized the mercantilists for supporting agricultural protectionism. List also referred to the benefits of free trade, but believed that states had to follow other policies because of the possibilities of war. Thus, free trade would be valuable in the long term for states that had achieved industrial supremacy. The United States and Germany had to adopt protectionist trade policies to increase their productive potential, but after they were “raised by artificial measure,” List wrote, “freedom of trade” could then “operate naturally.”

**REALISM IN THE INTERWAR PERIOD**

Although Britain ushered in a period of free trade with the repeal of its Corn Laws in 1846, changes in the late nineteenth century caused trade liberalization to lose some of its appeal (see Chapter 2). Under the pressures of World War I and the economic crises of the interwar years, cooperative relations based on liberalism virtually collapsed. Many scholars wrote on economic nationalism during the interwar period, and states sought to protect their national interests with trade barriers, competitive currency devaluations, and foreign exchange controls. The dire economic conditions also encouraged extreme ideologies such as fascism, which “took advantage of the economic dislocation to attack the entire liberal-capitalist system and to call for assertive ‘national’ policies, backed if necessary by the sword.” The extreme nationalism and protectionism contributed to the Great Depression and World War II and gave leaders at Bretton Woods the impetus to establish a liberal economic system. In the postwar international political system, however, realist thought was to reign supreme.
REALISM AFTER WORLD WAR II

Although Thucydides, the mercantilists, Hamilton, and List had been highly attuned to economic issues, U.S. realist scholars after World War II focused almost exclusively on security issues. Security was a major concern with the emergence of the Cold War, and economic issues seemed to have less political importance. A consensus formed under U.S. leadership at Bretton Woods ushered in a period of economic stability and prosperity, and LDCs that did not share in this prosperity had little influence. The Cold War was also largely excluded from the postwar economic system because most Soviet bloc countries were not members of the IMF, World Bank, and GATT. These organizations functioned well without the Soviet bloc because it accounted for only a small share of global economic transactions. Thus, realist scholars considered economic issues to be “low politics” and not worthy of much attention. Postwar realists were also influenced by liberal views on the separability of economics and politics. However, unlike liberals such as Adam Smith who favored a laissez-faire economy free of political constraints, realist scholars emphasized politics and largely ignored economics. The U.S. view that the state should be separated from the economy also influenced postwar realists. Although U.S. government involvement in military defense matters was accepted, government involvement in the economy was considered less legitimate. Finally, America’s superpower status led U.S. realists to focus so firmly on the struggle with the Soviet Union that they “overlooked the economic relations beneath the flux of political relations.” Thus, liberalism and Marxism clearly overshadowed realism as IPE perspectives during the 1950s and 1960s.

THE REVIVAL OF REALIST IPE

In the 1970s and 1980s, theorists such as Robert Gilpin and Stephen Krasner returned “to a realist conception of the relationship of economics and politics that had disappeared from postwar American writings.” Two factors contributed to the revival of realism as an IPE perspective. First, the decline of the Cold War and increasing disarray in the global economy induced many realists to shift some attention from security to economic issues. Although Western economic relations had prospered under U.S. leadership during the 1950s and 1960s, major changes in the 1970s and 1980s—such as the OPEC price increases, the relative decline of U.S. hegemony, and the foreign debt crisis—destabilized the global economy. These issues forced realists to revise their view that economic issues were low politics. Second, realists returned to IPE because they considered liberal and Marxist IPE studies to be economistic; that is, they exaggerated the importance of economics and underestimated the importance of politics. A number of developments demonstrated the need for realist studies focusing on the economic role of the state. For example, the “Keynesian Revolution” caused DC governments to become heavily involved in macroeconomic management, the decline of colonialism led to the creation
of newly independent states that differed from the Western liberal democratic model, and growing international competition put pressure on states to promote industry and technology. Thus, realists had to “bring the state back in” to the study of IPE.29

Whereas liberals believed that postwar international economic relations had flourished because of the growth of interdependence, the newer realists argued that the distribution of power among states was a more important factor. A major issue was whether there was a global hegemonic state with predominant power willing and able to provide leadership. Thus, the realists strongly supported hegemonic stability theory. Although hegemonic stability theory is closely tied with realism, it is a hybrid theory that also draws on liberalism and historical materialism. However, we discuss hegemonic stability theory here because it has been central to the realist approach to IPE.

HEGEMONIC STABILITY THEORY AND U.S. HEGEMONY

Hegemonic stability theory asserts that the international economic system is more likely to be open and stable when a dominant or hegemonic state is willing and able to provide leadership, and when most other major states view the hegemon’s policies as relatively beneficial. When a global hegemon is lacking or declining in power, economic openness and stability are more difficult—but not impossible—to maintain. Scholars generally agree that Britain was a global hegemon during the nineteenth century and the United States was a hegemon after World War II. Some studies assert that Portugal, Spain, the United Provinces (or present-day Netherlands), and the British were world powers before the nineteenth century.30 However, most scholars believe that these states were less influential than the British and American hegemons of the nineteenth and twentieth centuries. Hegemonic stability theory spawned a vast array of literature and “remained atop the agenda of IPE in the United States” for two decades.31 Scholars critiqued virtually all aspects of the theory, and many of the criticisms were based on empirical grounds. For example, critics questioned whether theorists could draw meaningful conclusions about hegemonic behavior from the experience of only two global hegemons during limited historical periods. Theorists also did not have consistent definitions and measures of hegemony, with different authors focusing on the military, political, economic, or cultural aspects. Thus, there was no consensus on when British hegemony declined, and on whether—or by how much—U.S. hegemony was declining. Some critics questioned a basic premise of the theory: that a global hegemon contributes to economic openness and stability. As a result of these criticisms, U.S. scholars gradually became less interested in hegemonic stability theory. However, it has been noted that “the hegemonic stability research program has sensitized the current generation of scholars to the international political underpinnings of the international economy. This insight should be preserved and built upon, not abandoned.”32 Furthermore,
scholars have continued to debate whether or not U.S. economic hegemony has declined as a result of the U.S. foreign debt, the 2008 global financial crisis, and the growing influence of emerging powers such as China and India. This section focuses on some key questions related to hegemonic stability theory and on the current debate regarding U.S. hegemony:

1. What is hegemony?
2. What are the strategies and motives of hegemonic states?
3. Is hegemony necessary and/or sufficient to produce an open, stable economic system?
4. What is the status of U.S. hegemony?

What Is Hegemony?
Realists define the term hegemony as an extremely unequal distribution of power, in which “a single powerful state controls or dominates the lesser states in the [international] system.” However, this definition does not tell us how much control a state must have to be a hegemon. Can a state with military or economic power alone have hegemony, or must it predominate in both areas? Most theorists have stringent conditions for hegemony and believe that only two or three states have been global hegemons. Thus, one definition limits hegemony to a relationship in which one state “can largely impose its rules and wishes (at the very least by effective veto power) in the economic, political, military, diplomatic and even cultural arenas.” Whereas realists define hegemony in state-centric terms, Gramscian theorists use the term in a cultural sense to connote the complex of ideas social groups use to exert their authority; for example, Gramscians refer to the hegemony of ideas such as capitalism and to the global predominance of American culture (see Chapter 5). According to Gramscians, the capitalist class offered subordinate social classes some concessions such as welfare payments, unemployment insurance, and the rights to unionize; the subordinate classes in return viewed capitalist hegemony as perfectly legitimate. This hegemony is difficult to overcome because subordinate classes are not aware they are being oppressed. Neo-Gramscians assert that globalization in trade, foreign investment, and finance is enabling a “transnational capitalist class” to establish its hegemony and remove all impediments to the free flow of capital. Although the Gramscian views alert us to other aspects of hegemony, mainstream scholars usually define hegemony only in state-centric terms.

What Are the Strategies and Motives of Hegemonic States?
Hegemonic stability theorists have differing views of a hegemon’s strategies and motives. A first model portrays the hegemon as benevolent—promoting general benefits rather than its self-interest, and using rewards rather than threats to ensure compliance by other states. A second, mixed model portrays the hegemon as seeking both general and personal benefits, and as relying on both threats and rewards to achieve its goals. A third model portrays the hegemon as purely exploitative—pursuing only its self-interest and using coercion.
to enforce compliance. Benevolent hegemons focus on absolute gains, coercive hegemons seek relative gains, and hegemons with mixed strategies and motives seek both absolute and relative gains.  

Liberals view the hegemon in benevolent terms as willing to “take on an undue share of the burdens of the system” by providing public goods to help create open, stable economic regimes. Public goods (or collective goods) are nonexcludable and nonrival. Nonexcludability means that others can benefit from the good, even if they do not contribute to its provision. For example, a sidewalk is nonexcludable because even individuals who do not help pay for it through taxes are free to use it. Nonrivalness means that a state’s or an individual’s use of the good does not decrease the amount available to others. A sidewalk is nonrival because many individuals can benefit from using it. In the liberal view, a benevolent hegemon provides public goods to ensure there is economic openness and stability. At the end of World War II, the United States provided security as a public good through the U.S. nuclear umbrella so that Western Europe and Japan could focus on economic recovery. The United States as a global hegemon also permitted its currency to be used as the main reserve asset, supplied U.S. dollars to facilitate international trade, provided finance for LDC economic growth, and maintained an open market for other countries’ exports. (In reality, there are very few pure public goods because a hegemon may at least partially exclude some countries.) Rational choice theorists point out that public goods are underproduced in IR even though rational individuals and states benefit from them, because states receive public goods even if they are noncontributors or free riders. To convince states that they will benefit from contributing to the provision of public goods, it is necessary to overcome collective action problems. A collective action problem occurs when the uncoordinated actions of individuals or states do not produce the best possible outcome for them. Liberals assume that the hegemon will rely on rewards rather than coercion in encouraging others to contribute.

Realists are more inclined than liberals to portray the hegemon as furthering its national interest rather than the general good. The realists expect a rising hegemonic state to prefer an open international system because this contributes to its economic growth, national income, and political power. They also often portray the hegemon as coercive, threatening to cut off trade, investment, and aid to force other states to share the costs of providing public goods. However, many realists believe that hegemonic states have mixed motives and that the effects of hegemony may be beneficial. Thus, one realist writer asserts that

the creation of a system of multilateral trade relations was in the interests of the United States. . . . It does not follow from this fact, however, that American efforts to achieve such a system were solely self-serving. . . . Nor does it follow that what is good for the United States is contrary to the general welfare of other nations.

Historical materialists are the least likely to view a hegemon as benevolent. Some historical materialists see the hegemon as coordinating the actions
Hegemonic stability theorists believe that the international economy is more likely to be open and stable if there is a hegemonic state. A hegemon promotes openness and stability by helping create liberal international regimes, or “sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors’ expectations converge in a given area of international relations.” The regime concept refers to the fact that a degree of governance exists above the state in the absence of a centralized world government. For example, WTO members abide by certain trade regime principles, norms, and rules. The United States as the postwar global hegemon helped create and maintain open and stable monetary, trade, and aid regimes by providing public goods and using coercion when necessary. Hegemonic stability theorists make several assertions about the effects of British and U.S. hegemony:

- British hegemony was a major force behind trade liberalization in the nineteenth century.
- Britain’s hegemonic decline after 1875 led to an increase in trade protectionism.
- Protectionism increased between World Wars I and II because there was no hegemon willing and able to lead.
- The United States as global hegemon after World War II helped create open and stable international regimes.

Despite these claims, a number of empirical studies question whether hegemony is in fact necessary or sufficient to produce economic openness. For example, some critics argue that World War I, not Britain’s hegemonic decline after 1875, “sounded the death knell for liberalized international trade.” Some liberal critics also argue that a hegemon that helped create open international regimes may not be necessary for the maintenance of those regimes. Other states that benefit from open regimes may collectively maintain them even after the hegemon declines. Thus, it is important to ask not only whether there is a hegemon to supply open regimes, but also whether there is sufficient demand to maintain those regimes after a hegemon declines. Some liberal theorists go even further and argue that hegemony is not necessary for the creation of regimes. Negotiated regimes may arise among states that are relatively equal in stature, and spontaneous regimes may arise when countries’ expectations converge even without negotiating an explicit agreement.
Others point out that hegemonic states are not always committed to open economic regimes because domestic groups may favor barriers to the free flow of goods, services, or capital. Although the United States generally supported an open international trade regime in the 1940s, it joined European countries in supporting national controls on capital flows. Even in the trade area the United States was not uniformly liberal; in response to domestic interests, it insisted that GATT treat agriculture as an exception and it supported a Multi-Fiber Agreement limiting textile imports (see Chapter 7). Some writers assert that factors other than hegemony can account for economic openness and stability. Whereas world prosperity can result in open economic regimes, economic downturns may cause states to adopt protectionist policies. A prime example is the trade protectionism resulting from the 2008 global financial crisis. Furthermore, industries tend to support trade openness during periods of shortages and trade protectionism when surpluses accumulate. In sum, while there may be some connection between hegemony and economic openness, critics question whether hegemony is necessary and/or sufficient to create and maintain open, stable economic regimes.

**What Is the Status of U.S. Hegemony?**

Scholars have had vigorous debates on the status of U.S. hegemony. Some theorists are “declinists,” who see hegemony as inherently unstable. Declinists predict that the hegemon will overextend itself in military and economic terms (*imperial overstretch*), that free riders will gain more than the hegemon from economic openness, and that dynamic economies will rise to challenge the hegemon’s predominant position. Thus, an historian writes that “the only answer to... whether the United States can preserve its existing position is ‘no’—for it simply has not been given to any one society to remain permanently ahead of all the others”; and a political scientist claims that “one of the most important features of American hegemony was its brevity.” Pitted against declinists are “renewalists” who question whether the United States is in fact declining. Although most renewalists concede that U.S. economic power has declined in a relative sense since 1945, they argue that U.S. hegemony remains largely intact. U.S. predominance at the end of the war was so great that its relative position had to decline with economic reconstruction in Europe and Japan. However, U.S. economic power continues to be “quite enormous when compared to that of any other country, and has an international aspect which gives the U.S. government a unique prerogative *vis-à-vis* the rest of the world.” As evidence of its continued hegemony, renewalists argue that the United States has not only hard power based on the use of coercion and payments, but also structural or soft power based on attraction and co-option; that is, the United States can persuade “other countries to *want* what it wants.” Thus, the United States has a major role in setting the global agenda. Renewalists also criticize declinists for disregarding noneconomic factors such as U.S. military supremacy and cultural influence through television, movies, and magazines. Events in the late 1980s and 1990s resulted in an
upsurge of renewalist writing. In the security sphere, the end of the Cold War led some scholars to argue that we were entering a “unipolar” period with the United States as the only superpower.\textsuperscript{52} The 1990s East Asian financial crisis and Japan’s inability to revive its lagging economy led renewalists to argue that the United States was also regaining its economic predominance.

Declinists and renewalists can be found on all ends of the political spectrum. Prominent among the renewalists are U.S. neoconservatives, who called for greater U.S. activism when the Soviet bloc and Soviet Union imploded in the late 1980s and 1990s. For example, Robert Kagan and William Kristol argued that the United States achieved its recent position of strength not by practicing a foreign policy of live and let live, nor by passively waiting for threats to arise, but by actively promoting American principles of governance abroad—democracy, free markets, respect for liberty.\textsuperscript{53}

Although Kagan and Kristol have cautioned that “no doctrine of foreign policy can do away with the need for judgment and prudence,” they support a more activist U.S. foreign policy “premised on American hegemony.”\textsuperscript{54} The tragic terrorist events in the United States on September 11, 2001, increased the resolve of neoconservatives to follow an activist foreign policy combining moral purpose with the national interest. For example, after 9/11 Charles Krauthammer wrote that “the new unilateralism argues explicitly and unashamedly for maintaining unipolarity, for sustaining America’s unrivaled dominance for the foreseeable future.”\textsuperscript{55} However, the results of the Iraq War show that neoconservatives overestimated the United States’ ability to replace coercive regimes in complex developing societies with Western-style governments; and the United States’ growing economic problems (discussed in this book) show the pitfalls of defining unipolarity mainly in security terms. Thus, Francis Fukuyama, who previously identified with neoconservatism, now argues that “the neoconservative moment appears to have passed.”\textsuperscript{56}

In assessing the declinist–renewalist debate, economic as well as security issues must be considered. Renewalist arguments that the breakup of the Soviet bloc and Soviet Union enabled the United States to become the unchallenged hegemon in a unipolar world were mainly applicable to the security sphere. This book discusses the sources of U.S. strength and also the challenges the EU, Japan, and the BRIC (Brazil, Russia, India, and China) economies pose to U.S. hegemony. For example, we discuss the challenge the euro is posing to the U.S. dollar as the key international currency, the decline of the United States in the global trade regime, and the growing importance of non-U.S. multinational corporations. Military supremacy has enabled the United States to maintain its presence around the world, but this has been accompanied by declining U.S. economic fortunes because of a “low savings rate, poor educational system, stagnant productivity, declining work habits . . . [and] the low tax ideology of the 1980s, coupled with America’s insatiable desire for yet higher standards of living without paying any of the cost.”\textsuperscript{57} As we discuss in this book, the U.S. subprime mortgage crisis followed by the 2008 global financial crisis add weight to these arguments.
Whereas renewalists underestimate the importance of economic issues, declinists sometimes overlook political-security issues. For example, some declinists who see the euro as posing a serious challenge to the U.S. dollar devote too little attention to the EU’s weak position in the political-security spheres. The EU is highly vulnerable on a range of security issues such as external dependence on natural resources—about 40 percent of EU oil and gas depends on Russia or territories controlled by Russia. Coordination on many political and economic issues is also hindered by the fact the EU consists of 27 sovereign states. Only 16 of the EU’s 27 members have adopted the euro, and the 2008 global financial crisis has had markedly different effects on the 16 countries with the euro. Whereas Germany and some other richer countries have financial surpluses, Greece, Spain, Portugal, and Ireland are coping with debts that may become unsupportable. (Political issues such as stalemate in the U.S. Congress are also preventing the United States from adopting decisive economic policies to deal with decreasing confidence in the U.S. dollar.)

A cursory look at U.S.–China relations shows that both declinists and renewalists offer important arguments. (Part III discusses China’s position in greater detail.) After China began to reform its economy in 1978, its annual GDP growth rate averaged 9.4 percent, and its foreign trade increased from $20.6 billion in 1978 to $851 billion in 2005. China’s massive trade surplus with the United States and the United States’ dependence on China’s purchase of its government bonds to deal with U.S. foreign debt has given China considerable influence. However, China’s economy is only one-seventh the size of the United States’ and it ranks about a hundredth in the world in per capita income. China’s large population is also putting great pressure on its natural resources, which could impose limits on its economic development. Whereas China was East Asia’s largest oil exporter 20 years ago, it is now the world’s second largest oil importer. Despite its limitations, China has great economic potential, and its policies can have a major effect on the United States. For example, if China becomes more reluctant to hold U.S. treasury bills, this could have a serious effect on U.S. economic conditions and on the role of the U.S. dollar as the key international currency. China’s current use of its vast international reserves to secure exploration and supply agreements with states that produce oil, gas, and other sources of energy could also limit the supplies available to the United States and Europe.58

It is also important to consider soft as well as hard power in assessing the views of declinists and renewalists. During the Cold War, Western Europeans “welcomed the United States as their protector against the other superpower,” but after the Cold War, Europeans responded to the possibility of unrivalled U.S. military power by strengthening their own “military capacity, and forging an inner core within an enlarged European Union, as a balance to American power.”59 The penchant of President George W. Bush’s administration to follow unilateral policies without consultation further contributed to alienating its allies. Thus, Joseph Nye has advised U.S. leaders to use “hard power in a manner that does not undercut . . . [their] soft power.”60 In sum, declinists and renewalists have presented sharply divergent points of view, and Part III of this book will assess the strength of their arguments.
REALISM AND NORTH–SOUTH RELATIONS

Although the realists focus mainly on relative gains, their preoccupation with power and security leads them to emphasize distributional issues among the most powerful states. During the Cold War, realists were less concerned about conflict in the South (Korea, Vietnam, and the Middle East were exceptions) than about possible conflict in Europe, where fear of “East-West confrontations prevented even the most minor form of warfare between the two power blocs.”  

In IPE, the realist tendency to ignore Southern interests was especially evident in earlier years. For example, Friedrich List believed that the United States and Germany should adopt protectionist policies to develop their manufacturing industries so that they could compete with Britain, but he ruled out industrialization for the South. Northern states were “specially fitted by nature for manufacturing,” in List’s view, whereas Southern states should provide the North with “colonial produce in exchange for their manufactured goods.”  

Realist scholars have directed more attention to the South in recent years, but they are mainly interested in LDCs that pose a challenge to the North’s predominance. In the 1970s, for example, realists became interested in OPEC when it wrested control over oil prices from the international oil companies and launched “the most effective exercise of power by the South against the North since the conclusion of the Second World War.”  

When OPEC supported the G77’s demands in the United Nations for a New International Economic Order (NIEO), realists examined the NIEO’s possible impact. In the 1980s and 1990s, realists devoted attention to the East Asian NIEs, which posed a new economic challenge to the North. More recently, realists have focused on the challenge posed by the emerging BRIC economies, and on “resource nationalism” of the OPEC countries, Russia, and other oil exporters. Realists, by contrast, do not have a sustained interest in the poorest LDCs and the poorest groups within LDCs.  

The realist and liberal perspectives on North–South relations differ in several respects. Whereas liberals see LDCs as seeking wealth and prosperity, realists argue that LDCs seek increased power as well as wealth. In the realist view, LDC problems result not only from their poverty but also from their weak position in the international system; the South can decrease its vulnerability to the North only by increasing its power. Thus, even when LDCs have absolute economic gains they feel vulnerable because of their weak position vis-à-vis the North. Realists refer to several strategies LDCs employ to decrease their vulnerability. First, in line with Hamilton and List’s view that late industrializers require state involvement, many LDCs depend on government involvement to further their development. As discussed in Chapter 10, LDCs have often adopted policies such as import substitution and export-led growth in which the government supplements the market. An important realist contribution in this regard has been the concept of the developmental state, which has helped promote economic development in several East Asian NIEs (see Chapters 10 and 11).  

A second LDC strategy is to engage in collective action because they lack power individually. For example, the G77 has been a vehicle for Southern pressure on the North (see Chapter 2). Third, LDCs try to
alter international economic regimes and organizations. At the end of World War II, the United States as hegemon helped establish liberal economic regimes, but LDCs would prefer more authoritative, less market-oriented regimes in which IOs redirect some power and wealth from the North to the South.\(^{68}\)

Although realists focus on the North–South struggle for a redistribution of power and wealth, they assume that such a redistribution is possible within the capitalist system. Thus, both realists and liberals generally accept capitalism as the most desirable system for conducting international economic relations. As discussed in Chapter 5, historical materialists by contrast believe that a significant redistribution of power and wealth between the North and the South can only occur under socialism.

**CRITIQUE OF THE REALIST PERSPECTIVE**

Realists sharply differentiate domestic and international politics, and assume that states respond to external threats as rational, unitary actors. These simplifying assumptions have enabled realists to develop parsimonious international theories that purport to explain a great deal about the role of states in the global political economy. However, liberal and critical theorists are more attuned to the importance of domestic variables such as the history, social structure, and cultural values of a state in determining its role in IPE. Realists often correctly criticize both liberals and historical materialists for “economism,” or for overestimating the importance of economics; but realists by contrast tend to overemphasize the centrality of politics. The preoccupation of U.S. realists in the early postwar period with security issues and their neglect of economic issues was a prime example of this error. Since the 1970s, some realists have “returned to” economic issues with studies of hegemonic stability theory and the role of the state in IPE. Nevertheless, they often downgrade the importance of economic issues that are not related to realist concerns with power, security, and relative gains. For example, realists do not have a sustained interest in the effects of IPE on the poorest LDCs. Realists also place more emphasis on relative gains because of their concern with state survival and security in an anarchic self-help system. Relative gains are of primary concern in some interstate relationships, such as U.S.–Soviet relations during the Cold War; but absolute gains are often of greater concern in interdependent relationships among states that do not threaten each other with force. Even when realists study international economic organizations, they are more attuned to relative gains. For example, one realist study of the EU concludes that the weaker members “will seek to ensure that the rules” give them the opportunity “to voice their concerns and interests and thereby prevent their domination by stronger partners.”\(^{69}\) The preoccupation of realists with relative gains causes them to be highly skeptical about the influence of international institutions. If states are always fearful of gaining less than others, they will not transfer
authority to IOs. However, the IMF, World Bank, WTO, EU, and NAFTA all have a significant effect in IPE. Despite the realist perspective’s influence in IR, its preoccupation with security issues and relative gains has limited its influence in IPE. This book now turns to liberalism, the most important IPE theoretical perspective.

QUESTIONS

1. What is rational choice, and what are its main strengths and shortcomings as an analytical approach to the study of IPE?
2. What were the similarities and differences between the mercantilists and Friedrich List in their approach to IPE? Did liberalism have any effect on List’s views?
3. Why did realists devote little attention to IPE issues after World War II, and why did this change in the 1970s and 1980s?
4. What is hegemony, and how do theorists differ in their views regarding the strategies and motives of hegemonic states? Is a hegemon necessary to create and maintain open, stable economic regimes?
5. What are “public goods”? Why are they necessary for the functioning of the global economy, and why does their provision present “collective action” problems? What is the relationship between hegemony and public goods?
6. How and why do theorists differ in their views regarding the current status of U.S. hegemony? Is any other actor likely to replace the United States as the global hegemon?
7. What aspects of North–South relations are of most, and least, interest to realists?
8. What are the strengths and weaknesses of the realist approach to IPE?

KEY TERMS

absolute gains 57  
hegemony 63  
rational choice 54  
collective action 64  
international regimes 65  
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problem 64  
mercantilism 59  
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hard power 66  
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variable-sum game 57  
theory 62  
public goods 64  
zero-sum game 57

FURTHER READING


NOTES


The Liberal Perspective

Liberalism is the most influential perspective in IPE. Most international economic organizations and the economic policies of most states today are strongly influenced by liberal principles. However, the term liberal is used differently in IPE and in U.S. politics. Whereas U.S. conservatives support free markets and minimal government intervention, U.S. liberals support greater government involvement in the market to prevent inequalities and stimulate growth. Liberal economists, by contrast, have similarities with U.S. conservatives; they emphasize the importance of the free market and private property and seek to limit the government’s role in economic affairs. However, this chapter points to the fact that there are also variations among economic liberals. Although some liberal economists favor as little government involvement as possible, others believe that some government intervention is necessary for the effective functioning of markets.

BASIC TENETS OF THE LIBERAL PERSPECTIVE

It is easier to provide a “core statement” in realism and Marxism than in liberalism, because realists and Marxists place more emphasis on developing parsimonious theories that rely on a small number of concepts and variables. Unlike realists who focus on the rational unitary state, and Marxists who view the world in terms of class relations, liberals deal with a wider range of actors and levels of analysis. Although this broader outlook enables liberals to capture complexities that realists and Marxists overlook, it also hinders the development of a coherent liberal international theory. This chapter focuses on three types of liberalism relevant to IPE: orthodox, interventionist, and institutional liberalism. Orthodox liberals promote “negative freedom,” or freedom of the market to function with minimal interference from the state.
Interventionist liberals believe that negative freedom is not sufficient because the market does not always produce widespread benefits; thus, they support some government involvement to promote more equality and justice in a free market economy. Institutional liberals also view some outside involvement as necessary to supplement the market, and they favor strong international institutions such as the WTO, IMF, and World Bank. In addition to these three variants of liberalism, liberals also employ different methods of studying IPE. Liberals may rely on rationalism, constructivism, or some combination of the two. We discussed rational choice in the introduction to Part II, and we discuss constructivism in Chapter 5 because liberal as well as critical constructivists are critical of the rationalist assumptions of most liberals and realists.

The Role of the Individual, the State, and Societal Groups

Liberals see politics in “bottom-up” or pluralist terms, in which individuals and groups seek to achieve their goals through political means. In IPE, liberals therefore give primacy of place to the individual consumer, firm, or entrepreneur. They place more emphasis than realists on domestic–international interactions, and view individuals as having inalienable rights that must be protected from collectivities such as labor unions, churches, and the state. Thus, the orthodox liberal Adam Smith (1723–1790) argued in his discussion of the “invisible hand,” that the welfare of society depends on the individual’s ability to pursue his or her interests:

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 the 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 the society.

Because the “invisible hand” of the market performs so efficiently, society can regulate itself best with minimal interference from the state. Some liberals even reject the idea that the state is an autonomous actor and see public policy as resulting from a struggle among private interests. However, interventionist liberals favor some activism by the government because of the market’s limitations in dealing with problems such as unemployment.

The Nature and Purpose of International Economic Relations

The KIEOs—the IMF, World Bank, and WTO—uphold liberal economic principles, and liberals therefore have a positive view of international economic relations as currently structured. They assert that the KIEO liberal principles are politically neutral and that states benefit from economic growth and efficiency when their policies conform to those principles. If international relations do not result in growth and the efficient allocation of resources, the problem is not with the global economic system but with government failure
to pursue liberal economic policies. Liberals also assume that international
economic interactions can be mutually beneficial, or a positive-sum game, if
they operate freely. All states are likely to gain from open economic relation-
ships, even if they do not gain equally. Thus, liberals are often less concerned
with *distributional* issues and less likely to differentiate between rich and poor
or large and small states. Although liberalism encompasses a range of views on
distributional issues, with interventionist liberals emphasizing equality and
social democracy as well as liberty and efficiency, all liberals believe that the
international economic system functions best if it ultimately depends on the
price mechanism and the market.

Many liberals assume that the South faces basically the same challenges
that the North did during the nineteenth century. Unlike the nineteenth
century, however, the South benefits from the North’s diffusion of advanced
technology and modern forms of organization. Integration with the DC
centers of activity therefore spurs LDC economic growth, whereas isolation
from these centers results in LDC backwardness. According to liberals, the
purpose of international economic activity is to achieve optimum use of the
world’s scarce resources and to maximize economic efficiency and growth.
Thus, liberals consider aggregate measures of economic performance such as
the growth of GDP, trade, foreign investment, and per capita income as more
important than relative gains among states.

**The Relationship Between Politics and Economics**

Liberals tend to view economics and politics as separate and autonomous spheres
of activity. Orthodox liberals argue that governments should not interfere in
economic transactions and that their role should be limited to creating an open
environment in which individuals and private firms can freely express their
economic preferences. Thus, the state should prevent restraints on competition and
provide public goods such as infrastructure (roads and railways) and national
defense to facilitate production and transportation. If governments permit the
market to operate freely, a natural division of labor develops in which each state
produces goods for which it has a comparative advantage and everyone benefits
from the efficient use of the world’s scarce resources. As this chapter discusses,
interventionist liberals accept a greater degree of government involvement.

**The Causes and Effects of Globalization**

Whereas realists emphasize the role of the state, liberals attribute globali-
ization to technological change, market forces, and international institutions.
For example, one liberal argues that “our new international financial
regime . . . was not built by politicians, economists, central bankers or by
finance ministers. . . . It was built by technology.”¹ Some liberals argue that
governments can do nothing to stop the globalization process, because
technological advances in transportation and communications are rapidly
shrinking time and space. Other liberals believe that governments have
choices but that technological progress makes it more costly for them to close their economies. In addition to technology, liberals attribute globalization to the competitive marketplace and to legal and institutional arrangements. Thus, they examine the role of the KIEOs in facilitating globalization. In regard to the effects of globalization, Kenichi Ohmae argues that globalization is leading to the demise of the state, but this is an extreme view (see Chapter 2). Most liberals believe that the state lacks the capacity to deal with many global issues such as climate change, capital mobility, and financial crises. Thus, globalization is constraining the state and forcing it to vie with other significant actors such as MNCs, IOs, and NGOs. Liberals generally view these changes as positive developments, but this chapter discusses the fact that there is a range of liberal views.

ORTHODOX LIBERALISM

The liberal tradition dates back at least to John Locke (1632–1704), who argued that the state’s primary role was to ensure the “Preservation of . . . [peoples’] Lives, Liberties and Estates, which I call by the general Name, Property.” Locke predated Adam Smith by almost a century, but Smith is more associated with the orthodox liberal approach to political economy, because he opposed mercantilism and favored laissez-faire economics (see Chapter 3). Whereas the mercantilists assumed that a state could gain power and wealth only at the expense of other states, Smith cautioned that

By such maxims as these . . . nations have been taught that their interest consisted in beggaring all their neighbours. Each nation has been made to look with an invidious eye upon the prosperity of all the nations with which it trades, and to consider their gain as its own loss. Commerce, which ought naturally to be . . . a bond of union and friendship, has become the most fertile source of discord and animosity.

Thus, Smith opposed mercantilist state barriers against the free exchange of goods. Although he realized that merchants might favor protectionism to preserve their advantages, he differentiated such specific groups from the general populace who would benefit from free trade. Smith’s free-trade arguments were based on the principles of division of labor and interdependence. Each state in an unregulated international economy would find a productive niche based on absolute advantage; that is, it would benefit by specializing in those goods it produced most efficiently and by trading with other states. David Ricardo (1772–1823) strengthened the free-trade defense by arguing that two states would benefit from trade based on comparative advantage. Even if a state had no absolute advantage in producing any good, it should specialize in products for which it had a relative advantage, or the least cost disadvantage. (Chapter 7 has a detailed discussion of absolute and comparative advantage.) Although Smith strongly supported free trade, he did not view it as a unilateral or unconditional policy. For example, a state should be able to retaliate against
unfair trade restrictions and it might implement free trade gradually to give
domestic industry and labor groups time to adjust to international com-
petition. Smith was also open to limited government intervention because of
political realities: He argued that a state should be able to engage in national
defense, protect individuals from injustice or oppression, and provide public
works and institutions that private actors would not provide on their own.8
Despite his openness to a role for the government, Smith as an orthodox
liberal believed that it should be limited mainly to actions that promoted the
functioning of the market.

THE INFLUENCE OF JOHN MAYNARD KEYNES

The ideas of John Maynard Keynes (1883–1946) greatly influenced the theory
and practice of political economy, and some scholars view him as “the most
influential economist of his generation.”9 Although Keynes strongly opposed
the extreme nationalism of the interwar years, he also viewed the Great Depres-
sion as an indication that orthodox liberals overestimated the degree of conver-
gence between self-interest and the public interest. In contrast to the orthodox
liberal view that markets contribute to a socially beneficial equilibrium, Keynes
argued that a market-generated equilibrium might occur at a point where labor
and capital are underutilized. For example, he noted that economic adjustment
often resulted in unemployment rather than wage cuts because labor unions
resisted the downward movement of wages; this unemployment in turn led to
decreased demand and reductions in production and investment. Thus, Keynes
wrote in The General Theory of Employment, Interest, and Money that “the
central controls necessary to ensure full employment will, of course, involve a
large extension of the traditional functions of government.”10 He called on
governments to implement fiscal policies (and to a lesser extent monetary
policies) to increase demand, and he supported government investment when
necessary in public projects. Keynes’s view that the state should intervene in the
economy differed sharply from the laissez-faire doctrine of orthodox liberals.

Keynes’s support for government involvement resulted in a greater
“willingness to accept public sector deficits in order to finance public works or
other spending programs designed to lower unemployment.”11 His emphasis
on full employment also caused him to place less priority than orthodox liberal-
s on specialization and international trade. Thus, he argued that limits on
imports were sometimes justifiable to bolster domestic employment, even if
the goods could be produced more cheaply abroad. When unemployment
reached record highs in the 1930s, Keynes wrote that goods should “be
homespun whenever it is reasonably and conveniently possible.”12 After
World War II, Keynes supported internationalist solutions at Bretton Woods,
largely because of his preference for planning on a global scale (the United
States overruled this idea) and because of Britain’s financial problems. As
Britain’s chief postwar negotiator, he pressured the Labour government to
pursue open liberal policies, and in return the United States provided the
British with $3.75 billion in loans.13
In sum, Keynes called for the state to help combat unemployment, and his support for national and international economic management had a major impact on liberal economic thought. Despite Keynes’s divergence from liberal orthodoxy, as an economic liberal he believed in the importance of individual initiative and the efficiency of the market. In Keynes’s view, greater management would facilitate the efficient functioning of market forces. Thus, he favored government intervention not to replace capitalism but to rescue and revitalize it; this perspective gave rise to interventionist liberalism.\textsuperscript{14}

**LIBERALISM IN THE POSTWAR PERIOD**

The ideas of Karl Polanyi as well as Keynes were important for avoiding a recurrence of the economic problems of the interwar years. In *The Great Transformation*, Polanyi warned that the orthodox liberal commitment to the “self-regulating market” had produced disasters such as the Great Depression, and he predicted that society would move to protect itself from unregulated market activities.\textsuperscript{15} Influenced by the ideas of Keynes and Polanyi, the postwar planners designed the international economic order on the basis of an interventionist or “embedded liberal compromise.” John Gerard Ruggie coined the term *embedded liberal compromise* in reference to the fact that postwar efforts to maintain an open liberal international economy were embedded in societal efforts to provide domestic security and stability for the populace.\textsuperscript{16} Thus, policies to promote openness in the global economy included government measures to cushion domestic economies, and government policies to provide domestic stability in turn were designed to minimize interference with expansion of the global economy. In trade policy, for example, Western leaders called for multilateral tariff reductions, but they permitted states to use safeguards when necessary to protect their balance of payments and promote full employment. Underlying the embedded liberal compromise was a domestic class compromise between business and labor. Business induced labor unions to temper their demands that the economy be socialized by acceding to labor’s demands for collective bargaining and the welfare state. As a result, business won broad acceptance of trade liberalization, private ownership, and the market.\textsuperscript{17} In sum, postwar liberals favored government intervention to counter socially unacceptable aspects of the market, but they opted for government measures that would reinforce rather than replace the market.

**A RETURN TO ORTHODOX LIBERALISM**

Although postwar policy makers supported interventionist liberalism, orthodox liberals continued to have influence in some circles. Friedrich Hayek was highly critical of Keynes’s preference for economic planning, and he argued in his classic 1944 study *The Road to Serfdom* that a greater role for government would produce inefficiency and less individual freedom. Free markets by contrast would regulate themselves, allocate resources efficiently, and promote
economic freedom. In 1947, Hayek organized what became known as the Mont Pelerin Society, a private transnational forum of scholars and political figures committed to orthodox liberalism. Prominent members such as Hayek, Ludwig von Mises, and Milton Friedman favored competitive markets, the efficient allocation of resources, and a strict separation between politics and economics. Thus, Milton Friedman and Rose Friedman strongly criticized state interference with the market:

Wherever we find any large element of individual freedom, some measure of progress in the material comforts at the disposal of ordinary citizens, and widespread hope of further progress in the future, there we also find that economic activity is organized mainly through the free market. Wherever the state undertakes to control in detail the economic activities of its citizens . . . ordinary citizens are in political fetters, have a low standard of living, and have little power to control their own destiny.

Despite the persistence of orthodox views, most Western leaders followed interventionist liberal policies during the expansive years of the 1950s and 1960s. However, the 1973 OPEC oil price shock and the prolonged global recession after 1974 made welfare and full-employment policies more costly for governments. As economic growth declined, policies that redistributed some of the wealth posed a greater threat to capital accumulation by business groups. Thus, the writings of Hayek and Friedman had more influence on government policies in the late 1970s and 1980s. Foremost among political leaders pushing for the revival of orthodoxy were British prime minister Margaret Thatcher and U.S. president Ronald Reagan. Critics argued that the Thatcher–Reagan policies revitalized business confidence by rejecting the attempt to ease the effects of liberalism on vulnerable groups; these policies resulted in open conflict with government employees, trade unions, and welfare recipients. As these changes became more widespread, governments felt growing pressure to adopt orthodox liberal policies such as privatization, deregulation, and free trade and foreign investment. In contrast to the liberalism of Adam Smith, the return to orthodox liberalism was global in extent for several reasons:

- Advances in technology, communications, and transportation have enabled MNCs and international banks to shift their activities and funds around the world.
- The IMF, World Bank, and DCs have provided LDC debtors with financing since the 1982 foreign debt crisis, but the conditions on this financing have included privatization, deregulation, and liberalization of the LDC economies.
- With the breakup of the Soviet bloc, orthodox liberal pressures have also spread to the transition economies.

Scholars often use the term neoliberalism to differentiate this new liberal orthodoxy from the liberalism of Smith and Ricardo. Some scholars have focused on the role of ideas in promoting the changes from the orthodox liberalism of
Adam Smith to the interventionist liberalism of Keynes, and then back to the neoliberalism of Hayek and Friedman. In his book *Great Transformations*, Mark Blyth has discussed the role of ideas, first in building embedded liberalism and then in disembedding it.^{22} (See the discussion of constructivism in Chapter 5.)

**LIBERALISM AND INSTITUTIONS**

As discussed in Chapter 1, “hegemony” and “institutions” are important mechanisms for managing the global political economy. Robert Keohane defines institutions as “persistent and connected sets of rules (formal and informal) that prescribe behavioral roles, constrain activity and shape expectations.”^{23} International institutions can take three forms, namely IOs, international regimes, and international conventions. A liberal scholar first used the term regime in an IPE context, and a realist scholar edited a definitive volume on regimes.^{24} However, we discuss institutions in this chapter because liberals attach more importance to them than realists. International regimes promote cooperation in areas such as trade and monetary relations, where there is a high degree of interdependence. Before turning to regimes, we therefore discuss the liberal approach to interdependence and cooperation in IPE.

**Interdependence Theory**

Interdependence can be defined as “mutual dependence,” in which “there are reciprocal (although not necessarily symmetrical) costly effects of transactions.”^{25} Theorists have focused on interdependence since the early 1900s, but Richard Cooper’s *The Economics of Interdependence* (1968) was the first systematic study of economic interdependence among states.^{26} Cooper argues that growing interdependence as a result of advances in transportation, communications, and technology “negates the sharp distinction between internal and external policies,” and limits the ability of states “to achieve their desired aims, regardless of their formal retention of sovereignty.”^{27} States should respond to interdependence in Cooper’s view by coordinating their policies in “taxation, the regulation of business . . . [and] the framing of monetary policy.”^{28} However, Cooper devotes only limited attention to the political aspects of interdependence. In *Power and Interdependence*, Robert Keohane and Joseph Nye analyze how interdependence transforms international politics:

> Asymmetrical interdependence [i.e., mutual dependence that is not evenly balanced] can be a source of power. . . . A less dependent actor in a relationship often has a significant political resource, because changes in the relationship . . . will be less costly to that actor than to its partners.^{29}

Nevertheless, Keohane and Nye have a rather benign view of the effects of asymmetrical interdependence on smaller states. For example, they conclude that Canada often can successfully confront the United States in conflicts because of the high degree of “complex interdependence” between the two
countries. In complex interdependence, multiple channels (nongovernmental as well as governmental) connect societies, there is an absence of hierarchy among issues (military security does not dominate the agenda), and one government does not use military force against another. However, critics of the Keohane–Nye study argue that the United States as the larger power does not let market transactions dictate its interdependence with Canada and instead demands a wide array of “side payments.” For example, side payments in NAFTA include Canadian concessions to U.S. demands regarding openness to foreign investment and the sharing of energy resources (see Chapter 8).

Interdependence theorists question the realist assumptions that states are rational unitary actors, that states are the only important actors in IR, and that states can rely on military force to promote their national interest. Military force is of little use in dealing with interdependence issues such as environmental pollution, monetary and trade relations, and sustainable development. Interdependence theorists note that these issues are also more *intermestic* (domestic as well as international) than traditional security issues, and they criticize realists for overemphasizing the division between international and domestic politics. Despite these criticisms, interdependence theorists view their model as supplementing rather than replacing realism. Whereas realism is the best model for studying security issues, interdependence theory is best for studying international economic issues.

The Liberal Approach to Cooperation

Liberals are interested in how states can cooperate in an anarchic international system, and a fundamental problem in game theory called *prisoners’ dilemma* explores how states can achieve a better collective outcome through cooperation. *Game theory* investigates the interaction of two or more individuals or states, in which each individual or state acts according to rational choice; it seeks to explain how the actors’ decisions are interrelated and how these decisions affect outcomes. Prisoners’ dilemma is a “mixed-motive game,” in which two players can benefit from mutual cooperation but have an incentive to “defect” or cheat on each other and become free riders. The term *prisoners’ dilemma* derives from the story used to describe the game: The police arrest two individuals, A and B, for committing fraud, and they suspect that A and B have also committed robbery but cannot prove it. To get A and B to confess, the police put them in different cells so they cannot communicate with each other, and question them separately. In Figure 4.1, prisoners A and B “cooperate” with each other if they do not confess to committing robbery, and they “defect” (or cheat on each other) if they confess. The sentences the prisoners receive depend on the decisions they make. The numbers in bold at the top right-hand corners of the squares are A’s years in prison, and the numbers at the bottom left-hand corners are B’s years in prison. The police make a tempting offer to induce A to confess (i.e., defect). They inform A that conviction for fraud is certain and will result in a two-year sentence for both prisoners if they do not confess (square I in
Figure 4.1). However, if A confesses to robbery (i.e., defects) and B does not (i.e., cooperates), A will go free and B will get 10 years in prison (square II). If both A and B defect and confess to robbery, they will get a reduced sentence of five years (square III). Finally, if A does not confess (i.e., cooperates) but B confesses (i.e., defects), A will get 10 years in prison and B will go free (square IV). The police provide the same offer to B.

What will the prisoners do? According to individual rationality, if B defects, A is better off defecting (5 years in prison) than cooperating (10 years). If B cooperates, A is also better off defecting (goes free) than cooperating (2 years in prison). Thus, individual rationality pushes A to defect regardless of what B does, and the same reasoning applies to B! Furthermore, A and B mistrust each other, and they both fear that they will receive the worst possible penalty by cooperating (10 years) if the other prisoner defects. As a result, A and B are both likely to defect and end up with five years in prison (square III), even though both would get only two years (square I) if they
cooperated. Square I is the best *collective* outcome or the **Pareto-optimal outcome** for A and B, because no actor can become better off without making someone else worse off (i.e., if A confesses and goes free, B will get 10 years in prison). Square III is an inferior collective outcome or **Pareto-deficient outcome**, because both actors (A and B) would prefer another outcome (square I).

As is the case for the provision of public goods (see Chapter 3), prisoners’ dilemma presents a *collective action problem* in rational choice analysis, because rational actors may be “unable to reach a Pareto-optimal solution, despite a certain degree of convergence of interests between them.”[^34] The dilemma in both the provision of public goods and the prisoners’ dilemma game is that *individual* rationality differs from *collective* rationality: The decision of rational, self-interested states to become “free riders” may interfere with the provision of public goods, and the decision of rational, self-interested prisoners to defect may lead to a Pareto-deficient outcome (square III in Figure 4.1) for both prisoners.[^35] In IPE, we ask how states can move from a Pareto-deficient (mutual defection or DD) to a Pareto-optimal outcome (mutual cooperation or CC). In the liberal view, “cheating” or free riding by states can inhibit cooperation, and mutual cooperation is possible if cheating can be controlled. A global hegemon can prevent cheating by providing public goods and coercing other states to abide by agreed rules and principles. Institutions such as IOs can also prevent cheating by bringing states together on a regular basis. A state that interacts regularly with others is less likely to cheat because the other states have many opportunities to retaliate. International institutions also enforce principles and rules to ensure that cheaters are punished and they collect information on members’ policies, increasing transparency or confidence that cheaters will be discovered. Furthermore, international institutions contribute to a learning process in which states realize that mutual gains can result from cooperation.[^36]

Realists are more skeptical than liberals that international institutions have an important role in moving states to a Pareto-optimal (CC) outcome for several reasons. First, realists see international institutions as existing more often in “low politics” socioeconomic areas than in the “high politics” areas of national security and defense. Second, realists often view institutions as having no independent standing, because they serve the interests of the most powerful states. Third, realists see state concerns with *relative gains* as posing a major obstacle to cooperation. Even if two states have common interests, they may not cooperate because of each state’s concern that the other will receive greater gains. Institutions can promote cooperation, according to realists, only if they can ensure that members’ gains are balanced and equitable; but this is difficult to achieve because gains are rarely equal.[^37]

**Regime Theory**

Regime theory first developed from efforts to explain why international interactions are more orderly in some issue areas than in others. *Regimes* are “sets of implicit or explicit principles, norms, rules, and decision-making procedures
around which actors’ expectations converge in a given area of international relations.” Regime principles and norms refer to general beliefs and standards of behavior that guide relations in specific areas; for example, principles of the global trade regime include trade liberalization, reciprocity, and nondiscrimination. Rules and decision-making procedures stem from the broader principles and norms; for example, to promote the “trade liberalization” principle, the WTO has rules and decision-making procedures that limit protectionism and increase transparency. International regimes are normally associated with international organizations (IOs), which are formal arrangements created across national boundaries that help establish international machinery to facilitate cooperation among members. IOs are more concrete, formal institutions that are often embedded within regimes: For example, the WTO is embedded in the global trade regime and the IMF is embedded in the global monetary regime.

Regime studies focus on several themes. A first theme concerns the formation of international regimes. Researchers disagree as to whether a hegemon is necessary for the creation of regimes (see Chapter 3), and they also examine the strategies and processes that lead to the creation of regimes. A second theme concerns the maintenance of regimes. Some writers such as Robert Keohane argue that it is easier to maintain regimes than to establish them and that states benefiting from a regime may collectively maintain it even after a hegemonic state declines (see Chapter 3). Others relate the durability of regimes to their adaptability and examine the changes in regimes over time. A third theme relates to the results of regimes, or whether regimes “make a difference” in IR. Initially, there were few detailed studies on the results of regimes, but in more recent years theorists have examined regime significance in a wide range of areas such as global debt, the environment, transportation, and communications. To assess regime results, scholars examine whether states regularly abide by regime principles, norms, and rules; whether regimes effectively manage international problems; and whether regimes cause states to broaden their perceptions of self-interest.

Because liberals place emphasis on the role of institutions in promoting cooperation, regime theorists are most closely associated with the liberal perspective. Nevertheless, most regime theorists accept “the realist view of states as the central actors of international politics, and . . . the central realist premise that state behavior is rooted in power and interest.” Thus, some realists such as Krasner have devoted considerable attention to the role of regimes in IPE. However, “traditional realists” do not accept the idea that regimes have an important role in IPE, because they believe that states are mainly concerned with survival, security, and power. States participate in regimes simply to improve their relative positions, and regimes become arenas for acting out power relationships. The most powerful states establish regime principles, norms, and rules that further their national interests, and they do not adhere to the principles, norms, and rules when they conflict with their interests. For example, one realist asserts that “all those international arrangements dignified by the label regime are only too easily upset when either the balance of bargaining power or the perception of national interest . . . change among
those states who negotiate them." As global interdependence increased, "modified" realists such as Krasner acknowledged that regimes may be important in certain areas (e.g., trade and monetary relations). However, they continue to emphasize the centrality of the state and national power and see regimes as existing only under rather restrictive conditions. Liberals by contrast view regimes as a pervasive and significant phenomenon in IR.

This book assumes that regimes have a significant impact on international behavior in certain areas. Regime principles, norms, and rules can increase understanding and cooperation, and help establish standards that states and nonstate actors use to assess each others’ behavior. Regimes can also induce states to follow consistent policies, limit actions that adversely affect others, and become less responsive to special interests. To say that regimes and their IOs influence behavior does not indicate that their effect is always positive. As realists and historical materialists point out, a regime’s principles, norms, and rules may further the interests of the most powerful actors, often at the expense of the least powerful. Despite the value of regime theory, even liberal theorists argue that it has some serious shortcomings, and many now focus instead on global governance. The next section discusses the problems with regime analysis and compares the regime and global governance concepts.

**LIBERALISM, GLOBAL GOVERNANCE, AND REGIMES**

Governance refers to formal and informal processes and institutions that organize collective action, and global governance describes formal and informal arrangements that produce a degree of order and collective action above the state in the absence of a global government. As globalization has increased, global governance has become a central issue in IPE, because states have more difficulty managing their economic affairs individually, and actions states take have a greater effect on others. Some liberal theorists believe that the global governance concept avoids the limitations of regime analysis. First, most regime studies are state-centric, devoting too little attention to nonstate actors. Global governance studies by contrast assess the degree to which authority is being relocated from states to subnational, transnational, and supranational actors. Second, the focus of regime theorists on issue areas causes them to overlook broader aspects of global management; for example, most regime studies do not examine the crucial linkages between the global trade and environmental regimes. Global governance by contrast is a more encompassing concept that examines the linkages among issue areas and helps us understand these linkages. This book will highlight the linkages between monetary, trade, foreign investment, and international development issues. Third, regime theorists are criticized for assuming that “everyone wants . . . more and better regimes” and that “order and managed interdependence should be the collective goal.” Global governance studies are less obsessed with order and cooperation among states and more open to NGO demands for greater equity and justice.

Despite the advantages of the global governance concept, it also has shortcomings. Most importantly, the global governance literature does not offer a
consistent theoretical framework for testing the coherence or utility of its ideas; instead, it addresses a wide array of diverse issues and uses a number of theoretical approaches. Furthermore, regime theorists have altered their studies in response to the criticisms of regime analysis. For example, some analysts examine private and transnational regimes, in which nongovernmental actors agree on principles, norms, rules, and decision-making procedures to regulate their interactions. Some regime analysts have also devoted more attention to the linkage among issue areas. Thus, the international regimes and global governance concepts are not incompatible. Although “they differ in emphasis, both concepts [now] recognize the significance of nonstate actors and the relationships between issue areas.” Part III of this book relies on regime theory because it permits us to analyze specific issue areas. However, we are attuned to the criticisms of regime analysis and also refer to some broader issues of global governance.

**LIBERALISM AND DOMESTIC–INTERNATIONAL INTERACTIONS**

IPE scholars focus on domestic–international interactions because domestic groups often see a close relationship between international economic issues such as trade and their own economic welfare. Literature on domestic–international interactions cannot be categorized under a single IPE perspective, but we discuss this issue here because liberals have a particular interest in the role of domestic societal pressures on the state. Realists devote less attention to domestic issues with their emphasis on the rational, unitary state. (Some Marxists view the state as an “instrument” of the dominant capitalist class; see Chapter 5.) Although many IPE scholars recognize the importance of domestic–international interactions, integrating the domestic and international areas is a difficult process. This section examines the theoretical advances in this area, and the chapters in Part III give examples in specific IPE issue areas.

IPE theorists often examine domestic–international interactions in foreign economic policy making. In a 1977 study, Peter Katzenstein and others identified domestic political structure as a factor explaining differences in national responses to international economic events. For example, they argued that more centralized states such as Japan and France respond more decisively than decentralized states such as the United States to external shocks such as the 1973 OPEC oil price increase. The U.S. separation of powers between the president and Congress, and the division of powers between the federal government and the states make the U.S. government more vulnerable to interest group pressures and less able to respond promptly to external economic events. Although the strong state–weak state distinction may help us compare national policies in a general sense, later studies found that states are not uniformly strong or weak across different issue areas or time periods. For example, the U.S. executive has more leeway in making monetary than trade policy because societal groups see their economic fortunes as being more
affected by trade. More centralized states such as Japan also do not act decisively on every economic issue. During the East Asian financial crisis in the late 1990s, Japan had great difficulty in adopting the bold policy measures required to deal with the crisis (see Chapter 11).

International trade is an area where domestic–international interactions are particularly evident. For example, scholars have examined the effect of domestic producers and the general public on a state’s foreign trade policy. Consumers may benefit from lower prices and a greater variety of goods if import tariffs are abolished, but local producers may suffer because of increased competition from imports. Although consumers greatly outnumber producers, the gains of free trade to consumers are more diffuse, whereas the losses to producers are more concentrated. Thus, local producers are often more united and vociferous in demanding protection than consumers are in seeking free trade. Rational choice theorists argue that concentrated protectionist industries have more influence over policy makers than the diffuse free-trade interests of consumers, because politicians adopt policies that improve their chances for re-election. However, it is not sufficient to simply distinguish between concentrated and diffuse domestic interests for several reasons. First, concentrated interest groups do not necessarily have common interests. Concentrated “anti-protection interests” such as exporters, import-using industries, retailers, and multinational corporations often counteract the influence of concentrated protectionist interests. Second, concentrated producer interests do not always exert more influence than the general public, which sometimes reacts strongly to policies affecting employment, taxation, and inflation, and threatens to express its views in the ballot box. For example, dissatisfaction of the general public since the 2008 global financial crisis is clearly influencing the policy options open to U.S. political decision-makers. In sum, it is not true that “debates over foreign economic policy always pit concentrated interests against the public or that the mass electorate is always bested by concentrated interests.”56

The influence of producer groups on trade policy also depends on the nature of a country’s domestic governmental institutions. For example, members of the U.S. Congress, who are elected by constituencies, are more susceptible to pressure from concentrated protectionist interests than the U.S. president, who is elected by the entire voting public. Concentrated groups can often exert strong protectionist pressures because the U.S. Constitution gives Congress the sole power to regulate commerce and impose tariffs. As Chapter 7 discusses, the change in U.S. trade policy from protectionism to free trade was made possible by Congressional delegation of trade negotiating authority to the president. In contrast to the U.S. presidential system, parliamentary systems with strong party discipline are better equipped to limit protectionist forces; but legislators in parliamentary systems with weaker party discipline are more responsive to protectionist demands. A country’s trade policies, of course, are determined not only by domestic interests and institutions but also by the country’s position in the international system. Peter Gourevich and others focus on domestic structure as a consequence as well as a cause of foreign economic policy making. For example, interdependence and globalization have altered domestic
structure, causing governmental actors to share power with private actors such as MNCs.\(^{57}\)

Two-level game theory, a term coined by Robert Putnam, highlights the complexity of domestic–international interactions.\(^{58}\) For example, theorists often view international negotiations as a two-level game involving a state’s international interests and obligations (level 1) on the one hand and domestic interactions within the state (level 2) on the other. At the international level, state representatives bargain with each other to reach an agreement. At the domestic level, these representatives bargain with domestic actors whose concurrence is needed to give the agreement legitimacy and effectiveness. A degree of consistency must develop between the state’s international interests at level 1 and the domestic interests within the state at level 2 if an agreement is to be signed and implemented. Game theorists try to identify “win-sets,” or all possible level 1 agreements that would win ratification at level 2. Executives negotiating international agreements are aware that legislative concurrence may be a necessary part of their win-sets, because legislatures can sometimes block or limit the implementation of agreements even if they do not require formal legislative approval; as Chapter 7 discusses, this is often the case in the U.S. presidential system.

Two-level game theory is also used to assess the leverage states have in negotiations. For example, Putnam notes the irony that “the stronger a state is in terms of autonomy from domestic pressures, the weaker its relative bargaining position [may be] internationally.”\(^{59}\) A democracy can claim more easily than a dictatorship that domestic pressures prevent it from signing a disadvantageous agreement. When an executive leader’s options are limited domestically, others must recognize that she has more restricted domestic win-sets. For example, a negotiator may have more bargaining leverage if an international agreement requires legislative ratification and the legislature strictly limits the agreements it will approve. Chapter 7 shows that the U.S. Congress’s constitutional powers on trade often limit the executive’s options and give the president more leverage in international trade negotiations. A minority government in a parliamentary system may also have more leverage if it can convince others that its domestic position limits its win-set.

The substantive chapters in Part III provide more examples of domestic–international interactions in specific issue areas.

**LIBERALISM AND NORTH–SOUTH RELATIONS**

Liberals see the key factors in development as the efficient use of scarce resources and economic growth, which they often define as an increase in a state’s per capita income. Beyond these broad areas of agreement, the liberal development school “lacks a central unifying, theoretical argument.”\(^{60}\) The division between orthodox and interventionist liberals is also evident among development theorists.
Orthodox Liberals and North–South Relations

Orthodox liberals devote little attention to North–South distributional issues because they assume that international economic relations are a positive-sum game and that interdependence has a mutually beneficial effect on states. Indeed, orthodox liberals often argue that North–South linkages provide more benefits to LDCs than to DCs. The sections that follow outline the orthodox liberal views regarding domestic and external determinants of development.

Domestic Development Factors  Orthodox liberals assume that development problems stem largely from inefficient LDC policies. Although liberal modernization theory of the 1950s–1960s was considered to be passé by the 1970s, its precepts continue to influence orthodox liberal thought. Modernization theory asserts that the DCs achieved economic development by abandoning traditional practices and that LDCs must also replace their traditional practices with Western norms and institutions if they are to achieve development; for example, a system of rewards for innovation is essential because it helps generate surpluses that contribute to increased investment and self-sustaining growth. Although the changes required may produce dislocation and hardship, there are greater rewards and opportunities for societies that successfully modernize. Most scholars today would concede that the terms traditional and modern are imprecise and that “modern” values and practices are not always superior to “traditional” ones. However, orthodox liberals continue to believe that the main factors hindering LDC development are domestic. In their view, Western states that protected private property rights successfully industrialized, and LDCs that do not enforce these rights hinder foreign investment and development. LDCs should permit private producers to operate freely through the price mechanism and should rely on governments only to provide national security, education, and services to improve the functioning of markets.

Paths to Development  Although some modernization theorists suggested that LDCs might follow different routes to development, most modernization theorists were deterministic, advising the South to follow the same path to development that the North had taken. For example, one theorist wrote that the Western development model “reappears in virtually all modernizing societies of all continents of the world, regardless of variations of race, color, or creed.” Walt Rostow’s book The Stages of Economic Growth was highly deterministic, claiming that societies move through five stages on the path to modernity: traditional society, the preconditions for takeoff, the takeoff, the drive to maturity, and the age of high mass consumption. Despite the initial appeal of this model, Rostow’s predictions regarding LDC growth were overly optimistic, and it was difficult to apply his stages to specific LDCs. For example, Rostow argued that an LDC’s growth would become self-sustaining when it reached the takeoff stage; this prediction raised false hopes that LDC development was readily achievable and irreversible. Critics of modernization theory point out that the challenges facing LDCs today are very different from
those confronting early developers. Southern development cannot be a repetition of the earlier Western model because of globalization, MNCs, and the difficulty in competing with the North. Despite these criticisms, orthodox liberals continue to view the Western model as the only legitimate path to development. In the late 1980s, one liberal wrote that “third-world countries are much like those of the first world and will, with a modicum of external aid and internal stability, follow in the path of their predecessors,” and another predicted that we may be witnessing “not just the end of the Cold War” but “the universalization of Western liberal democracy as the final form of human government.”

External Development Factors Internationally, orthodox liberals view North–South relations as a positive-sum game that benefits the South, and they often argue that “the late-comers to modern economic growth tend to catch up with the early-comers.” The South requires foreign investment, the diffusion of advanced technologies, and export markets. Thus, LDCs that achieve development are integrated in the global economy through freer trade and capital flows, whereas the least developed LDCs have few trade and investment linkages with the North. Orthodox liberals believe that the East Asian NIEs developed rapidly in the 1960s–1980s because of their market orientation. Thus, Milton Friedman and Rose Friedman wrote in 1980 that “Malaysia, Singapore, Korea, Taiwan, Hong Kong, and Japan—all relying extensively on private markets, are thriving,” while “India, Indonesia, and Communist China, all relying heavily on central planning, have experienced economic stagnation and political repression.” Realists by contrast see government–business cooperation and selective government involvement as the key to East Asian economic development. Chapter 10 examines the liberal–realist debate on this issue.

Interventionist Liberals and North–South Relations
Interventionist liberals, like orthodox liberals, believe that LDCs with efficient, market-oriented policies are most likely to achieve economic growth. However, interventionists point to the inequalities between the North and the South, and some interventionists argue that “economic forces left entirely to themselves tend to produce growing inequality.” Interventionists therefore call on the North to consider the special needs of the South and recommend changes that involve some intervention in the market. For example, they propose that DCs remove trade barriers to LDCs, permit some protectionism for LDC industries, provide IMF and World Bank financing to indebted LDCs, and ensure that MNCs do not take advantage of LDC needs for foreign investment and technology. Interventionists see DC assistance to LDCs as a matter of enlightened self-interest because “the countries of the North, given their increasing interdependence with the South, themselves need international economic reform to ensure their own future prosperity.” Although interventionists argue that reforms are needed to provide for the
Critique of the Liberal Perspective

South’s special needs, they believe that the necessary changes can occur within the liberal order and that a radical redistribution of wealth and power between North and South is not necessary. They also believe in private enterprise and agree with orthodox liberals that many LDC development problems stem from domestic inefficiencies.\(^{72}\)

CRITIQUE OF THE LIBERAL PERSPECTIVE

As this chapter notes, orthodox liberals believe that all states benefit from free trade and foreign investment in a competitive market. They are not concerned about the fact that all states do not benefit equally, because the economic linkages produce mutual benefits. Interventionist liberals note that unemployment can occur under market conditions and that LDCs may require special treatment, but they believe that these problems can be remedied by supplementing rather than replacing the liberal economic system. Both realists and historical materialists criticize liberals for their inattention to power and distributional issues. Realists argue that relative gains are more important than absolute gains, because the most powerful states capture the largest share of the benefits. Economic exchanges are rarely free and equal, and bargaining power based on monopoly and coercion can have important political effects. Thus, powerful states can harm weaker states simply by reducing trade, aid, and investment.\(^{73}\) Historical materialists accuse liberals of legitimizing inequality and exploitation. Domestically, liberals mislead the working class into believing that it will benefit along with the capitalist class, and internationally, liberals disguise exploitation and dependency relations under the cloak of “interdependence.”

Critics also question the liberal view that advances in technology, transportation, and communication can solve the world’s economic and environmental problems. Even with technological advances, the liberal international order that seemed so positive-sum in the immediate postwar years is becoming more competitive as global resources such as energy, water, and food become less abundant. Furthermore, technological advances may in fact contribute to greater North–South inequalities. Endogenous growth theory posits that technological change is not the result of fortunate breakthroughs in knowledge exogenous to the factors of production. Instead, technological knowledge is an endogenous factor of production along with labor and capital. In other words, technological progress depends on investment in science and education, and on research and development (R&D). Because DCs and their firms have more resources than LDCs to subsidize education and R&D, they continue to increase their productivity and “grow indefinitely at a faster pace” than small and poor economies.\(^{74}\) Although some claims of endogenous growth theorists are controversial, they raise important questions about the orthodox liberal assumption that “the late-comers to modern economic growth tend to catch up with the early-comers.”\(^{75}\)
Orthodox liberals also assume that open economic policies and interdependence will improve LDC conditions, without considering North–South political power relationships. Aside from cases such as OPEC, the East Asian NIEs, and the BRIC economies, North–South relations are highly asymmetrical. Thus, Tanzania’s president Julius Nyerere remarked to a G77 meeting,

...What we have in common is that we are all, in relation to the developed world, dependent—not interdependent—nations. Each of our economies has developed as a by-product and a subsidiary of development in the industrialized North, and is externally oriented.\textsuperscript{76}

This dependent relationship provides the North with a potent source of power over the South. Economic liberals tend to discount the effects of this power asymmetry by arguing that North–South relations are a positive-sum game in which everyone benefits. One liberal assessment of NAFTA, for example, indicates that the United States, Canada, and Mexico agreed to “a partial surrender of autonomy in order to achieve the benefits that are available from mutual relaxation of protectionism.”\textsuperscript{77} However, orthodox liberals avoid asking whether LDCs (i.e., Mexico in NAFTA) must surrender more autonomy than DCs (the United States and Canada). Liberals are also criticized for putting too much faith in the market and for disregarding the role of the state. Interventionist liberals view states as performing corrective functions, but even interventionists are criticized for undertheorizing the role of the state. Thus, realists argue that we should “bring the state back in” to our research because of its central role in policy making.\textsuperscript{78}

Whereas liberals and realists accept the capitalist system as a given, historical materialists view capitalism as an exploitative system that should—and will—eventually be replaced by socialism. We discuss historical materialists and other critical theorists in the next chapter.

\textbf{QUESTIONS}

1. What are the similarities and differences among orthodox, interventionist, and institutional liberals?

2. Why did John Gerard Ruggie’s “embedded liberalism” become so important after World War II, and how did it draw upon the ideas of John Maynard Keynes and Karl Polanyi?

3. When did neoliberalism emerge, and why? How did it draw on the ideas of Milton Friedman? How did it differ from the liberalism of Adam Smith?

4. In what way do both the provision of public goods and prisoners’ dilemma demonstrate “collective action problems”? How and why do liberals and realists differ in their views regarding the possibilities for cooperation under prisoners’ dilemma?

5. What are international regimes, and what are the views of regime theorists regarding the formation, maintenance, and results of regimes?

6. In what way does regime theory draw on both the liberal and realist perspectives? What are the major criticisms of regime theory? Is “global governance” a more useful concept than “regimes”?
7. In what ways have studies of foreign economic policy making, concentrated and diffuse domestic interests, and two-level game theory increased our understanding of domestic–international interactions in IPE?

8. How do orthodox and interventionist liberals approach the issue of North–South relations? What are some of the criticisms of their approach?

**KEY TERMS**

- endogenous growth theory 95
- interdependence 84
- Pareto-deficient outcome 86
- global governance 89
- international organizations 88
- Pareto-optimal outcome 86
- governance 89
- interventionist liberals 78
- prisoners’ dilemma 85
- institutional liberals 78
- market economy 78
two-level game theory 92
- institutions 84
- orthodox liberals 77

**FURTHER READING**


**NOTES**


42. Stein, “Neoliberal Institutionalism,” p. 203.


47. Strange, “Cave! Hic Dragones,” p. 345.


49. For other criticisms of the global governance literature see Hira and Cohn, “Toward a Theory of Global Regime Governance,” pp. 12–16.

50. See Further Readings in this chapter for examples.


64. Daniel Lerner, *The Passing of Traditional Society: Modernizing the Middle East* (New York: Free Press, 1964), pp. viii–ix. (This quotation is in the preface to the paperback edition.)


69. Friedman and Friedman, *Free to Choose*, p. 57.


This chapter is more broad ranging than Chapters 3 and 4 because it discusses four critical perspectives that do not agree on a core set of assumptions: historical materialism, constructivism, feminism, and environmentalism. Their main common feature is that they are all critical of the traditional mainstream liberal and realist perspectives. However, the “mainstream” is not static, and we will discuss the fact that there are liberal as well as critical constructivists, feminists, and environmentalists. This chapter devotes more attention to historical materialism than to the other critical perspectives because it encompasses the largest group of critical theories, including Marxism, dependency theory, world-systems theory, and Gramscian analysis. Although all these approaches have some roots in Marxism, they often diverge substantially from classical Marxist thought. Historical materialism is “historical” because it examines structural change in terms of class and sometimes North–South struggles over time, and it is “materialist” because it examines the role of material (especially economic) factors in shaping society.¹

BASIC TENETS OF HISTORICAL MATERIALISM

The Role of the Individual, the State, and Societal Groups

Marxists see “class” as the main factor affecting the economic and political order. Each mode of production (e.g., feudalism and capitalism) is associated with an exploiting nonproducing class and an exploited class of producers. Classes are absent only in the simplest primitive-communal mode of production and in the future Communist mode. Thus, Karl Marx and Friedrich Engels wrote that modern bourgeois society “has not done away with class antagonisms. It has but established new classes, new conditions of oppression,
new forms of struggle in place of the old ones.” Marx and Engels depict the state as being an agent of the bourgeoisie, which uses it as an instrument to exploit wage labor. Although the state may have some autonomy from a dominant class during transition periods when the power of classes is more equally balanced, the state cannot escape from its dependence on the capitalist class in the longer term. Only when the proletarian revolution eliminates class distinctions based on private ownership will the state no longer be an instrument of class oppression. A number of scholars criticize Marx and Engels’ position that state actions simply reflect the views of the dominant class (see the following discussion).

The Nature and Purpose of International Economic Relations

Historical materialists view economic relations as basically conflictual, with one part of society exploiting another. It is well known that the views of historical materialists evolved along with changes in the international system. Thus, Marx and Engels predicted that contradictions within capitalism would contribute to poverty of the working class, surplus production, economic downturns, and the collapse of capitalism. Lenin later cited imperialism to explain why capitalism survived, asserting that colonies provided the “metropole” states with a cheap source of raw materials and a market for the metropoles’ surplus production. When capitalism persisted after decolonization, historical materialists explained this as neocolonialism: Although the imperial powers ceded political control, they continued to have economic control over their former colonies. As this chapter discusses, dependency, world-systems, and Gramscian theorists offer other explanations for the persistence of capitalism. Historical materialists favor a redistribution of power and wealth, but unlike realists they do not believe that such a redistribution can occur with unfettered capitalism. Although historical materialists advocate for the poor and less powerful, they take different approaches to dealing with capitalism’s inequities. Some accept certain elements of market capitalism while others totally reject it, some want LDCs to become socialist while others seek the overthrow of the capitalist system, and some believe in evolutionary reform while others advocate revolution.

The Relationship Between Politics and Economics

Marx describes history as a dialectical process in which there is a contradiction between the economic mode of production (e.g., feudalism, capitalism, and socialism) and the political system. This contradiction is resolved when changes in the mode and relations of production eventually cause the political “superstructure” to change. Thus, Marx provided the foundation for instrumental Marxism, which—like liberal pluralism—sees government (i.e., politics) as responding in a rather passive manner to economic pressures. Liberals, however, see any societal group as having political influence, whereas instrumental Marxists believe that a state’s policies reflect the interests of the
capitalist class. To support their position, instrumental Marxists point to personal ties between capitalists and public officials and to the movement of individuals between business and government. After World War II, many scholars criticized instrumental Marxism because DCs adopted welfare and unemployment insurance policies despite the opposition of major business groups. As a result, structural Marxism emerged, which sees the state as relatively autonomous from direct political pressure of the capitalist class. Although some capitalists oppose state policies benefiting workers, they do not realize that these policies serve their long-term interests. By providing welfare and other benefits, the state placates the workers and gains their support for the continuance of capitalism. Structural Marxists differ from realists even though they both see the state as somewhat autonomous. In the structural Marxist view, the bourgeoisie does not directly control the state, but the two share a commitment to the survival of capitalism. Realists, by contrast, see the state as furthering the “national interest” independently of the economic interests of any societal group.

The Causes and Effects of Globalization

In the Marxist view, the bourgeoisie promote globalization because it increases their profits and gives them dominance over the proletariat. Marxists agree with liberals that technological advances can facilitate globalization. However, liberals see these technological advances as resulting from natural human drives for economic progress, while Marxists believe that they result from “historically specific impulses of capitalist development.” Historical materialists agree with liberals that globalization is a pervasive force, but unlike liberals they see it as a negative process that prevents states from safeguarding domestic welfare and employment. Adjustment to global competitiveness is the new imperative, and states must adapt to the needs of the global economy; for example, indebted LDCs must impose adjustment measures on vulnerable groups such as women and children to become more globally competitive. Globalization is also increasing the structural power of capital over labor. Capital is one of the factors of production, along with land and labor; it consists of physical assets, such as equipment, tools, buildings, and other manufactured goods that can generate income and financial assets. Historical materialists view capital in social, political, and economic terms and focus on capital’s exploitation of labor in the capitalist system. For example, states are more dependent on foreign investment and must respond to business demands by disciplining trade unions and pressuring for lower wages. Furthermore, a new transnational managerial class has divided the labor force by shifting production from the mass production factory to many small component–producing and servicing units. Historical materialists also see globalization as a cause of environmental degradation, the illegal drug trade, intra-ethnic conflict, and civil society protests. Whereas some historical materialists oppose globalization in general, most focus their criticisms on capitalist globalization.
EARLY FORMS OF HISTORICAL MATERIALISM

Karl Marx and IPE

Although Karl Marx (1818–1883) did not write systematically about IR, his theory of capitalism and class struggle provided the basic framework for historical materialism in IPE. Marx wrote many articles about the effect of Western capitalism on non-European areas, but he had little direct experience with these areas. He believed that capitalism emerged in the West (in Europe) when private feudal landholdings were converted into private bourgeois property. India and China, by contrast, had an “Asiatic” mode of production that Marx viewed as outside the mainstream of Western development. The state’s presence was much greater in the Asiatic mode, with the central governments in China and India developing large public work projects to provide water over extensive land areas. At the local level India and China had small, self-sufficient village communities with communal rather than individual ownership. Because of this communal and public property at the local and central levels, Marx saw no basis for a transformation to private capitalist holdings in the Asiatic mode. Thus, Marx argued that external pressure from Western imperialism was necessary if China and India were to progress to capitalism and then to socialism.

Marx harshly criticized England for destroying India’s textile industry by preventing it from exporting cotton to Europe and by inundating it with British textiles; but he also criticized India for lacking capitalism’s capacity for development. In contrast to stagnating Asiatic societies, Marx viewed capitalism as a dynamic, expansive system with a historic mission to spread development throughout the world. Thus, Marx believed that England performed a dual function in India: destroying the old society and providing the foundation for Western society, which would in turn provide the conditions for a Communist revolution in Asia:

Can mankind fulfill its destiny without a fundamental revolution in the social state of Asia? If not, whatever may have been the crimes of England, she was the unconscious tool of history in bringing about that revolution.

Marx’s analysis of Asia had major defects due to his lack of firsthand knowledge and his Eurocentric prejudices, and later in life he repudiated some of his own ideas regarding the Asiatic mode of production.

Marxist Studies of Imperialism

Although Marx wrote about capitalism and non-European societies, systematic studies of imperialism depended on later writers. Theories of imperialism portray the world as hierarchical, with some societies engaging in conquest and control over others. John Hobson (1858–1940), a non-Marxist English economist, developed an economic theory of imperialism
that identified three major problems of capitalist societies: low wages and underconsumption by workers, oversaving by capitalists, and overproduction. In Hobson’s view, workers are paid low wages, and therefore they have limited purchasing power. Thus, the capitalists must look to countries abroad as an outlet for their surplus goods and profits, and this gives rise to imperialism. Despite Hobson’s influence, Vladimir Lenin’s (1870–1924) *Imperialism: The Highest Stage of Capitalism* became the most widely cited work in this area. Lenin focused on the expanded imperialism of the late nineteenth century “in which the dominance of monopolies and finance capital established itself” and “the division of all territories of the globe among the great capitalist powers [was] . . . completed.” Although Hobson and Lenin agreed that imperialism resulted from low wages and underconsumption by workers, they offered different solutions. As a liberal, Hobson assumed that imperialism would no longer be needed as an outlet for surpluses if workers’ wages increased *within* the capitalist system. However, Lenin as a Marxist viewed exploitation of the workers and imperialism as *inevitable* outcomes of capitalism. Whereas Hobson believed in evolution within the capitalist system, Lenin saw revolution as the only alternative.

Lenin also turned to imperialism to explain why the revolution had not occurred as Marx predicted. The export of capital and goods to colonial areas provided “superprofits,” which the capitalists used to bribe the working class in their home countries with higher wages and social benefits. This created a “labor aristocracy” committed to the metropole states that slowed the movement toward Marxist internationalism. However, imperialism did not mark an end to capitalism’s underlying contradictions, and the revolution was still inevitable. Once the capitalist states had divided the globe into colonial areas, competition among them would lead to interimperialist wars and the downfall of capitalism. Lenin’s position on the effects of colonialism was somewhat ambivalent. Although he argued that capitalist states opposed industrialization in the colonies and used them as sources of raw materials, like Marx he viewed colonialism as a *progressive* force essential for Southern development. Western exports of capital and technology to their colonies would help create foreign competitors with lower wages, and the increased competition between rising and declining capitalist powers would eventually lead to imperial rivalries and conflict. However, colonialism did not bring industrialization and development to the colonies as Marx and Lenin had predicted. Even after Latin American colonies gained their independence in the nineteenth century, they depended on external capital and technology and continued to produce more primary products than industrial goods. The failure to bring about capitalist development led to major rifts among Marxists, with some arguing that imperialism was economically regressive. As the following discussion shows, dependency theorists turned Marxism on its head and focused on capitalism’s role in hindering rather than facilitating LDC development.
**Dependency Theory**

Dependency theory, the dominant approach to development among Latin American intellectuals during the 1960s, rejects the optimism of liberal modernization theory (see Chapter 4) and argues that advanced capitalist states either underdevelop LDCs or prevent them from achieving autonomous development. Dependency theory is based on two theoretical traditions: Marxism and Latin American structuralism. Like Marxists, dependency theorists focus on capitalist development; use terms such as *class*, *mode of production*, and *imperialism*; and support the replacement of capitalism with socialism. However, dependency theorists reject Marxist views that DCs benefit LDCs in the long term by contributing to the spread of capitalism. Dependency theory is also based on the ideas of the Argentinian economist Raúl Prebisch and other Latin American “structuralists,” who focused on structural obstacles to LDC development. Prebisch rejected liberal assumptions regarding the benefits of free trade and argued that LDCs in the periphery suffer from declining terms of trade with DCs in the core. The South is hindered by its dependence on primary product exports because people demand more finished goods as their incomes increase, but *not* more primary products. If LDCs try to raise prices for their raw materials, the North can develop substitute or synthetic products. Thus, Prebisch argued that LDCs should adopt protectionist *import substitution industrialization* (ISI) policies that impose import barriers and should produce manufactures domestically to satisfy demand previously met by imports. In the 1950s and 1960s many LDCs adopted ISI, but it contributed to numerous problems and growing balance-of-payments deficits (see Chapter 10). Scholars challenged Prebisch’s views, and many leftists turned to dependency theory. Unlike Prebisch, dependency theorists argue that the core will never permit LDCs to achieve genuine, autonomous development.

There are two main groups of dependency theorists. The first, inspired by André Gunder Frank’s *Capitalism and Underdevelopment in Latin America*, takes a more doctrinaire position on the impact of dependency; the second, inspired by Fernando Henrique Cardoso and Enzo Faletto’s *Dependency and Development in Latin America*, takes a less doctrinaire approach. Dependency theorists argue that the North benefits from global capitalist linkages and dynamic development based on internal needs, while the South’s development is severely constrained because of its interaction with the North. However, Cardoso and Faletto were more inclined than Frank to reject the idea that “external factors . . . were enough to explain the dynamic of societies,” and they examined the relationship between “internal and external processes of political domination.” For example, dependency theorists in the Cardoso–Faletto strain contend that elites in the South (compradores) have alliances with the capitalists in the North and often take actions that reinforce the pattern of LDC dependency. Dependency theorists in the Frank strain also argued that the development of capitalist economies in the core *required* the
underdevelopment of the periphery. Although LDCs were undeveloped in the past, they became underdeveloped as a result of their involvement with the core countries. Theorists in the Cardoso–Faletto strain took a more nuanced approach, arguing that “associated dependent development” was sometimes possible in the periphery. Dependent development differs from autonomous development, because LDC workers produce less sophisticated capital goods in the periphery and continue to depend on imports of machinery, technology, and foreign investment from the core. The Cardoso-Faletto strain gained support because industrialization was occurring in some LDCs, and many dependency studies in the 1970s–80s focused on “dependent development” rather than “underdevelopment.”

Frank’s views evolved, and even he began writing about dependent development in the East Asian NIEs.

Dependency theory became a major target of criticism in the 1970s and 1980s. First, dependency theorists were criticized for failing to adequately define their concepts: They see states as either dependent or independent and do not measure different levels of dependence. Furthermore, “core” and “periphery” are overly broad categories. How do we justify including Haiti with Brazil in the periphery, or Greece with the United States in the core? Second, the only form of exploitation dependency theorists discuss is capitalism. Critics argue that the most important factor in dependency is not capitalism per se but unequal power among states; thus, capitalism and Soviet communism were both marked by “asymmetric and unequal linkages between a dominant center and its weaker dependencies.” Third, dependency theorists often prescribe a breaking of linkages with the core and a socialist revolution to bring about social justice and equality. However, critics note that cutting linkages with the core does not ensure that a country will “emphasize distribution and participation rather than accumulation and exclusion.” Fourth, dependency theorists focus so much on the global economy as the source of LDC problems that they do not adequately explain why LDCs may respond differently to similar external constraints. Even the Cardoso–Faletto strain gives primacy to external factors. Fifth, dependency theory’s predictions regarding development are simply incorrect. For example, theorists held up China as a model of agrarian self-reliance, but in 1976 it adopted more open policies that contributed to its rapid economic growth. Some of the criticisms come from Marxists, who assert that dependency theorists are overly nationalistic. Whereas dependency theorists see the central problem as foreign control, Marxists see it as private control of the means of production. Thus, dependency theorists focus more on “relations of exchange” (between core and peripheral states) than on “relations of production” (between classes). These criticisms led to the decline of dependency theory, but they were aimed more at the radical version than at the less extreme Cardoso–Faletto strain. Although development theorists today rarely identify themselves as dependency theorists, they continue to examine “many issues and areas of development where dependency plays a major role.”
WHITHER THE HISTORICAL MATERIALIST PERSPECTIVE?

With the breakup of the Soviet bloc and the end of the Cold War, some mainstream theorists see historical materialism as no longer relevant. For example, one liberal theorist argues that “the implosion of the Soviet Union, and domestic changes in Eastern Europe, have eliminated the significance of the socialist economic model,” and another claims that we are witnessing the “victory of economic and political liberalism.” However, there are reasons to expect a renewed interest in historical materialism in future years. First, the breakup of the Soviet bloc enables theorists to express Marxist ideas without having to defend the heavy-handed actions of the Soviet Union. Second, Marxist analyses of capitalism’s contradictions have gained some support from the 1980s foreign debt crisis, the 1990s East Asian financial crisis, and the 2008 global financial crisis. Third, growing inequalities between rich and poor in a number of states are reviving interest in alternatives to the liberal economic model. As a 2005 UN Report notes, “historically, the highest levels of income inequality have been found in Africa and Latin America, and in the 1980s and 1990s the situation deteriorated even further.” Thus, some analysts warn that “Latin America is swerving left, and distinct backlashes are under way against . . . free-market reforms, agreement with the United States on a number of issues, and the consolidation of representative democracy.”

The growing inequalities are not only evident in LDCs. For example, the share of total income going to the top one percent of earners in the United States rose from 8.9 percent in 1976 to 23.5 percent in 2007. Historical materialism continues to have appeal because of its focus on the poor, the weak, and distributive justice issues. The following sections discuss some contemporary theories with links to historical materialism.

World-Systems Theory

Whereas dependency theory focuses on core–periphery relations, world-systems theory focuses on the entire world-system, including relationships among core states and the rise and decline of hegemons. The following discussion refers mainly to the ideas of Immanuel Wallerstein, who founded world-systems theory, but we sometimes discuss areas where other theorists diverge from Wallerstein’s views. The main unit of analysis in world-systems theory is the world-system, which has “a single division of labor and multiple cultural systems.” There are two types of world-systems: world-empires, which have a common political system, and world-economies, which have many political systems. In a world-empire, a single political entity (such as ancient Rome) often uses coercive power to control the economic division of labor between the core and the periphery. The modern world-system is a world-economy, because no single state has conquered the entire core region. Instead, states engage in a “hegemonic sequence,” in which various hegemonic states (the Netherlands, Britain, and the United States) rise and fall. Today the capitalist world-economy
is the only world-system. Although states in the world-economy establish a 
power hierarchy through market mechanisms, the core states may use force 
when peripheral states challenge the market rules that sustain the core’s 
dominance. Wallerstein asserts that the capitalist world-economy emerged 
in Europe during the “long” sixteenth century (1450–1640), but some other 
theorists argue that it originated earlier in the Middle East or Asia.40 
The capitalist world-economy’s main features are production for the market 
to gain the maximum profit and unequal exchange relations between core 
and peripheral states.41 

Because the world-economy is their unit of analysis, world-systems 
theorists do not consider states to be meaningful actors apart from their 
position in the world-economy; thus, long before the breakup of the Soviet 
Union, Wallerstein wrote that there are “no socialist systems in the world-
economy any more than there are feudal systems because there is one 
[capitalist] world-system.”42 They also believe that a state’s internal and 
external strengths cannot be viewed separately from its position in the 
world-economy; core states are strong and peripheral states are weak. 
World-systems theorists introduced the semiperiphery as a third category 
between the periphery and the core to account for the fact that some LDCs 
are industrializing. Some states have moved up or down on the core/semipe-
riphery/periphery hierarchy, but world-systems theorists are more 
pessimistic than liberals about the prospects for today’s LDCs. Although 
some semiperipheral states seem to be models of economic success, they are 
simply “the more advanced exemplars of dependent development.”43 
Thus, the core, the periphery, and the semiperiphery are enduring features 
of the capitalist world-economy. The semiperiphery divides the periphery so 
the core states do not face a unified opposition, and the semiperipheral 
states view themselves “as better off than the lower sector rather than as 
worse off than the upper sector.”44 Thus, the semiperiphery stabilizes the 
capitalist world-economy. Despite this apparent stability, capitalism has 
contradictions that threaten its long-term survival, and world-systems 
theorists raise the prospect of its replacement by socialism. 

Theorists have subjected world-systems theory to wide-ranging 
criticisms. Realists see world-systems theory as undertheorizing the role of 
the state. In their view, Wallerstein’s interest in individual states “is limited 
to showing how” they are “incorporated into” the world-economy, and he 
simply assumes that strong states are in the core and weak states are in the 
periphery.45 As realists point out, in the sixteenth century some strong 
states such as Spain and Sweden were in the periphery, while some core 
states such as Holland and England had relatively weak state structures. 
Indeed, late industrializers often require a strong state to promote their 
development.46 Liberals argue that world-systems theorists make 
broad generalizations about capitalism, without pointing to the variations 
in capitalism during different historical periods. For example, the merchant 
capitalism under Dutch hegemony was quite different from the competitive 
capitalism under U.S. hegemony. Marxists assert that world-systems theory
(like dependency theory) puts more emphasis on “relations of exchange” among the core, the semiperiphery, and the periphery than on “relations of production” between capitalists and workers. Despite its shortcomings, world-systems theory provides an alternative approach to IPE that offers a long-term historical view of economic and political change. Many liberals by contrast underestimate the historical differences between industrializing countries in the past and LDCs today, and the realist approach is often ahistorical. World-systems theory is also more flexible than dependency theory as it asserts that states sometimes ascend from the periphery to the semiperiphery and core. However, world-systems theorists avoid the overoptimism of liberals regarding LDC development prospects. Although world-systems theorists overestimate the degree to which external exploitation causes LDC problems, orthodox liberals err in the opposite direction by downplaying the role of external exploitation in the capitalist world economy.

Neo-Gramscian Analysis

Neo-Gramscian analysis is “the most influential Marxist theory in ... contemporary international relations.” Its name derives from the fact that it draws on the writings of Antonio Gramsci (1891–1937), a theorist and social activist who was a former leader of the Italian Communist party. Despite his Marxist linkages, Gramsci saw Marxism as unable to explain crucial aspects of Italian politics and society such as the role of Catholicism and the rise of Mussolini because it was economistic (it exaggerated the importance of economics). Thus, Gramsci’s theory focused largely on domestic politics in Italy. In discussing capitalist domination and the reorganization of society under socialism, Gramsci examined the interaction between economics on the one hand and politics, ideology, and culture on the other. In the 1980s Robert Cox extended Gramsci’s ideas to the international sphere, and this resulted in the emergence of “neo-Gramscian IPE.”

Whereas realists identify hegemony solely with the power of a predominant state, Gramscians view hegemony in terms of class. A dominant class that rules only by coercion is not hegemonic in Gramscian terms because its power does not extend throughout society and it can be overthrown simply by physical force. To attain hegemony, the dominant class must gain the active consent of subordinate classes on the basis of shared values, ideas, and material interests. For example, the bourgeoisie gained the support of subordinate classes for its leadership by offering them concessions such as economic benefits and the acceptance of labor unions. Gramscians use the term historic bloc to refer to the congruence between state power, ideas, and institutions that guide the society and economy; it is difficult for subordinate groups to replace the bourgeois historic bloc because it is supported by the power of ideas as well as physical power. Like classical Marxists, Gramsci was committed to political action, and called for building a counterhegemony—an alternative ethical view of society—to challenge capitalism. The decline
of government economic benefits in this age of global competitiveness could induce subordinate classes to develop a counterhegemony.49

Applying Gramsci’s ideas to IPE, Cox writes that postwar institutions such as the IMF, World Bank, and GATT upheld liberal norms and legitimized U.S. hegemony with a minimal amount of force. Cox also sees a transnational historic bloc composed of the largest MNCs, international banks, business groups, and economic organizations as extending class relations to the global level. A crucial part of this historic bloc is the power and mobility of transnational capital, which is extending neoliberalism on a global scale. The ability of transnational capital and MNCs to shift location from one state to another enables them to play off less mobile national labor groups against one another. Workers employed by MNCs also identify their interests with transnational capital, and this divides the working class and limits its ability to build a counterhegemony. Further solidifying this transnational historic bloc is a hegemonic ideology that sees capital mobility as contributing to economic efficiency, consumer welfare, and economic growth.50

Despite the solid foundations of this transnational historic bloc, civil society dissatisfaction could eventually stimulate a counterhegemony. As discussed in Chapter 2, civil society groups can be conformist, reformist, and transformist (or rejectionist). Conformist civil society groups are part of a top–down process in which the capitalist class gains acquiescence from the population. Transformist civil society groups are part of a bottom–up process in which disadvantaged people try to displace the capitalist order. Although civil society protests at IMF, World Bank, and WTO meetings have not attained the status of a counterhegemonic alliance, they demonstrate considerable concern about the effects of neoliberal globalization on people’s lives.51

Liberal critics charge that neo-Gramscians are so preoccupied with capitalist hegemony that they do not explore the problems of dominance and subordination in other systems such as socialism. Neo-Gramscians avoid some of the pitfalls of classical Marxists who predicted the early downfall of capitalism. However, some critical theorists charge that neo-Gramscians focus more on how capitalism endures than on how a counterhegemony might develop and bring about social change. Many Marxists also criticize neo-Gramscians for focusing so much on ideology and culture that they underestimate the centrality of economics, and some even argue that “a recognizable Marxism has been largely purged from neo-Gramscian IR.”52 Feminist theorists criticize neo-Gramscians for focusing mainly on class and treating gender as a side issue; this is viewed as curious for “a perspective that focuses on social relations” and emancipation.53 Despite these criticisms, Gramscian analysis has many strengths. Because realists and liberals define hegemony in state-centric terms, their ability to examine the effects of hegemony is limited to a small number of relatively brief historical periods. Neo-Gramscians, by contrast, use the term hegemony in a cultural sense to connote the complex of ideas social groups use to assert their legitimacy and authority, and they extend the concept
of hegemony to include nonstate actors such as MNCs and international banks as well as states. Thus, the Gramscian concept of hegemony can be applied to a much wider range of relationships in the global economy. As discussed, neo-Gramscians focus on the interaction of ideas and material interests and thus avoid the economism of Marxists.

**CONSTRUCTIVISM**

The discipline of IPE developed under the realist, liberal, and Marxist traditions, with theoretical tools that were mainly rationalist and materialist. The tools were *rationalist* in assuming that actors such as states, business firms, and classes make decisions by weighing the costs against the benefits. The tools were *materialist* in assuming that international constraints on state behavior stem from material factors such as military weaponry, money, and natural resources. For example, the realist writer John Mearsheimer asserts that “the distribution of material capabilities among states is the key factor for understanding world politics.”

Constructivism questions the rationalism and materialism of the traditional IPE perspectives, and it is also an important tool for studying IPE. Constructivists such as Alexander Wendt focus on *normative* elements such as ideas, values, and rules and examine how actors formulate preferences and the processes by which they make and implement decisions. Instead of assuming that an actor’s preferences reflect rational choices, constructivists examine the beliefs, traditions, roles, ideologies, and patterns of influence that shape preferences, behavior, and outcomes.

Constructivists also suggest “that material forces must be understood through the social concepts that define their meaning for human life.” They devote considerable attention to the role of collectively held (or “intersubjective”) ideas in IR, and they believe that reality or knowledge is socially constructed. They are also interested in understanding how our sense of identity and our interests become established as *social facts*, or the meanings people attach to objects. Social facts result from collectively held beliefs, which exist only because people agree they exist. For example, shared understandings that a country’s monetary reserves have value determine that they are not simply worthless pieces of paper. Social facts differ from *material facts*, or the physical properties of objects that exist regardless of shared beliefs about their existence. Constructivists do not reject material reality; however, they note that the meaning and construction of material reality depend on ideas and interpretation. In their attention to social facts, constructivists also examine the relationship between structures and agents. Whereas *structures* are “the institutions and shared meanings that make up the context of international action” (e.g., the international system), *agents* are “any entity that operates as an actor in that context” (e.g., states are agents that operate in the international system).

Constructivists refer to the “co-constitution” of agents and structures, because the actions of states (agents) can alter the institutions and norms of international life, and the institutions and norms (structures) can alter the ways in which a state defines itself and its situation in the
world. For example, states are concerned both with revising the rules and norms of international trade to condone their behavior, and with altering their own behavior to adhere to the international trade rules and norms.

Although constructivism can be traced to the writings of Immanuel Kant (1724–1804), it did not emerge as a social theory in IR until the 1980s, and Nicholas Onuf coined the term in 1989. Constructivists began to critique the mainstream rationalist and materialist approaches, with some willing to engage in a dialogue with the mainstream and others taking a more extreme position. We discuss constructivism in this chapter because critical constructivist theorists are less willing to engage in dialogue. They seek to “deconstruct” what mainstream theorists assume are givens and advocate a change in social structures and relationships. However, it is important to note that liberal constructivists are actively involved in dialogue with the mainstream. As with other IPE theoretical approaches, the boundaries between constructivism and materialism are sometimes blurred. For example, although Robert Cox has labeled his neo-Gramscian approach as “historical materialist,” the Gramscian emphasis on hegemonic ideas has similarities with constructivist thought. Constructivists ask whose interests and ideas shape the rules and norms of the system, and a hegemon in the Gramscian sense promotes institutions and ideas that help persuade others that they have common interests with the hegemon.

Unlike critical constructivists, liberal constructivists have increased their influence in the mainstream, and constructivism today has become “one of the main analytic orientations for mainstream IR research.” Even materialist theories now incorporate nonmaterial factors such as socially constructed ideas and interests, but they continue to attribute much more importance to the role of material factors. Whereas the most prominent debates in IR theory in the 1980s and 1990s were between realism and liberalism, some argue that the most important IR mainstream debate today is between rationalism and constructivism. Despite the influence of constructivism on mainstream IR, many U.S. scholars are uncomfortable with the approach because it devotes more attention to “social facts” than “material facts” and does not adhere to the systematic, objective testing of hypotheses. Even those who agree that ideas, cultures, and identities affect political actors often assume that economic actors rationally pursue material interests. Thus, security specialists have been more open to constructivism than IPE specialists. We discuss how constructivism has affected the study of IPE in the examples below and in the substantive chapters of this book.

Scholarly work in some areas such as epistemic communities has enabled liberal regime theorists to benefit from the insights of constructivists. An epistemic community is “a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area.” The epistemic community literature explores the role of knowledge-based experts (e.g., economists, physicists, and environmentalists) in framing international issues and in helping states define their interests. For example, an epistemic community helped shape the Bretton Woods order discussed in Chapter 2. Whereas U.S. State Department officials
wanted an open trading system, British cabinet officials favored a preferential trading system that would ensure full employment and economic stability. A set of policy ideas inspired by Keynes and supported by an epistemic community of U.S. and British government specialists and economists helped create a new system of interventionist capitalism acceptable to both countries, which John Ruggie labeled “embedded liberalism” (see Chapter 4). Material interest–based explanations for the creation of the postwar economic order underestimate the role this epistemic community played in devising a U.S.–British agreement based on shared ideas and values.

Constructivists also point out that IPE concepts such as the gross domestic product (GDP) are based on shared ideas and values. Although the GDP would seem to be a “material fact” that measures the output of goods and services, it is also a “social fact,” because shared values determine what is included and not included. Whereas goods and services with market values are included in the GDP, economic activities within households are excluded. Feminist scholars argue that this decision reflects the downgrading of the role of women, who do most of the household work in the economy. Shared values also determine that environmental measures are not included in the GDP. Although environmental degradation may have detrimental effects on a state’s economic productivity, the GDP does not include a measure of whether the state is pursuing environmentally sustainable policies.

Some constructivists believe that national identities influence how countries “interpret the material facts of their foreign economic relations.” For example, scholars have examined the divergent policies states have followed after the breakup of the Soviet Union in 1991. Whereas some former Soviet republics viewed economic dependence on Russia as a threat to national security, others saw it as a reason for closer ties with Russia. These policy makers observed the same material fact regarding the world economy (economic dependence), but they disagreed on its meaning. Thus, some former Soviet republics adopted a Western orientation in finance and trade, while others joined Russia in the new Commonwealth of Independent States (CIS). Constructivists attribute these differences to each new state’s sense of self, arguing that states with a stronger sense of national identity were more inclined to distance themselves from the CIS. Scholars have also examined the effects of national identity on economic policies and processes for other parts of the world.

This book does not delve deeply into constructivism, but we provide some discussion of the role of culture, and individual and collectively held ideas in IPE.

**Feminism**

This section provides a brief introduction to the relationship between feminist theory and IPE, and it cannot possibly cover the range and scope of feminist research. As a group that is often marginalized in IR and IPE, feminist theorists are open to a diversity of thought and reject the idea that they should develop a single IR theory. Thus, one classification divides feminist thought...
into liberal, radical, Marxist and socialist, psychoanalytic, existentialist, postmodern, multicultural and global, and ecofeminist variants. We discuss feminist thought in this chapter because feminist theorists have generally been critical of the mainstream perspectives for their inattention to gender issues. In contrast to sex, which refers to biological differences between male and female, feminist scholars view gender mainly as a constructivist concept, which can be defined as “a structural feature of social life” that “shapes how we identify, think, and communicate.” Whereas men are associated with the public sphere as wage earners, women are associated with the private sphere as housewives, mothers, and caregivers. When women work outside the home they often receive lower wages than men for similar work, because their pay is seen as supplemental to family income. Although there are major differences in the economic position of women based on their class, race, and nationality, they are located disproportionately on the lower end of the socioeconomic scale. Thus, feminist scholars examine “the unequal gender hierarchies that exist in all societies and their effects on the subordination of women and other marginalized groups with the goal of changing them.”

Feminist studies came much later to IR than to some other academic disciplines, partly because IR specialists after World War II focused on the “high politics” of diplomacy, war, and statecraft. Scholars simply assumed that the political and military leaders and soldiers involved in high politics were male. When IPE emerged as a discipline in the 1970s, its emphasis on international finance, trade, and production and its rationalist methodology also left little room for the study of gender relations. Development theory was the one exception to this generalization, but the literature on women and development was “marginalized from mainstream theories of political and economic development.” A major theme of the women and development literature is that pre-existing gender relations affect the outcome of development policies. For example, IMF and World Bank structural adjustment loans required indebted LDCs to reduce spending on social services such as health care, education, and food subsidies; this downloaded more responsibility to women as the main caregivers in households (see Chapter 10). Other than the early writing on women and development, the focus of IPE on the impersonal structure of states and markets does not take account of the degree to which women’s activities are devalued and relegated to the private sphere. Thus, feminist scholars often ask “Where are the women?” in studies of IR and IPE. Liberal feminists basically accept the existing liberal institutions and propose that the greater inclusion of women in positions of influence is the best way to address the gender inequality problem. Critical feminists by contrast believe that inequality and exclusion are inherent characteristics of liberal institutions. Thus, they view the replacement of these institutions with more egalitarian models as the only way to move beyond patriarchy based on the oppression of women.

Feminist scholars argue that the main IPE perspectives largely ignore the role of women. Liberalism measures production and participation in the labor force only in terms of the market, or working for pay or profit.
However, women often work in the subsistence sector of LDC economies or provide basic needs in the household. Because this work does not involve payment for goods and services, these women are considered “nonproducers” who should not expect to share in the benefits of global economic production. Deregulation, privatization, and other neoliberal restructuring strategies have been especially damaging to women because of their dependence on the state for public services such as child care and elder care that support families. Realism views the state as the main unit of analysis, but in many respects the state is a gendered construct. Survival and security are the main state objectives according to realists, and men are normally responsible for defining and advancing the state’s security interests. States also relegate women to an inferior position by sanctioning gender differences in inheritance rights and wages for comparable work, and by tacitly accepting or even condoning domestic and sexual violence. Realism also gives priority to maximizing wealth and power, but it does not consider the effects on women who are near the bottom of the economic scale. Historical materialism focuses on class-based oppression of workers and on the core’s oppression of the periphery, but it does not consider patriarchy-based oppression of women. Feminist scholars point out that by ignoring gender, historical materialism “mirrors the tactics that have so commonly been wielded by the mainstream against the fringes.” Some claim that the main IPE perspectives do not address gender because they are “gender neutral, meaning that . . . the interaction between states and markets . . . can be understood without reference to gender distinctions.” However, feminists argue that those who ignore gender distinctions simply reinforce the unequal economic relations between men and women. The emphasis of the mainstream perspectives on rationalist and materialist methodologies is also not sufficient, and it is necessary to focus on subjective factors such as culture and ideology. Thus, many feminist theorists take a constructivist or postmodern approach to increase our understanding of “subjectivity, reflexivity, meaning, and value.”

Feminist scholars have examined the gendered effects of a number of IPE processes such as global restructuring and the changing international division of labor, the tourism industry, labor migration, and IMF and World Bank structural adjustment loans (discussed in Chapter 10). These studies tend to be highly normative in their commitment to achieving gender equality, and often concerned with issues involving the entire society that have implications for men as well as women. In view of their commitment to activism, feminist scholars have an interest in transnational feminist networks (TFNs), which are “structures organized above the national level that unite women from three or more countries around a common agenda, such as women’s rights, reproductive health and rights, violence against women, peace and antimilitarism, or feminist economics.” Although the results of such activism “have been uneven, in many ways insufficient, and often contradictory,” IR and IPE feminist scholars will “continue to challenge disciplinary boundaries and methods that . . . impose limitations on the kinds of questions that can be asked and the ways in which they can be answered.”
ENVIRONMENTALISM

Traditionally IR specialists devoted little attention to the environment, but it has become more central because issues such as environmental degradation, resource scarcity, global warming, and nuclear accidents can have global consequences. International gatherings such as the 1972 Stockholm Conference and 1992 Rio Conference have also linked environmental concerns with development and the global economy. Thus, the environment is becoming an important area of study in IPE. Environmental theory is discussed in this chapter because environmentalists have criticized the traditional IPE perspectives for their inattention to environmental concerns. However, environmental theorists are a diverse group, with some identifying more closely with mainstream IPE theorists and others identifying with critical theorists. This discussion examines the approach of realists, liberals, and critical theorists to environmental issues.

Realists have often viewed environmental issues as peripheral to their main concerns with national power and security. However, energy security, which has strong geopolitical as well as environmental linkages, has become a major issue to realists. Oil is central to energy security concerns because it is a finite resource that has a vital role in national economies. Conflicting views about the extent of global petroleum reserves and the economic and environmental consequences of exploiting them have made oil an important source of power and influence. Realists first began to view energy security as a major issue when oil prices quadrupled after the October 1973 Mideast war because Arab OPEC countries limited oil supplies. Although there was a reduction in oil prices in the late 1980s and 1990s, in recent years energy prices and “resource nationalism” have re-emerged as major issues. Thus, energy security has become a critical issue to realists:

> It is in the energy sector that strategic planners now find it easiest to imagine major states reconsidering their reluctance to use force against each other. “Energy security” is now deemed so central to “national security” that threats to the former are liable to be reflexively interpreted as threats to the latter.\(^1\)

However, “security” is a contested concept that some liberal and critical environmental theorists see as requiring collaboration rather than conflict. For example, a cooperative security concept emerged in the post-Cold War era that extends beyond the military and includes environmental, demographic, and other common threats to humanity. To deal with these threats, cooperative security depends on collaborative rather than confrontational relations.\(^2\) Another important concept is human security, which broadens the focus on the state to include the security of people and the planet. The UNDP Human Development Report describes “human development” as the process of increasing the range of people’s choices, and “human security” as people’s ability to exercise those choices freely and safely.\(^3\) International cooperation is necessary to deal with human security problems such as pollution, famine, disease, terrorism, and drug trafficking, because
they cannot be contained within national boundaries. Environmental theorists use the term *environmental security* to explicitly examine the relationship between security and global environmental politics. However, realists fear that broadening the security concept to include general welfare issues provides little specific guidance for policy formation and weakens the resolve to deal with “real” national security threats.\(^8^4\)

Liberals are optimistic about peoples’ ability to improve environmental conditions through progress in science and technology; but orthodox, interventionist, and institutional liberals have a range of views regarding the role of government and institutions (see Chapter 4).\(^8^5\) *Orthodox liberals* believe that economic growth is the main factor behind better environmental policies. Even if some business activities adversely affect air and water quality in the short term, they contribute to economic growth which will improve environmental conditions over time. As income of people increases, they may have more ability and incentive to improve the environment. Thus, the best policy for the environment is to promote economic growth through open trade and foreign investment policies without government interference. *Interventionist liberals* also prefer market-based solutions to environmental problems, but they favor some government involvement to address the market’s inadequacies and ensure that business firms follow environmentally friendly policies. Governments should use market-based policies rather than mandatory policies whenever possible to protect the environment such as environmental taxes, tradable pollution permits, and market incentives to encourage firms to produce environmental products. Governments should also encourage firms to adopt voluntary measures to improve environmental conditions. *Institutional liberals* also prefer market-based solutions, but they call for strong global institutions to coordinate efforts to deal with environmental degradation, pollution, and resource scarcity. For example, liberals such as Oran Young have examined the effectiveness of international environmental regimes in dealing with oil pollution, the management of fisheries, and acid rain.\(^8^6\) Institutional liberals also believe that the World Bank, United Nations Environment Program, and Global Environment Facility should provide technology, finance, and knowledge to help LDCs promote sustainable development. *Sustainable development* refers to development that “meets the needs of the present without compromising the ability of future generations to meet their own needs.”\(^8^7\)

Critical environmental theorists, whom we refer to as the *greens*, often argue that DCs follow environmentally exploitative practices; that economic growth *causes* global environmental problems; and that environmental degradation affects some people and states more than others because of globalization and inequality. Some greens are historical materialists, arguing that capitalism is the main source of environmental degradation. Thus, greens criticize the World Bank, IMF, and WTO and call for a radical restructuring of the global economy. Many greens reject economic globalization and favor a return to autonomy for local and indigenous communities.\(^8^8\) The greens
believe that the overconsumption of resources threatens the earth’s ability to support life. The concept of “common property goods” is central to this problem. Figure 5.1 lists four types of goods. We discussed public goods, which are nonexcludable and nonrival in Chapter 4. Private goods are excludable and rival; for example, I must have money to buy food and clothing (they are excludable), and I must purchase items that are in short supply before someone else does (they are rival). Club goods are excludable but not rival; for example, cable television and private golf club memberships are usually not rival, but the fees charged make them excludable. The greens (and some liberal institutional theorists) argue that major problems stem from common property goods, which are rival but nonexcludable. Resources such as the air, water, fish outside territorial waters, and outer space can be depleted (they are rival), but no one owns them (they are not excludable). Common property goods present a collective action problem because we see little benefit as individuals from conserving the resource; but we all lose when the resource is depleted. Garrett Hardin described this as the “tragedy of the
Comparing the unregulated use of the atmosphere and the oceans to the pre-industrial overuse of the English commons, Hardin predicted this would be detrimental to all. In terms of prisoners’ dilemma (Chapter 4), individual rationality leads us to deplete our common property resources. To avoid this outcome, the greens call for limits on economic growth and population growth.

CRITIQUE OF THE CRITICAL PERSPECTIVES

It is difficult to provide a general critique of the critical perspectives (historical materialism, constructivism, feminism, and environmentalism), because they do not agree on a core set of assumptions. However, in some respects all of these perspectives are critical of traditional realism and liberalism. It is important to assess the validity of their arguments, and whether they provide viable alternatives to the mainstream perspectives in IPE.

A major criticism of historical materialism relates to its repeated tendency to overestimate the degree to which capitalism is in decline. As discussed, Marx and Engels predicted that contradictions within capitalism would lead to its collapse, and when this did not occur, Lenin asserted that imperialism explained the survival of capitalism. After decolonization, historical materialists argued that capitalism persisted because it benefited from neocolonialism. The breakup of the Soviet bloc led the liberal analyst Francis Fukuyama to declare that the capitalist liberal system had triumphed, but the world-systems theorist Wallerstein went to the opposite extreme and predicted that the end of the Cold War would lead to “the collapse of liberalism.” Neo-Gramscian theorists call for a counterhegemony to topple the hegemony of capitalism, but they rarely venture to guess when this counterhegemony will materialize. More recently, historical materialists have reacted to the 2008 global financial crisis by again predicting the end of capitalism. In sum, one can ask whether historical materialist predictions regarding the demise of capitalism (like Fukuyama’s predictions regarding the triumph of liberalism) are affected by a degree of wishful thinking.

Some mainstream theorists also argue that the critical perspectives have little influence on the mainstream IPE perspectives and on the practice of IPE. Of the critical perspectives discussed, only constructivism has been involved in one of the major mainstream debates (rationalism versus constructivism). Many critical theorists would concede that they have had little effect on the mainstream. For example, a feminist theorist asserts that “in spite of the consistently high quality and quantity of gender analysis, gender has not been able to achieve more than a marginal status in International Political Economy (IPE).” When critical perspectives do manage to enter the mainstream arena, they often must do so on the mainstream’s terms. For example, Steven Bernstein argues that “liberal environmentalism legitimates the primacy of the global marketplace... rather than adapting the marketplace to operate in sympathy with requirements of ecological integrity and
The World Bank, WTO, OECD, UNCTAD, and the United Nations Development Program (UNDP) have become lead organizations on global environmental issues; but they generally give priority to economic over environmental concerns.

Critics also question whether the critical perspectives can provide viable alternatives to the mainstream perspectives, because of the major divisions within the ranks of critical theorists. Although feminists, constructivists, and others view this multiplicity of views as consistent with their acceptance of marginalized voices, mainstream theorists question whether such a diversity of voices can offer coherent and meaningful alternatives. Indeed, the most vehement critics of critical theorists are often other critical theorists. For example, Marxists criticize dependency and world-systems theorists for giving priority to relations of exchange (between North and South) over relations of production (between classes); and feminists argue that Marxists are so focused on class that they devote little attention to gender issues.

Although the mainstream has devoted little attention to most of the critical perspectives, it is important to note that critical theorists play a vital role in the study of IPE. Constructivists increase our awareness of the effects of historical and social contexts on our preferences and decisions; historical materialists and feminists give a voice to poorer, marginalized people and states; and environmentalists alert us to the risks of ignoring the long-term effects of the environment on the economy. Furthermore, current instability in financial, trade, and foreign investment relations indicates that alternatives are necessary to dependence on the unrestrained market. Although some critical theorists advocate the replacement of the capitalist global economy, others seek to make it more socially responsible.

**QUESTIONS**

1. What are the similarities and differences between Marxism, dependency theory, and world-systems theory?
2. What are the main features of Gramscian and neo-Gramscian analysis and how does it differ from classical Marxism?
3. How does the constructivist approach differ from the rationalist approach to IPE?
4. In what ways do the mainstream IPE perspectives not adequately address gender issues, and how do you think gender issues should be dealt with in IPE?
5. What are the differences between realist, liberal, and critical environmental theorists? What are the differences between liberal and critical constructivists? How significant are the differences among feminist theorists?
6. What is the difference between public goods, private goods, club goods, and common property goods? In what way do common property goods present a collective action problem?
7. Do you believe that historical materialism is passé as a result of the breakup of the Soviet bloc and the end of the Cold War?
8. What are some of the criticisms of the critical perspectives, and how valid do you think they are?
FURTHER READING


NOTES

12. For Marx’s writings on non-European areas, see Shlomo Avineri, ed., *Karl Marx on Colonialism and Modernization: His Dispatches and Other Writings on China, India, Mexico, the Middle East and North Africa* (Garden City, NJ: Doubleday, 1968).


38. On the differences between dependency and world system theory, see Peter Evans, “Beyond Center and Periphery: A Comment on the Contribution of the World...


42. Ibid., p. 35.

43. Evans, *Dependent Development*, p. 33.


56. Ibid., p. 303.


77. Tickner, *Gender in International Relations*, pp. 69–70.

Part III focuses on the substantive issue areas in IPE. Chapter 6 discusses international monetary relations, because most transactions in the international economy including trade, investment, and finance depend on the availability of money and credit. Chapter 7 examines trade relations at the global level and the emergence of the World Trade Organization. Although regional issues are discussed throughout Part III, Chapter 8 focuses specifically on trade relations at the regional level. Chapter 9 deals with the most important private actor in the global economy, the multinational corporation, and its relationship with the state. Chapter 10 focuses on alternative strategies for promoting LDC economic development, and Chapter 11 deals with foreign debt and international financial crises. The World Bank is the most important IO for development, and the IMF is the lead IO dealing with foreign debt and financial crises. We devote considerable attention to the 2008 financial crisis and its persistent effect on the global economy. The final section of each chapter in Part III draws linkages between the issue areas and the main themes and IPE theoretical perspectives.
The first issue area we discuss in this book is international monetary relations, because “it is impossible to understand the operation of the international economy without also understanding its monetary system.”\(^1\) Although monetary issues are difficult for students to master, some background in this area provides a sound basis for understanding other IPE issues such as trade and investment. The 2008 financial crisis is a prime example of how international monetary and financial transactions can reshape the global economy. Indeed, the amount of money foreign exchange markets handle daily increased from negligible amounts in the late 1950s, to $590 billion in 1989, $1.5 trillion in 1998, and $1.9 trillion in 2008.\(^2\)

Realists argue that financial transactions have increased with the permission and sometimes encouragement of the most powerful states, and that these states continue to dictate the terms for such transactions. Liberals by contrast assert that the increased transactions result from advances in communications, transportation, and technology, and that it is difficult for states to regulate global financial activities.

Realists also point to the fact that international monetary transactions rely mainly on separate national currencies, even though 16 EU members now use the euro. However, a liberal monetary specialist argues that the concept of one state, one currency is a myth today, because “international relations... are being dramatically reshaped by the increasing interpenetration of national monetary spaces.”\(^3\) About 29 percent of the world's circulating currency is located outside the country issuing it, and during the mid-1990s at least $300 billion of the three top currencies at the time (the U.S. dollar, German deutsche mark, and Japanese yen) were circulating outside the country of origin. Cross-border currency competition is a reality today, and a prime example is the challenge the euro is posing to the U.S. dollar.\(^4\) Although monetary flows and cross-border currency competition are eroding some
governmental powers, monetary relations continue to function in a world of states. It is therefore necessary to discuss the balance of payments, which tells us about a state’s overall financial position.

THE BALANCE OF PAYMENTS

The balance of payments records the debit and credit transactions that residents, firms, and governments of one state have with the rest of the world over a one-year period; it has two main components: the current account, which includes all transactions related to a state’s current expenditures and national income, and the capital account, which includes all movements of financial capital into and out of a state. As Table 6.1 shows, the current account comprises four types of transactions:

1. Merchandise trade, or trade in tangible goods. The difference between the value of merchandise exports and imports is the merchandise trade balance.
2. Services trade, or trade in intangible items such as insurance, information, transportation, banking, and consulting. A state’s merchandise and services exports minus imports (items 1 and 2 in the table) are equal to its overall balance of trade.
3. Investment income and payments measure interest and dividend payments on investments by citizens of a country to foreigners and by foreigners to citizens of the country. (This item is in the current account, because the investment income is in fact compensation for the services provided by foreign investments.)
4. Remittances and official transactions include income that migrant workers or foreign companies send out of a country, military and foreign aid, and salaries and pensions paid to government employees abroad.

Table 6.1 shows that in 1992 Japan had a current account surplus of $117.64 billion (U.S.) and the United States had a current account deficit of $66.30 billion. The critical item for both countries was the merchandise trade balance: Japan had a merchandise trade surplus of $132.40 billion and the United States had a merchandise trade deficit of $96.14 billion. As Chapter 7 discusses, the United States has had merchandise trade deficits since 1971, and its largest trade deficits have often been with Japan, and more recently with China. Table 6.1 shows that in contrast to merchandise trade, the United States had a positive services trade balance in 1992 (plus $42.32 billion). The strong U.S. export position in services results from its skilled consultants and its highly developed markets in insurance and banking. Thus, the United States applied pressure to include services trade in the GATT and the NAFTA. The balance on U.S. investment income and payments was also positive in 1992 (plus $20.40 billion) because of interest and dividend payments received on past investments. However, the positive balances on services trade and investment income were not sufficient to
overcome the large U.S. merchandise trade deficit. Thus, the U.S. current account balance was negative (minus $66.30 billion) in 1992.

The second major item in the balance of payments is the capital account, which measures long- and short-term capital flows (items 5 and 6 in Table 6.1). A country’s capital exports are debit items because they involve the purchase of financial assets from foreigners, and its capital imports are credit items because they involve the sale of financial assets to foreigners. (This is the opposite of merchandise trade, in which exports are credits and imports are debits.) Short-term investments normally have a maturity of less than one year, and long-term

### TABLE 6.1

<table>
<thead>
<tr>
<th>Current account</th>
<th>United States</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Merchandise trade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>+440.14</td>
<td>+330.87</td>
</tr>
<tr>
<td>Imports</td>
<td>−536.28</td>
<td>−198.47</td>
</tr>
<tr>
<td>Merchandise trade balance</td>
<td>−96.14</td>
<td>+132.40</td>
</tr>
<tr>
<td>2. Services trade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit</td>
<td>+159.40</td>
<td>+48.31</td>
</tr>
<tr>
<td>Debit</td>
<td>−117.08</td>
<td>−89.73</td>
</tr>
<tr>
<td>Services trade balance</td>
<td>+42.32</td>
<td>−41.42</td>
</tr>
<tr>
<td>Balance of trade (1 + 2)</td>
<td>−53.82</td>
<td>+90.98</td>
</tr>
<tr>
<td>3. Investment income and payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit</td>
<td>+130.95</td>
<td>+145.75</td>
</tr>
<tr>
<td>Debit</td>
<td>−110.55</td>
<td>−114.47</td>
</tr>
<tr>
<td>Balance</td>
<td>+20.40</td>
<td>+31.28</td>
</tr>
<tr>
<td>4. Remittances and official transactions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current account balance</td>
<td>−66.30</td>
<td>+117.64</td>
</tr>
<tr>
<td>Capital account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Direct investment and other long-term capital</td>
<td>−17.61</td>
<td>−30.78</td>
</tr>
<tr>
<td>6. Short-term capital</td>
<td>+54.19</td>
<td>−75.77</td>
</tr>
<tr>
<td>Capital account balance</td>
<td>+36.58</td>
<td>−106.55</td>
</tr>
<tr>
<td>Statistical discrepancy</td>
<td>−12.34</td>
<td>−10.46</td>
</tr>
<tr>
<td>Total</td>
<td>−42.06</td>
<td>+0.63</td>
</tr>
<tr>
<td>Change in reserves</td>
<td>+42.06</td>
<td>−0.63</td>
</tr>
</tbody>
</table>

*a Increase in reserves, −; decrease in reserves, +.

investments extend beyond this period. Long-term capital flows are further subdivided into foreign direct investment (FDI) and portfolio investment. FDI is capital investment in a branch plant or subsidiary of an MNC in which the investor has some operating control. Portfolio investment, by contrast, refers to the purchase of stocks and bonds that does not involve operating control.

A country often seeks to offset a current account deficit with foreign investment or an inflow of funds into its capital account; a current account surplus by contrast permits a country to have a capital account deficit through investment abroad or the purchase of foreign assets. As Table 6.1 shows, Japan (with a current account surplus) had a capital account deficit of $106.55 billion in 1992, and the United States (with a current account deficit) had a capital account surplus of $36.58 billion. In addition to the current and capital accounts, the balance of payments includes two less important items. The statistical discrepancy item results partly from errors in data collection but mainly from a government’s failure to include all the goods, services, and capital that cross its borders. The final item is the change in official reserves. Each country has a central bank such as the U.S. Federal Reserve or Bank of Canada that manages the money supply and holds official international reserves as a buffer against economic problems. When a country has a deficit in its current and capital accounts (the “Total” item in Table 6.1), it loses reserves, and when a country has a surplus in its current and capital accounts, it adds to its reserves. The total of a country’s current account, capital account, statistical discrepancy, and change in reserves always equals zero, hence the term balance of payments. Note in Table 6.1 that, by standard accounting procedures, a minus figure equals an increase in reserves and a plus figure equals a decrease in reserves. This is merely a bookkeeping exercise so the balance of payments will equal zero. Thus, in 1992, U.S. reserves declined by $42.06 billion, and Japanese reserves increased by $0.63 billion.

Although the balance-of-payments account always balances (i.e., equals zero) in a bookkeeping sense, countries can have payments difficulties. When a country has a balance-of-payments surplus or a balance-of-payments deficit, these terms refer only to the current and capital accounts and exclude any changes in official financing. A government with a balance-of-payments surplus reduces its liabilities and/or adds to its official reserves, whereas a government with a balance-of-payments deficit increases its liabilities and/or reduces its official reserves. The main body of the balance of payments therefore informs us about a state’s overall financial position.

GOVERNMENT RESPONSE TO A BALANCE-OF-PAYMENTS DEFICIT

A country with large balance-of-payments surpluses may feel some pressure to correct its imbalances in the longer term. Large payments surpluses can force up the value of its currency making its exports more expensive for foreigners, and excessive official reserves can lead to inflationary pressures and rising
domestic prices. However, countries with payments deficits feel more pressure to correct the imbalances than countries with surpluses, because a deficit country’s reserves can be depleted but a surplus country can increase its reserves indefinitely. Thus, surplus countries normally view their payments disequilibrium as an economic asset, and we focus here on a country’s response to a payments deficit. A government with a payments deficit has two policy options: to finance the deficit or adjust to it. Adjustment measures have political risks because some societal groups must bear the adjustment costs in the present; thus, governments often prefer financing measures that defer the adjustment costs to the future.6

**Adjustment Measures**

Governments opting for adjustment rely on monetary, fiscal, and commercial policy instruments. **Monetary policy** influences the economy through changes in the money supply. A central bank uses monetary policy to deal with a balance-of-payments deficit by limiting public access to funds for spending purposes and making such funds more expensive. For example, a central bank raises interest rates to make borrowing more costly, decreases the amount of money available for loans by requiring commercial banks to hold larger reserves, and sells government bonds to withdraw money from the economy. These policies can lower the payments deficit through a contraction of the economy and decreased spending on goods and services. A government uses **fiscal policy** to deal with a payments deficit by lowering government expenditures and raising taxes to withdraw purchasing power from the public. (Countries with payments surpluses by contrast often seek to expand the money supply, increase the budget deficit, and inflate the economy.) **Commercial policy** lowers a country’s payments deficit through trade by increasing its exports and decreasing its imports.

A government’s use of monetary, fiscal, and commercial policies depends on whether it opts for external or internal adjustment measures. **External adjustment measures** such as tariffs, import quotas, export subsidies, and currency devaluation are used to decrease imports and foreign investment outflows and increase exports and foreign investment inflows. External adjustment measures impose most of the adjustment costs on foreigners; foreigners often retaliate and everyone loses in the long run. For example, external adjustment measures can result in the competitive devaluation of currencies, with every country trying to lower the relative price of its exports. Although a government may adopt external measures to avoid politically unpopular decisions, even external measures impose some costs on domestic groups. For example, a reduction of imports adversely affects importing businesses and the products available to consumers. **Internal adjustment measures** include deflationary monetary and fiscal policies to slow business activity and decrease the deficit; for example, higher taxes and interest rates reduce spending by individuals, business, and the government. Internal adjustment measures cause individuals and groups at home to pay more of the
adjustment costs through unemployment, lower living standards, business bankruptcies, and fewer publicly financed programs. However, internal adjustment can also affect foreigners by deflating the economy and lowering the demand for imports.

Financing
A country may also seek financing for its balance-of-payments deficit by borrowing from external sources or decreasing its foreign exchange reserves. Financing is often the preferred option when access to credit is available because it is easier to postpone difficult adjustment measures. However, financing may not be available over the long term; a country’s reserves may be depleted, and foreigners are reluctant to invest in a country with chronic foreign debt problems. The United States has depended mainly on financing through its capital account (plus $36.58 billion in 1992, in Table 6.1) to counter its current account deficit (minus $66.30 billion in 1992). The United States has had persistently high current account deficits in recent years, and its dependence on financing has resulted in a growing foreign debt. As Table 6.2 shows, in 2009, China, Japan, and Germany recorded the largest current account surpluses while the United States, Spain, and Italy had the largest current account deficits. The “Rank” category gives each country’s ranking in a list of 190 countries. Whereas China ranked first with a current account surplus of 296.2 billion dollars (U.S.), the United States ranked 190th with a current account deficit of 380.1 billion dollars in 2009. Table 6.2 also shows that the merchandise trade balance is the most important item in the current account of both countries. Whereas China had a merchandise trade surplus of 272.5 billion dollars, the United States had a merchandise trade deficit of 450.3 billion dollars. (The U.S. current account deficit was lower than its merchandise trade balance deficit because of other items in the current account, including the services trade balance and investment income and payments.) As a result of its chronic current account deficits,

<p>| TABLE 6.2 |
| Current Account Balance and Merchandise Trade Balance—2009 |
| Billions of Dollars (U.S.) |</p>
<table>
<thead>
<tr>
<th>Current Account Balance</th>
<th>Rank</th>
<th>Merchandise Trade Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>296.2</td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>131.2</td>
<td>2</td>
</tr>
<tr>
<td>Germany</td>
<td>109.7</td>
<td>3</td>
</tr>
<tr>
<td>Italy</td>
<td>−55.4</td>
<td>188</td>
</tr>
<tr>
<td>Spain</td>
<td>−69.5</td>
<td>189</td>
</tr>
<tr>
<td>United States</td>
<td>−380.1</td>
<td>190</td>
</tr>
</tbody>
</table>

the United States has the world’s highest external debt, or the total public and private debt owed to nonresidents by residents of an economy.7

Some analysts have argued that the U.S. deficits and external debt are not a major concern for several reasons. First, although the United States has the highest external debt, the debt is equal to only 25 percent of the U.S. GDP. A number of countries with smaller economies have higher external debts as a percentage of their GDPs. Second, the negative U.S. trade balance is not a valid measure of U.S. competitiveness, because highly competitive U.S. firms often sell goods abroad through their foreign subsidiaries rather than exporting them from the United States. For example, in 1998, U.S. global exports of $933 billion were far less than U.S. foreign affiliate sales of $2.4 trillion. Third, the United States often has higher trade and current account deficits when U.S. productivity is increasing at a faster rate. For example, the United States had growing current account deficits while Japan and the euro area had current account surpluses in the late 1990s. The 1990s was a decade when the United States had sustained economic expansion, EU economic growth was largely stalled, and the Japanese economy was often in recession. Thus, U.S. trade and current account deficits may indicate that a vibrant U.S. economy is serving as the largest market for other countries’ exports. Fourth, some argue that the United States attracts so much foreign capital because others want to invest in the country. In view of this positive balance on its capital account, the United States balances its payments by incurring a deficit on its current account. Central banks in Europe and Asia will continue to buy U.S. dollars indefinitely, so there is no effective constraint on U.S. borrowing.8

A balance-of-trade surplus is certainly not the only measure of economic health, as Japan’s economic problems demonstrate (see Chapters 10 and 11). However, arguments that the U.S. trade deficit is of little concern are not convincing. Regarding the first argument, serious questions are being raised about the sustainability of the U.S. external debt, especially since the 2008 global financial crisis (see Chapter 11). Regarding the second argument, a state’s competitiveness is not synonymous with the competitiveness of its MNCs (see Chapter 9). In assessing U.S. trade competitiveness and employment prospects for U.S. workers, it is not sufficient to focus only on the sales of U.S. foreign affiliates. Regarding the third and fourth arguments, the United States does sometimes have higher deficits during periods of rapid economic growth, and it has been able to finance its deficits because its large economy and political stability attract foreign investors. However, a number of problems have resulted from the long-term U.S. deficits including a protectionist backlash against U.S. liberal trade policy, a loss of U.S. manufacturing jobs and disposable income, increased leverage of foreign governments with substantial U.S. dollar holdings, and disruptive market volatility against the U.S. dollar. There are also geopolitical implications, because two of the largest holders of dollar reserves—China and Russia—are U.S. rivals rather than allies. The degree to which China and Russia diversify their holdings into euros and other reserves can have a major effect on the future of the U.S. dollar as the top international currency.9 This chapter discusses the reasons for the U.S. deficits, and the rise of the euro as a rival to the U.S. dollar.
Adjustment, Financing, and the Theoretical Perspectives

In reality, states usually employ a combination of external and internal adjustment and financing measures to deal with payments deficits. Liberals, realists, and historical materialists have different preferences regarding these policies. Orthodox liberals believe that governments should adopt internal adjustment measures as a necessary form of discipline because they see payments deficits as resulting from domestic inefficiencies. They oppose external adjustment measures that raise trade barriers and distort economic interactions, and they oppose external financing because it permits states to delay instituting internal reforms. Realists by contrast see internal adjustment methods as posing a threat to a state’s policy-making autonomy, and historical materialists believe that LDCs should not have to bear internal adjustment costs in an international system that serves DC interests. External adjustment is much more acceptable to realists and historical materialists. Realists view external measures as “fair game” in a state’s efforts to improve its competitive position. For example, some analysts argue that the United States should adopt external adjustment measures because Japan and China’s manipulation of “their currencies to gain an unfair competitive advantage” has “a substantial impact on exchange rates and the U.S. trade deficit.”

Historical materialists argue that LDCs should impose import controls because of their unfavorable terms of trade with DCs, and that DCs should provide LDCs with liberal financing to help alleviate their balance-of-payments problems.

THE FUNCTIONS AND VALUATION OF MONEY

Before tracing the development of monetary relations, it is important to be familiar with the concepts of money and currency, which is simply money used as a medium of exchange. Money serves three main functions:

- As a medium of exchange, money must be acceptable to others in payment for goods, services, or assets.
- As a unit of account, it places a value or price on goods, services, or assets.
- As a store of value, it helps preserve purchasing power or wealth.

These functions depend on ideational as well as material factors, because “the key to all three of money’s roles is trust, the reciprocal faith of a critical mass of like-minded transactors.” A currency can serve effectively as a medium of exchange and a store of value only if individuals are confident that it can be used in financial transactions without significantly losing its value. Currencies can be priced by setting fixed exchange rates, by free markets, or by some combination of the two. Devaluation occurs when a state lowers its currency’s official price, and revaluation occurs when it raises the official price. Depreciation refers to a market-driven reduction in a currency’s price, and appreciation refers to a market-driven increase in its price.
INTERNATIONAL MONETARY RELATIONS BEFORE BRETTON WOODS

Four regimes have provided a degree of governance in international monetary relations: the classical gold standard from the 1870s to World War I, a gold exchange standard during the first part of the interwar period, the Bretton Woods system from 1944 to 1973, and a mixed system of floating and fixed exchange rates from 1973 to the present. This chapter focuses mainly on the third and fourth regimes, but it is necessary to provide some background on the first two regimes.

The Classical Gold Standard (1870s–1914)
The classical gold standard was a regime based on fixed exchange rates, in which national currencies had specific exchange rates in relation to gold, and countries held their official international reserves in the form of gold. Governments were committed to converting domestic currency into gold at the fixed rate, and individuals could export and import gold. By stabilizing national currency values, the gold standard facilitated trade and other transactions. For example, if the U.S. dollar and British pound were pegged at $35 and £14.5 per ounce of gold, the exchange rate between the dollar and the pound would remain constant at $2.41 per £1 (35 divided by 14.5). Although some states adhered to the gold standard more closely than others, it functioned reasonably well because it was backed by British hegemony and cooperation among the major powers. Britain helped stabilize the gold standard by providing other states with public goods such as investment capital, loans, and an open market for their exports. The three states at the center of the regime—Britain, France, and Germany—also defended their central banks’ gold reserves, maintained the convertibility of their currencies, and instituted domestic adjustments when necessary to preserve the gold standard. Thus, Western Europe and the United States maintained their official gold parities for about 35 years. The gold standard was based on the orthodox liberal objective of promoting monetary openness and stability by maintaining stable exchange rates. This was a period before Keynes introduced interventionist liberal ideas to combat unemployment, and states were expected to sacrifice domestic social objectives for the sake of monetary stability. Orthodox liberals sometimes refer to the gold standard in idealized terms, and in 1981 President Ronald Reagan created a special commission to determine whether the United States should return to the gold standard (its recommendation was negative). However, critics argue that the gold standard imposed the largest burden of adjustment in welfare and employment on the poorest people and states.

The Interwar Period (1918–1944)
World War I completely disrupted international monetary relations. After the war exchange rates floated freely, and central banks did not intervene in the foreign exchange market; but the floating rates contributed to volatile
currency values, and there were efforts to restore the gold standard. By 1927, the major states established a gold exchange standard regime, in which central banks held their reserves in major currencies as well as gold, and each central bank fixed the exchange rate of its currency to a key currency (the British pound) with a fixed gold price. Although central banks had held reserve currencies in earlier years, the gold exchange standard institutionalized this practice. A gold exchange standard permits more flexibility in increasing international reserves than a gold standard because the reserves are not limited to the supply of gold. However, the gold exchange standard did not operate as planned because some states had persistent balance-of-payments deficits and others had persistent surpluses. The Great Depression of 1929 put further stress on the gold exchange standard, and in 1931, Britain suspended the convertibility of the pound sterling into gold. States gradually returned to floating their currencies, but unlike the early 1920s this was a managed float in which central banks intervened to deal with excessive fluctuations in exchange rates. Some theorists argue that the failure to reestablish monetary stability in the interwar period resulted from Britain’s inability as a declining hegemon to stabilize policies; but others argue that the main factor was the growing reluctance of states to sacrifice domestic goals such as full employment for the sake of currency stability. Before World War I, voting in most states was limited, labor unions were weak, farmers were not organized, and leftist parties were restricted. Thus, governments could stabilize their currencies through policies that caused domestic hardship such as raising interest rates and taxes and decreasing government expenditures. By the end of World War I, the extension of suffrage, legalization of labor unions, organization of farmers, and development of mass political parties gave domestic groups more influence. Thus, embedded liberal views that some government intervention is necessary to deal with domestic economic problems took hold at this time, and governments could no longer sacrifice the welfare of their citizens to maintain monetary stability.¹⁵

**THE FORMATION OF THE BRETTON WOODS MONETARY REGIME**

World War II was marked by a breakdown of monetary cooperation and a period of exchange controls, and planning for a postwar monetary regime culminated in the 1944 Bretton Woods conference. To avoid the volatility of currency values experienced during the free float of the 1920s, the Bretton Woods planners established a gold exchange standard in which the value of each country’s currency was pegged to gold or the U.S. dollar as the key currency. A *key currency* is the currency that nonresident private and public actors most often hold, use globally for cross-border transactions, and purchase in the form of financial instruments such as bonds. Other states are also most likely to peg their currencies to the key currency.¹⁶ Unlike earlier monetary regimes, the Bretton Woods system was based on the embedded liberal compromise
(see Chapter 4). The postwar planners assumed that the pegged (or fixed) exchange rates would provide the monetary stability needed for international trade, but they also provided for some flexibility and assistance so countries could adopt domestic policies to combat inflation and unemployment. This marked a contrast with the classical gold standard, in which exchange-rate stability took precedence over domestic requirements.\textsuperscript{17} The embedded liberal compromise had three major elements. First, the gold exchange standard was an adjustable-peg rather than a fixed-exchange rate system. Although countries were to maintain the par value of their currencies in the short term, all countries other than the United States (as discussed later) could devalue their currencies under IMF guidance to correct chronic balance-of-payments problems. The IMF framework for changing currency values was designed to provide more flexibility than the classical gold standard and avoid competitive devaluations such as those of the interwar period. Second, the IMF would provide short-term loans to countries with balance-of-payments problems so they could maintain exchange-rate stability. Third, countries could impose national controls over capital flows. Speculative capital flows had led to instability during the interwar period, and the negotiators feared that such speculation could undermine postwar efforts to maintain pegged exchange rates and promote freer trade.\textsuperscript{18}

**THE INTERNATIONAL MONETARY FUND**

The International Monetary Fund (IMF), located in Washington, DC, was created to stabilize exchange rates and provide member states with short-term loans for temporary balance-of-payments problems. Under the IMF Articles of Agreement, members had to peg their currencies to gold or the U.S. dollar, which was valued at $35 per ounce of gold. Members also contributed to a pool of national currencies available for IMF loans to deficit countries. Each IMF member is given a *quota* based on its relative economic position, and its quota determines the size of its *subscription* or contribution to IMF resources, its voting power, and the amount it can borrow from the IMF. Under the IMF’s weighted voting system, the most economically powerful states have the largest subscriptions and the most votes. At regular intervals, the IMF adjusts members’ quotas to accord with changes in their economic positions. IMF conditionality ensures that borrowers must agree to adopt specific economic policies in return for IMF-funding, and the conditions become more stringent as a member borrows more from the IMF in relation to its quota. LDCs feel strong pressure to abide by IMF conditionality because they depend on IMF loans, and DCs and private banks often require the acceptance of IMF conditions before providing their own loans and development assistance. IMF officials usually require borrowers to adopt contractionary monetary and fiscal policies so they can correct their balance-of-payments problems and repay their IMF loans. However, many loan recipients feel that IMF conditionality infringes on their sovereignty and does not address the basic structural problems hindering their economic development (see Chapter 11).
The highest IMF decision-making body is the Board of Governors. Every IMF member appoints one governor to the board, but the voting power of each governor depends on the weighted voting system. The governors are usually finance ministers or central bank heads. For example, the U.S. governor is the secretary of the Treasury and the alternate representative is the Federal Reserve Board chair; the Canadian governor is the finance minister and the alternate representative is the governor of the Bank of Canada. The governors meet once a year at the IMF–World Bank Annual Meetings and delegate most of their powers to the Executive Board (or Board of Executive Directors), which also has weighted voting and is composed of 24 directors appointed or elected by the IMF members. The Executive Board is responsible for the IMF’s daily business, including requests for financial assistance, economic consultations with members, and policy development. The IMF managing director, appointed by the Executive Board for a five-year renewable term, is the top executive officer who appoints the staff and is chair of the Executive Board. The IMF also has an International Monetary and Financial Committee and a Development Committee (jointly with the World Bank) that provide advice to the Board of Governors.

The countries with the largest subscriptions and most votes in the IMF are the G5—the United States, Japan, Germany, France, and Britain. In March 2010, the G5 had 38.32 percent of the votes; the United States had 16.74 percent, followed by Japan with 6.01 percent, Germany with 5.87 percent, and France and Britain with 4.85 percent each. The G5 countries have enough votes to always appoint their own executive directors, and three other countries—China, Saudi Arabia, and Russia (with 3.65, 3.16, and 2.69 percent of the votes, respectively)—have also appointed their own executive directors. Coalitions of member states elect the other 16 executive directors every two years. Although most IMF decisions are made by consensus, the weighted voting is important because members are aware of “the likely outcome [of a vote] if the negotiation breaks down.” Most IMF votes require a simple majority, but 85 percent majorities are required for the most important decisions, such as changing the IMF quotas; these votes give an effective veto to the United States, the EU, and the LDCs. However, the large, amorphous group of LDCs rarely joins together to block an IMF decision. Thus, the weighted voting gives a good deal of control to the North. In April 2008, the IMF Board of Governors adopted a proposal to increase the quotas and voting shares of emerging market and low-income countries in response to new economic realities. As of March 2010, 65 member countries representing about 70 percent of total voting power had accepted this proposal; but the acceptance by at least 112 members representing 85 percent of the voting power is required for these changes to be implemented.

The DCs also have the most influence in the IMF operating staff. By tacit agreement, the IMF managing director has always been European, and the World Bank president has always been American. Furthermore, in 2007, DC nationals accounted for 56 percent of the IMF professional staff
and 71.2 percent of the managerial staff. Gender disparities are also evident. All the IMF managing directors have been men, and in 2007, men accounted for 64.1 percent of the IMF professional staff and 84.4 percent of the managerial staff.23

THE FUNCTIONING OF THE BRETTON WOODS MONETARY REGIME

Bretton Woods was a gold exchange regime in which the main reserves were gold and the U.S. dollar. Economists ask three questions about the adequacy of reserve assets in upholding a monetary regime. First, are there sufficient reserves (e.g., gold and the U.S. dollar) for liquidity, or financing purposes? As interdependence increases, more liquidity is needed to cover the growing number of economic transactions, but a surplus of liquidity can cause inflation and other problems. Second, is there confidence in the reserves? When countries lack confidence that an asset will retain its value, they are reluctant to hold it in their reserves. Confidence problems have led to periodic efforts to sell British pounds and U.S. dollars. And third, what adjustment options do countries have in dealing with balance-of-payments deficits? An effective regime should offer all deficit countries (including the top-currency country, the United States) adjustment options. The following discussion examines problems with liquidity, confidence, and adjustment in the Bretton Woods monetary regime.24

The Central Role of the U.S. Dollar

Central banks held their international reserves in gold and foreign exchange under the Bretton Woods monetary regime. However, the original attraction of gold—its scarcity—became a liability as increased trade and foreign investment led to growing demand for reserves. Most countries also preferred U.S. dollars to gold, because dollars earned interest and did not have to be shipped and stored. U.S. dollars were therefore vital for global liquidity purposes, but large U.S. balance-of-trade surpluses in the late 1940s contributed to a shortage of dollars in other countries. To remedy this problem, the United States distributed dollars around the world from 1947 to 1958 through economic aid and military expenditures. Other countries could devalue their currencies under IMF guidance, but the dollar’s value was to remain fixed at $35 per ounce of gold to ensure that it would be “as good as gold.” The United States agreed to exchange all dollars held by foreigners for gold at the official rate, and this seemed feasible because it had larger gold reserves than any other country. From the liberal perspective, the United States provided public goods by opening its market to imports, providing aid through the European Recovery Program or Marshall Plan, and supplying the U.S. dollar as the main source of international liquidity. However, the United States also benefited from having the key currency: It could avoid
exchange-rate risks and transaction costs by trading and borrowing in domestic currency; it was largely exempt from the discipline the international financial system imposed on other states; and the dollar’s role bolstered New York City as the world’s financial capital. Furthermore, the United States has gained additional revenue through seigniorage, or the ability of a national government to increase public spending through money creation. The extensive international use of the dollar gives the United States greater opportunities for seigniorage. U.S. policy was therefore based on both altruism and self-interest, and others accepted U.S. leadership because of the benefits they received.

However, several changes in the late 1950s led to concerns about U.S. leadership. Although the United States had large current account surpluses because of its positive balance-of-trade, it had even larger capital account deficits because of the economic and military finance it was providing. Thus, the United States began to have balance-of-payments deficits as early as 1950. U.S. payments deficits averaged $1.5 billion per year for most of the decade, but they increased rapidly in the late 1950s, and observers began to speak of a dollar glut rather than a dollar shortage. In 1960, foreign dollar holdings exceeded U.S. gold reserves for the first time, and European governments were reluctant to accumulate excessive dollar reserves. To some economists, the dollar’s declining fortunes demonstrated the problems with a monetary regime that relied on a single key currency. Although the need for sufficient liquidity caused the United States to supply dollars by running balance-of-payments deficits, these deficits lowered confidence in the U.S. dollar because the United States would not be able to continue exchanging dollars for gold at $35 per ounce. Any U.S. actions to restore confidence in the dollar by reducing its balance-of-payments deficit would contribute to global liquidity shortages. The Triffin dilemma (named after economist Robert Triffin) refers to the problem with a monetary regime that depends on a single key currency: The liquidity and confidence functions of the currency eventually come into conflict.

A second change that raised questions about U.S. leadership was the growth of the Eurocurrency market (or Euromarket). Eurocurrencies are national currencies traded and deposited in banks outside the home country. Although Eurocurrency activity first developed in Europe, in recent years it has expanded elsewhere. By the early 1990s, banks in Europe, North America, Asia, and the Caribbean had Eurocurrency deposits totaling more than $1 trillion; over half of these were Eurodollar deposits held in banks outside the United States. As early as 1917, the Russian communist government deposited U.S. dollars in European banks to prevent the United States from seizing them, and the Euromarket developed after World War II when the Soviet Union continued to hold its U.S. dollars in Europe because of the Cold War. In the 1960s, the Euromarket developed further when President Lyndon B. Johnson responded to U.S. balance-of-payments deficits by limiting foreign lending by U.S. banks. U.S. companies responded by financing their foreign operations from offshore banks, which were not subject to U.S. banking regulations. The Euromarket also grew because European firms involved with international trade found it
easier to use a single currency (the U.S. dollar), and because the Middle Eastern OPEC countries avoided keeping their huge dollar deposits in the United States after 1973. Eurodollars are not subject to the regulations governments impose on domestic banking activities. For example, the U.S. Federal Reserve requires banks to hold a certain percent of their deposits as reserves and impose a ceiling on interest rates they pay on deposits; but the United States does not have this control over Eurodollars. Thus, the growth of the Euromarket posed new obstacles to control over monetary relations by the United States and other countries. If a government tries to restrict credit to fight inflation, large firms can continue to borrow in the Eurocurrency market; and the size and speed of Eurocurrency flows can destabilize foreign exchange rates and domestic interest rates. Effective regulation of the Euromarket must be multilateral, but strong competition for Eurobanking has precluded that possibility.\textsuperscript{27}

Liberal interdependence theorists point to the role international bankers played in the expansion of the Euromarket as a result of the increase in capital mobility and global lending and borrowing. Realists note that the leading states also contributed to the growth of the Euromarket. For example, Britain allowed the Euromarket to operate without regulation to promote London as a leading financial center, and the U.S. government permitted its bankers to retain their dominance in international finance by avoiding U.S. capital controls. In view of the declining confidence in the dollar, the U.S. government also believed the Euromarket would enhance the appeal of its currency.\textsuperscript{28} However, British and U.S. support for the Euromarket “may prove to have been the most important single development of the century undermining national monetary sovereignty.”\textsuperscript{29} The growth of the Euromarket and the persistent U.S. balance-of-payments deficits raised questions about the U.S. ability to manage global monetary relations and contributed to a shift toward multilateralism.

A Shift Toward Multilateralism

A \textit{top currency} is favored for international monetary transactions because others have confidence in the economic position of the issuing state. A \textit{negotiated currency} does not benefit from this high degree of confidence, so the issuing state must induce others to accept its leadership. As U.S. balance-of-payments deficits increased, the dollar slipped from top-currency to negotiated-currency status, and there was a shift toward multilateral management.\textsuperscript{30} In 1962, 10 DCs (the G10) established the \textit{General Arrangements to Borrow (GAB)}, an agreement to lend up to $6 billion in their own currencies as supplementary resources to the IMF to deal with international monetary problems. This represented a shift from unilateral U.S. toward collective management, because the G10 had to approve each request for supplementary support.\textsuperscript{31} Another indication of the shift to multilateral management was the increased role of the Swiss-based \textit{Bank for International Settlements (BIS)}. Although the BIS was formed to help settle German reparations after World War I, its main purpose was to promote cooperation among central banks.
The BIS was controversial because of allegations that it had pro-Nazi sentiments and accepted looted gold from occupied countries; it resumed operations after returning the looted gold, but this stigma limited its role as an international financial institution. However, the BIS regained some stature in the 1960s by organizing mutual lines of credit among the central banks to stabilize exchange rates and alleviate the downward pressure on the U.S. dollar. The BIS has become the main forum for cooperation among DC central bankers, and it uses its deposits from the central banks to provide credit and deal with exchange-rate problems.\textsuperscript{32}

Despite these moves toward collective management, LDCs were not represented in either the G10 or the BIS. In 1971, the South therefore formed its own \textbf{Group of 24} (G24), which includes finance ministers or central bank governors from the three main LDC regions—Africa, Asia, and Latin America and the Caribbean. The G24 tries to coordinate LDC monetary policies and responds to G10 reports on monetary reform, but its influence is limited because its members are IMF borrowers.\textsuperscript{33} Although the G10 countries have considerable economic power, even their resources could not defend the dollar if it came under attack as U.S. payments deficits increased. The G10 therefore took actions to bolster the dollar, and the United States tried to improve its balance of payments by reducing capital outflows. However, U.S. gold stocks continued to fall, dollar claims against the U.S. gold supply rose, and by 1968, the dollar in effect had become inconvertible into gold.

Some observers attributed the U.S. balance-of-payments deficit to the public goods it provided such as the Marshall Plan, the U.S. dollar as the key currency, and an open market for other countries’ exports; but critics argued that the United States was unwilling to balance its revenues and expenditures. For example, the U.S. Congress refused to raise taxes to pay for the Vietnam War, President Johnson refused to cut domestic social programs, and the United States had a low personal savings rate. The personal savings rate as a share of disposable income in 1980 was 19.2 percent for Japan, 12.3 percent for Britain, 11 percent for France, 10.9 percent for West Germany, and only 6 percent for the United States. Thus, high-saving Japan provided large-scale capital flows to the low-saving United States.\textsuperscript{34} The U.S. payments deficit also resulted from its declining competitiveness as Western Europe and Japan recovered from the war. The Bretton Woods regime did not provide the United States with \textit{adjustment} options, because it was the only country that could not devalue its currency.

The U.S. payments deficit was not the only problem confronting the Bretton Woods system. The national controls on capital flows were becoming less effective because investors lacked confidence in the currency exchange rates. Speculative activity in the Euromarket was difficult to regulate, and MNCs evaded controls through transactions among their affiliates. MNCs moved capital from one country to another to take advantage of interest rate spreads and expected exchange-rate adjustments, and this put growing pressure on states to realign their currency exchange rates. To prevent a run on
their currencies, leaders often committed themselves to the established parities, severely limiting their policy options. Powerful domestic interests also prevented governments from realigning their currencies. Thus, modest changes in exchange rates were difficult to institute, and the monetary regime became overly rigid despite the need for flexibility.\(^{35}\)

To restore financial stability, IMF members agreed in 1969 (with the G10’s approval) to create special drawing rights (SDRs), an artificial reserve asset to provide a new source of liquidity in addition to the U.S. dollar. SDRs are not a currency. The IMF creates and manages them, and member countries use them in settling their financial obligations. (Private firms and individuals cannot hold SDRs.) Initially, 35 SDRs were equal to $35 (U.S.) or an ounce of gold, but after the move to floating currencies (discussed later), the SDR value was determined by a basket or weighted average of currencies; today, the basket consists of the U.S. dollar, the euro, the Japanese yen, and the British pound. Because some currencies rise while others fall in value, the SDR has served as a relatively stable unit of account for the IMF and other IOs. Decisions to allocate SDRs require approval by three-fifths of the IMF members with 85 percent of the voting power. A major obstacle to creating more SDRs for many years was that they are allocated in proportion to a country’s IMF quota, and the G5 countries receive the most SDRs. The South proposed that the creation of new SDRs be linked to the transfer of resources for development to LDCs, but the North argued that LDC needs for development assistance would lead to the creation of excess SDRs in liquidity terms. Furthermore, with an end to national capital controls (discussed later), DCs could readily borrow on capital markets and did not need SDRs.

Until 2009, there were only two general allocations of SDRs: 9.3 billion SDRs in 1970–1972 and 12.1 billion SDRs in 1979–1981. However, the G20 responded to the 2008 global financial crisis by calling for another allocation of SDRs to smooth the need for adjustment and provide financial resources to countries lacking liquidity. In August 2009, the IMF provided a third general allocation of 161.2 billion SDRs, and it also provided a special allocation of 21.5 billion SDRs to countries that joined the IMF after the 1970s and did not benefit from the first two SDR allocations. With the decline in value of the U.S. dollar in recent years, countries with large U.S. dollar reserves such as China and Russia have called for a greater role for the more stable SDR in the global monetary regime. However, despite the large increase in SDRs allocated in 2009, SDRs are not likely to ever replace the U.S. dollar or euro as a reserve asset because “no money has ever risen to a position of international preeminence that was not initially backed by a leading economy.”\(^{36}\)

### The Demise of the Bretton Woods Monetary Regime

By the late 1960s, the Bretton Woods monetary regime had become untenable. France’s president Charles de Gaulle was deliberately converting dollars into gold to bring about an end to U.S. hegemonic privilege as the key-currency
state, and the United States was making it more difficult for foreign central banks to change their dollars into gold. Although U.S. foreign investment and loans had been the main source of its balance-of-payments deficits, in 1971 the United States had its first balance-of-trade deficit since 1893. On August 15, 1971, President Richard M. Nixon therefore suspended the official convertibility of the dollar into gold and imposed a 10-percent tariff surcharge on all dutiable imports. In December 1971, the G10 countries therefore agreed to devalue the dollar by 10–20 percent vis-à-vis other major currencies in the first Smithsonian Agreement (negotiated at the Smithsonian Institution in Washington, DC). This did not correct the problem, and a second Smithsonian Agreement devalued the dollar further in February 1973.37

By the early 1970s, the requirements for adequate reserves—liquidity, confidence, and adjustment—all presented serious problems: The U.S. balance-of-payments deficits created a crisis of confidence in the dollar; countries were therefore reluctant to hold large supplies of U.S. dollars for liquidity purposes; and the dollar could not be adequately adjusted through devaluation because the dollar was to be “as good as gold” (the Smithsonian agreements were “too little, and too late”). With the increased global capital flows, the Bretton Woods system of pegged exchange rates was also becoming untenable. IMF members tried to reform the international monetary regime, but their discussions failed because of differences among the Americans, Europeans, and LDCs; destabilizing changes such as the 1973 increase in OPEC oil prices; and Germany and France’s preoccupation with establishing a European Monetary System (EMS). Thus, the Bretton Woods regime of pegged exchange rates collapsed and was replaced by a regime that permitted floating exchange rates.38

### THE REGIME OF FLOATING (OR FLEXIBLE) EXCHANGE RATES

By 1973, the major trading nations were “living in sin,” because they were ignoring the Bretton Woods ban on freely floating exchange rates.39 The 1976 IMF meeting in Jamaica finally legalized this situation by permitting each country to either establish a par value for its currency or shift to floating exchange rates. In a free-floating regime, countries do not intervene in currency markets, and the market alone determines currency values. IMF members often rely on managed floating, in which central banks intervene to deal with disruptive conditions such as excessive fluctuations in exchange rates. Although the IMF accepts managed floating, it opposes manipulative floating, which involves “manipulating exchange rates . . . in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage.”40 The current monetary regime is mixed in nature: Major DCs such as the United States, Japan, and Canada (and a number of LDCs) float their currencies; the EU members seek increased regional coordination of their policies; and many LDCs peg the value of their currencies to a key currency
or basket of currencies. The choice of a pegged versus a floating currency can have consequences for domestic groups in a state, and domestic as well as international factors therefore determine whether a state decides to peg or float its currency.\(^4\) Thus, some analysts describe the current monetary system as a “nonsystem.”\(^5\)

The move to floating exchange rates had an intellectual appeal for orthodox liberals, who argued that exchange rate adjustment should occur through the market rather than government involvement. As early as 1953 Milton Friedman had called for “a system of exchange rates freely determined in open markets, primarily by private transactions, and the simultaneous abandonment of direct controls over exchange transactions.”\(^6\) Although some liberals feared that floating rates would lead to speculative capital flows, Friedman argued that instability during the 1930s had resulted more from fundamental economic and financial problems. Floating rates also appealed to some realists and interventionist liberals, because they permit governments to establish their own independent monetary policies in a domestic context. As capital controls were abandoned, countries were finding it increasingly difficult to set their own monetary policies under the pegged-exchange-rate regime because of the so-called Unholy Trinity.\(^7\) The three elements of the Unholy Trinity are exchange-rate stability, private capital mobility, and monetary policy autonomy. Economists assert that states can attain only two of these three goals simultaneously. With pegged exchange rates and capital mobility, a state’s attempt to follow independent monetary policies can lead to capital flight and a downward pressure on the currency exchange rate until the state alters its monetary policies. For example, if domestic interest rates differ from global interest rates, capital flows can quickly eliminate the difference. Because most states have accepted a high degree of capital mobility (and cannot reverse this trend), the Unholy Trinity involves a trade-off between pegged exchange rates and policy autonomy. In shifting to floating exchange rates, states opted for more policy autonomy.

Although the shift to floating rates has permitted larger DCs to follow more independent monetary policies, most economists underestimated the degree to which increased capital mobility would disrupt exchange rates. As orthodox liberalism returned, the United States and Britain rejected any further attempts to control capital flows, and other DCs soon followed because countries were competing for foreign investment. The integration of financial markets, combined with technological advances, contributed to a massive growth in speculative capital flows. Thus, volatility and misalignment of currencies have been serious problems with the floating exchange rate regime. Volatility refers to the short-term instability of exchange rates. Under the floating system, unpredictable capital flows can produce highly volatile exchange rates that create uncertainty, inhibit productive investments, and interfere with international trade. Misalignment refers to the long-term departure of exchange rates from competitive levels. Misalignment is even more serious than volatility because it leads to prolonged changes in international competitiveness. Depending on whether a currency
is under- or overvalued, misalignment gives a country substantial price advantages or disadvantages vis-à-vis its competitors.\textsuperscript{45}

The shift to floating rates also created a crisis of purpose for the IMF because its role in stabilizing pegged exchange rates largely disappeared. The G5 and G7 discussed the floating regime outside of IMF auspices, and the G7 summits engaged in a limited degree of policy coordination. For example, at the 1978 Bonn Summit, the United States agreed to reduce its balance-of-payments deficits, and Germany and Japan agreed to adopt expansionary economic policies to increase their demand for U.S. goods.\textsuperscript{46} However, this limited policy coordination ended with the Reagan administration, which lowered taxes and raised spending for military-defense purposes. These policies contributed to an annual U.S. government deficit that exceeded $200 billion by the mid-1980s. To service its debt, the United States raised interest rates to attract foreign capital—but the increase in capital imports strengthened the U.S. dollar, and U.S. trade and payments deficits began to spiral out of control.

The Plaza–Louvre Accords
As its dollar appreciated and its deficits increased, the United States could no longer afford to neglect exchange rates. To lower the value of the dollar, U.S. Treasury secretary James Baker III assembled the G5 finance ministers and central bank heads in New York City’s Plaza Hotel in September 1985. The G5 agreed to raise the value of the major nondollar currencies through coordinated market intervention (i.e., by buying and selling currencies), and the United States in return promised to reduce government spending. The dollar depreciated significantly after the Plaza Agreement, and the G7 therefore met at the Louvre in Paris in February 1987 to prevent its value from slipping even further. The Plaza and Louvre accords marked a shift to managed floating, in which governments intervened to correct currency volatility and misalignment. However, the major economies have not coordinated their interventions on a consistent basis since the Louvre accord. Although policy coordination is important for maintaining currency stability, international capital flows and governments’ unwillingness to accept constraints on their fiscal and monetary policies preclude such coordination. Thus, the current monetary regime is much more unstable than liberal economists had predicted.\textsuperscript{47}

**ALTERNATIVES TO THE CURRENT MONETARY REGIME**
Some economists point to the problems of volatility and misalignment under the floating regime and favor a return to a pegged exchange rate regime.\textsuperscript{48} However, most analysts feel that efforts “to reestablish a system of pegged but adjustable rates will . . . prove futile.”\textsuperscript{49} States would find it difficult to defend pegged exchange rates because of the rise in international financial
transactions; and any effort to enforce capital controls would require policy coordination, a highly unlikely possibility. Thus, the global monetary regime is likely to retain floating exchange rates. In looking to alternatives to the current regime, the only “serious experiment” in international monetary reform is taking place in Europe. Monetary integration in Europe has global as well as regional consequences because of the euro’s growing use as an international currency. It is therefore important to discuss Europe’s Economic and Monetary Union (EMU), in which members substitute a common currency—the euro—for their national currencies and cede decision making to a central agency. This chapter discusses European monetary relations, and Chapter 8 examines the EU as a regional trade agreement. To reflect a name change in the EU, we use the term European Community (EC) when discussing the events from 1957 to 1992 and the term European Union (EU) when discussing events from 1993 to the present. Table 8.1 in Chapter 8 shows that the EC gradually enlarged from 6 members in 1957 to the 27-member EU in 2007. Only 16 of the 27 EU members have to this point joined the EMU and adopted the euro as a common currency (the 16 EMU members are identified in Table 8.1).

**EUROPEAN MONETARY RELATIONS**

The Treaty of Rome creating the EC in 1957 focused on eliminating trade barriers, but a series of events starting in the 1960s also gave concrete form to the idea of a European monetary union. In January 1999, 11 EU members formed an EMU and agreed to adopt the euro in place of their national currencies: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Greece, Slovenia, Cyprus, Malta, and Slovakia joined later, and the EMU now has 16 members. The following discussion examines the challenges in creating and maintaining the EMU, and the implications of the EMU for European and global monetary relations.

From 1958 to the late 1960s, the Bretton Woods pegged exchange rate regime provided the EC with some stability. However, two changes in the 1960s caused the EC to consider regional monetary integration: Growing U.S. balance-of-payments deficits decreased confidence in the U.S. dollar and threatened exchange-rate stability; and Europe’s rapid progress in developing a customs union and a common agricultural policy increased the need for exchange-rate stability among EC members. At a 1969 summit, the six EC members asked Pierre Werner, the Luxembourg prime minister, to develop a proposal for an EMU. The 1970 Werner plan recommended that the EC countries adopt similar fiscal and monetary policies and reduce fluctuations in their currency exchange rates; one element of the plan was a “snake agreement” that limited exchange-rate fluctuations among EC currencies to a narrow band of $+2.25$ to $−2.25$ percent. Because France, Ireland, Italy, and Britain had weaker currencies, they could not adhere to the band, and they soon left the snake agreement. Other factors contributing to the failure of the snake agreement were the increase in capital mobility, the divergent
macroeconomic policies of EC members, and global events such as the 1973–1974 oil price rise and the 1975 global recession. As discussed, states can attain only two of the three “Unholy Trinity” goals (exchange-rate stability, capital mobility, and monetary policy autonomy). Because capital mobility was increasing, the EC members could stabilize their currency exchange rates only by sacrificing monetary policy autonomy. However, the EC members’ divergent economic policies led to differential inflation rates, and speculative capital flows against the weaker currencies split the “snake” apart.

After the “snake” agreement failed, the EC launched a European Monetary System (EMS) and this time they were more successful. Kathleen McNamara argues from a constructivist perspective that a neoliberal policy consensus among EC leaders in the late 1970s induced them to give up autonomous monetary policies to achieve exchange-rate stability. To become more competitive internationally, the EMS members gave priority to exchange-rate stability and inflation control over social issues and were “willing to rule out the use of monetary policy as a weapon against broader societal problems, such as unemployment and slow growth.” The EMS had an exchange-rate mechanism (ERM) and a European currency unit (ECU). The ERM limited exchange-rate fluctuations to a $\pm 2.25$ percent band, and central banks intervened to keep the exchange rates within these levels. If this effort failed, a state could realign its currency after consultations with other EMS members. The ECU was a new currency based on a weighted basket of EMS currencies; it was used in cross-border banking and as a common unit of account, but not in commercial transactions. Although the EMS helped stabilize exchange rates, some EC members could not keep their exchange rates within the narrow ERM band because of increased financial flows, and they were permitted to move to a broader band of $\pm 6$ percent.

The problems of the EMS stemmed from the fact that it was only a partial monetary union, and the need for monetary stability increased as EC integration progressed. Hence, there were pressures for a full monetary union that would create a single European currency and give Europe a greater voice in international economic negotiations. In 1989, the Delors Committee proposed a three-stage process toward monetary union, involving a coordination of monetary policies, a realignment of currency exchange rates, and the creation of a single currency under a European central bank. This plan was included in the 1992 Treaty on European Union or Maastricht Treaty. However, the steps toward monetary union were difficult because the Maastricht agreement (at Germany’s insistence) had rigid requirements for developing a single currency. To join the EMU, a country’s budget deficit had to be no greater than 3 percent of its GDP and its public debt no greater than 60 percent of its GDP. Some EU countries did not meet these criteria, and the budgetary cuts required caused considerable discontent. For example, French workers staged massive strikes in 1995 to protest planned cutbacks in social programs. Many Germans also did not want to sacrifice the deutsche mark, which reflected the country’s economic strength, for what could be a weaker euro; but Germany’s chancellor
Helmut Kohl strongly supported the EMU. Other countries had different concerns. For example, Britain wanted to preserve its monetary sovereignty, and Britain and France opposed the decision to locate the new European Central Bank (ECB) in Frankfurt, Germany. Britain, Sweden, and Denmark decided not to join the EMU, and Greece was too weak economically to be a founding member. Despite the obstacles, 11 EU members formed the Economic and Monetary Union (EMU) in 1999 and agreed to replace their national currencies with the euro. Greece was admitted to the EMU in 2001, Slovenia joined in 2007, Cyprus and Malta joined in 2008, and Slovakia joined in 2009.

Debate has continued over the costs and benefits of the EMU. The benefits of a monetary union include reduced exchange-rate volatility, lower transaction costs, greater price transparency, and a better functioning internal market. The costs of a monetary union result mainly from the loss of the exchange rate as a policy instrument; that is, an EMU member can no longer pursue an independent monetary policy by altering its exchange rate. The Nobel laureate Robert Mundell framed this debate on costs versus benefits many years earlier. Mundell argued that an optimum currency area, which maximizes the benefits of using a common currency, has certain characteristics: It is subject to common economic shocks, has a high degree of labor mobility, and has a tax system that transfers resources from strong to weak economic areas. Mundell’s ideas have been highly influential (albeit controversial), and he has been called the “Father of the Euro.”54 When the EMU was created, there were serious questions as to whether countries with such different characteristics should be forming a common currency. Whereas more competitive countries such as Austria, Finland, and Germany had currencies that persistently appreciated, less competitive countries such as Portugal, Spain, Italy, and Greece (which joined the EMU later) had currencies that persistently depreciated. “Euro-optimists” hoped that the common currency would make the poorer countries more competitive. However, low interest rates within the EMU lured governments and households in these countries to engage in unwise budgetary policies and excessive consumption.

Greece, Portugal, and Spain could also rely on large inflows of foreign capital, because it was believed that membership of these countries in the eurozone made their bonds safe investments. However, the 2008 global financial crisis caused revenues to plunge, and capital inflows to countries where fiscal discipline was inadequate precipitously declined. Greece was the country hit hardest, and by April 2010 it was in danger of defaulting on its sovereign debt. Whereas EMU members were to incur budget deficits and public debts of no more than 3 percent and 60 percent of their GDPs respectively, Greece had a budget deficit of 13.6 percent and a debt of 115 percent of its GDP. If Greece were outside the eurozone, it could devalue its currency and become more competitive; but its use of the euro has precluded that possibility. Fears that Greece’s deficit and debt problems would spread to other countries such as Portugal, Ireland, Spain, and even Italy sparked efforts by the IMF and EMU to provide Greece with an economic rescue package.
However, political as well as economic factors will determine the outcome of this crisis in the eurozone. For example, there is political opposition in Germany (the strongest EMU member) to bail out euro countries because of their overspending habits, and there is opposition in the deficit countries to the stringent terms (e.g., cutbacks in wages and other economic benefits) the IMF and EMU would require for economic assistance. An examination of these economic-political linkages is critical to an understanding of the crisis facing the EMU.

To this point, we have looked mainly at the regional implications of the EMU. However, many have raised questions about the future of the U.S. dollar and whether the euro might replace it as the key international currency. The next section addresses this issue.

**What Is the Future of the U.S. Dollar as the Key Currency?**

In discussing the future of the U.S. dollar, it is important to examine its perceived benefits and drawbacks vis-à-vis other monetary reserves. When Japan was growing rapidly in the 1980s, some scholars thought the yen would rival the dollar as the key currency. However, rivalries and suspicions among Asian states, and Japan’s economic problems since the 1990s have precluded this possibility. In accordance with its growing economic influence, China has moved to promote its yuan (or renminbi) globally. For example, China has signed currency swap agreements with South Korea, Malaysia, Argentina, and other states to inject the yuan into foreign banking systems; and China is spreading the yuan’s influence through its loans and investments in other countries. However, the lack of development of China’s financial markets, China’s exchange restrictions and capital controls, and concerns about domestic political stability will limit the yuan’s influence in the short to medium term. Proposals to develop an Asian Currency Unit are also only in the planning stage for several reasons, including the competition and mutual suspicion between China and Japan. Thus, scholars generally agree that the euro is currently the only alternative to the U.S. dollar as the key international currency. Others will also have a role in determining the future of the dollar, especially China, Russia, and Middle Eastern countries that have large dollar reserves. This section begins with a discussion of the dollar versus the euro, and then examines the possible role of actors outside the EU and the United States.

**The Dollar Versus the Euro**

In comparing currencies, it is important to look at their three main functions. In 2005, the dollar was used as a medium of exchange in 89 percent of all foreign exchange transactions, compared with 37 and 20 percent for the euro and Japanese yen. Almost two-thirds of all countries that peg their currencies today peg them to the U.S. dollar as a unit of account compared with one-third
to the euro. The dollar is also used as a unit of account in the invoicing or pricing of almost half of all world exports. The share of dollars as a store of value in central bank holdings declined from 70.9 percent in 1999 to 65.7 percent in 2006, while the share of euros rose from 17.9 to 25.2 percent; but the dollar still accounts for almost two-thirds of official foreign exchange reserves. Thus, the U.S. dollar continues to be the key currency today.\(^5^7\)

In assessing whether the dollar’s dominance is likely to continue, economists look at three factors: the position of U.S. financial markets, the level of confidence in the U.S. dollar, and the importance of U.S. transactional networks.\(^5^8\) First, the dollar is more likely to retain its key currency status if the United States continues to have the most developed and open financial markets. Although European financial markets could pose a challenge to U.S. dominance, decentralization and fragmentation in the eurozone is a disadvantage relative to the more unified U.S. financial structure. The ECB has less supervisory capacity over EU financial markets than the U.S. Federal Reserve; and Britain, which has the most well-developed financial markets in Europe, has not adopted the euro. Confidence in U.S. financial markets was seriously tested in September 2008, when the subprime mortgage crisis expanded into a full-blown financial crisis. The U.S. role in the global financial crisis raises new questions about the dollar’s future as the key currency, but Europe’s difficulty in dealing with the financial crisis shows that the euro remains an uncertain alternative to the dollar. The EMU’s current difficulties in dealing with the financial problems confronting Greece and other weaker member states shows that the EU “has a long way to go before becoming the continent-wide economic and political authority it has set out to be.”\(^5^9\)

Second, the U.S. dollar is more likely to remain the key currency if there is confidence that its value will remain relatively stable. The U.S. deficit and debt problems have led to a dramatic decline in the dollar’s value and in the confidence level in recent years. Although the value of the euro initially fell from $1.18 (U.S.) on exchange markets in 1999 to 86 cents (U.S.) in January 2002, its value then recovered and rose to $1.59 (U.S.) in July 2008. The declining value of the dollar gives governments and investors an incentive to diversify their portfolios from dollars into euros and yens. However, the stronger EMU financial position overall masked the great differences among EMU members, and fears that Greece’s economic problems could spread to other weaker EMU countries such as Portugal, Spain, and Ireland have raised questions about the future of the euro. In crisis situations such as the world has experienced since 2008, investors tend to opt for the U.S. dollar as the world’s reserve currency despite the serious U.S. deficit and debt problems. Third, in regard to U.S. transactional networks, the size of the U.S. economy and its share of global trade have ensured that the dollar is widely used in global transactions. The widespread use of the dollar outside the United States tends to be self-perpetuating, because its use by so many others decreases transaction costs. The larger the size of a currency’s transactional network, the greater are the economies of scale in using the currency. The transactional network of the euro is limited by the fact that only 16 EU members have adopted it. If the eurozone
expanded to include all 27 EU members, the euro would pose a greater challenge to the dollar; but the current problems facing the poorer EMU members make this an unlikely possibility. In sum, in terms of economic criteria, the U.S. dollar should continue to be the key currency in the short to medium term, but its dominance in the longer term is by no means certain.\^60

Political as well as economic factors will affect the standing of the dollar. In some respects, political factors give the dollar an advantage over the euro. For example, U.S. military power and political stability contribute to confidence in the dollar; there is less confidence in the euro because of the EU’s lack of political unity and the difficulty EU members have in asserting their power collectively on international political issues. The difficulties the EMU has had in confronting the financial problems of its weaker members also shows the problems of monetary union without political union. The eurozone requires a crisis resolution system, better fiscal policy coordination, and policies to reduce the economic imbalances among the member countries. However, the EMU member states may lack the political will to implement such policies.\^61

Although the United States has the advantages of being a single country, it also faces major problems with governance. The U.S. political system of checks and balances combined with the strongly held differences between the Democratic and Republican parties today may prevent U.S. government leaders from taking the difficult political decisions to follow more fiscally prudent policies. In sum, the roles of the dollar and the euro will depend on whether the United States addresses its current account and debt problems, and on whether the EU takes a more assertive and unified position (both internally and externally).

**Countries with Large Foreign Reserves and the Future of the Dollar**

The growing U.S. deficits have been financed by foreigners. Of particular concern is the large volume of cashlike dollar assets held by central banks or other government-controlled bodies. China and non-Chinese Asia each have about $1.2 trillion of dollar assets; the OPEC states have $600 billion; and Russia has $400 billion due to its growing revenues from energy exports. Thus, total foreign-held U.S. dollar reserves by the end of 2006 amounted to about $5 trillion.\^62 Countries with large U.S. dollar reserves will have a major effect on the future of the currency, and both economic and political factors affect their behavior. Although China, Japan, and South Korea are shifting some of their reserves from U.S. dollars to euros, it is not in their economic interests to cause a rapid decline in the value of the U.S. dollar. They are highly dependent on the U.S. market for their exports, and U.S. consumers with a cheaper dollar would purchase less. The value of their dollar reserves would also decline along with the falling value of the dollar. Political factors also play a role in countries’ support for the dollar; for example, Japan and South Korea continue to depend on U.S. military support.

However, there are also economic and political reasons that countries have begun to shift more of their dollars to other reserve currencies. Russia and the OPEC exporters are large dollar holders; they have priced their
oil trade in dollars and have invested their surpluses mainly in dollar-denominated assets. However, the United States is not their main trading partner. Russia trades primarily with Europe, and the largest markets for Middle Eastern oil producers are in Asia. China has also been diversifying its trade, and almost half of its exports now go to countries other than the United States, Europe, and Japan; other important export markets are mainly in Asia, but also in the Middle East and Latin America. Indeed, the United States now accounts for only about 20 percent of China’s exports, and Europe recently surpassed the United States as an importer of Chinese goods. As for East Asia in general, its dependence on the dollar was viewed as an important cause of the 1997 Asian financial crisis (see Chapters 10 and 11), and Japan is promoting the use of the yen and considering an initiative to develop an Asian regional currency. Two of the largest holders of U.S. dollar reserves—China and Russia—are also geopolitical rivals. U.S.–China relations are marked by economic tensions over China’s large trade surplus with the United States, China’s reluctance to float its currency freely against the U.S. dollar, and competition for scarce resources around the world. Political tensions relate to differences over Taiwan and over China’s support for a number of regimes that the United States opposes. China is aware that the United States prevents it from being the dominant power in the western Pacific, and it may choose to cooperate in developing an Asian currency to weaken the United States in geopolitical and economic terms. U.S.–Russian tensions have been marked by Vladimir Putin’s efforts to strengthen the state and re-establish Russia’s economic and political influence.

Unlike China, Russia has only a limited amount of trade with the United States. Thus, Russia was one of the first countries to begin shifting its reserves from dollars to other currencies after Putin launched an antidollar campaign in April 2006. For several years Russian purchases of U.S. dollar assets had increased along with its growing surpluses from energy exports; but its purchases of U.S. dollar assets declined sharply in the latter part of 2006. Although Kuwait has been a close U.S. ally, it has shifted from pegging its currency to the U.S. dollar to pegging it to a basket of currencies; and by the end of 2006, more than 20 percent of Saudi Arabia’s official assets were in nondollar currencies. OPEC members that are openly hostile to the United States such as Venezuela and Iran are taking more forthright actions to decrease their dollar reserves. China has also begun to diversify its foreign exchange holdings, and the governor of the People’s Bank of China has proposed that SDRs should replace the dollar as the major global monetary reserve. As discussed, the top global currency must be backed by a strong economy, and it is highly unlikely that SDRs would replace the dollar. China is likely to act cautiously on this issue, because of its large dollar holdings and its dependence on the U.S. market for its exports.63

In sum, the dollar continues to be the key international currency, and the only major challenger (the euro) has its own sources of weakness as well as strength. However, large holders of U.S. dollar reserves are shifting more of their reserves to other currencies, and the dollar as the key currency faces
an uncertain future. The next section deals with the possible effects of “sovereign wealth funds” on the global monetary regime.

SOVEREIGN WEALTH FUNDS

Sovereign wealth funds (SWFs) are “government investment funds, funded by foreign currency reserves but managed separately from official currency reserves.” Whereas official reserves hold low-risk assets such as sovereign bonds, SWFs may hold equities, corporate bonds, and other assets; thus, SWFs are more important for financial markets. The rapid growth of SWFs signifies a partial return to state capitalism after decades of privatization in the West. Although SWFs have existed at least since the 1950s, they have grown dramatically over the last 15 years. The main factors behind the growth of SWFs are financial globalization, imbalances in the global financial system, and the large surpluses some states have acquired due to high oil prices. The countries with the largest SWFs include one DC (Norway), and the emerging economies of the United Arab Emirates, Saudi Arabia, China, Kuwait, Russia, and Singapore.

The emerging economies have used their SWFs to buy stakes in Western companies and invest in areas that will reduce the effect of volatile commodity prices on their revenues and balance of payments. For example, China’s SWF purchased shares in the U.S. financial firms Morgan Stanley and the Blackstone Group in 2007, and Dubai’s SWF bought up shares of several Asian companies such as Sony. However, many SWFs lack transparency, and it is difficult to get reliable data on the size of the funds and their goals and strategies. The SWF of a democratic society such as Norway is more transparent because it has an obligation to its citizens. However, most emerging economies are less democratic, and there is little pressure for transparency. With emerging economies growing faster than DCs and investing their surpluses in the West, concerns have increased about the power and investment strategies of SWFs. For example, China’s SWF has invested in major U.S. financial firms. Most countries do not have major objections to foreign private investment, but they are more sensitive to foreign state investment. The SWF issue, along with the shift of manufacturing and financial jobs away from the West, could produce rising trade tensions and protectionism. SWFs suffered major losses as a result of the 2008 global financial crisis, and countries with SWFs are more likely to invest more conservatively in the future. However, they will remain an important vehicle for foreign investment by emerging economies with surpluses.

Even if SWFs prove to be less important than some analysts predicted, Asian and Middle Eastern reserve assets are likely to cause some major changes in the role of the U.S. dollar and in IMF decision making. In 2007, Russia’s president Putin called for a “new architecture of international economic relations” and supported a rival candidate for IMF managing director against the EU’s choice of Dominique Strauss-Kahn of France. Although Strauss-Kahn was chosen for a five-year term, the IMF adopted selection procedures in 2007 which indicated that “any Executive Director may submit a nomination regardless of nationality,
for the [managing director] position.” Under pressure from the emerging economies, the April 2009 G20 meeting to deal with the global financial crisis agreed to complete a new balance of power in the IMF by 2011, in which heads of IOs would be selected by merit and not by nationality. Thus, it is unlikely that the EU will continue to select the IMF managing director by tacit agreement.

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**Considering IPE Theory and Practice**

In the 1940s, the Bretton Woods negotiators opted for a monetary regime based on interventionist or embedded liberalism, in which states pegged their exchange rates to gold and the U.S. dollar, the IMF provided short-term loans for balance-of-payments problems, and states controlled capital flows to maintain exchange-rate stability. However, growing U.S. balance-of-payments deficits, combined with pressures for a return to orthodox liberalism, contributed to a shift from pegged to floating exchange rates in 1973 and to a gradual freeing of capital controls. Liberal theorists point out that, with the globalization of capital flows, countries had to choose between independent monetary policies and a system of pegged exchange rates because of the “Unholy Trinity.” In a bid to preserve their independence in monetary policy, the major countries shifted from pegged to floating exchange rates. In the orthodox liberal view, the shift to floating currencies and the freeing of capital flows are positive developments enabling markets to function more freely, with little interference from the state. Historical materialists by contrast see the increased capital mobility as a negative development because the fear of capital outflows forces governments to adopt policies that adversely affect the poorest and weakest in society. If governments do not adopt capital-friendly policies, MNCs and international banks can shift their funds to more welcoming locations. Thus, governments often lower their tax rates on corporate income, even if this means sacrificing social programs. Increased capital mobility also adversely affects the working class, because countries with weak labor unions draw investment away from countries with stronger unions. Realists argue that the globalization of monetary and financial relations is greatly exaggerated, and they present evidence that there was more openness to capital flows before World War I. To the extent that global financial flows have increased, this has occurred with the permission and sometimes encouragement of the most powerful states, and these states continue to dictate the terms for such transactions. Whereas realists are correct that powerful states supported financial globalization, liberals correctly point out that this globalization “has had unintended consequences for those who promoted it.”

Thus, it is difficult for states to regain control over the global market forces they unleashed. Attempts to restore national controls on capital flows or to restore a system of pegged exchange rates would be like putting the genie back in the bottle.

To insulate themselves from global monetary instabilities, some countries are seeking regional alternatives, and the most important of these is the eurozone. Ideational as well as material factors have played a role in the EMU, because a neoliberal policy consensus among EC leaders in the late 1970s induced them to
give up autonomous monetary policies to achieve exchange-rate stability. As this chapter discusses, the euro has emerged as an important alternative reserve currency to the U.S. dollar. A currency's effectiveness as a medium of exchange, a unit of account, and a store of value depends on ideational as well as material factors, because individuals must be confident that the currency can be used in financial transactions without significantly losing its value. Growing U.S. current account deficits and foreign debt have decreased confidence in the U.S. dollar, but the EMU’s difficulty in forging sufficient political and economic unity among the member countries has also detracted from confidence in the euro. With financial globalization, the future of the dollar depends not only on the United States and its traditional European allies, but also on the actions of emerging economies with large U.S. dollar reserves such as China, Russia, and a number of OPEC countries.

This chapter has shown that the United States as the key currency country has been able to adopt policies not open to other states—such as “benign neglect” of its growing current account deficits and foreign debt. However, financial globalization is posing more limits on the policy choices of all countries today, including the United States. For example, in 2005 and 2006, the U.S. Congress sidetracked two efforts by emerging economies to use their SWFs to gain control of U.S. assets: a bid by a Chinese state oil company for Unocal, the twelfth largest U.S. oil company; and a bid by Dubai to purchase a controlling stock interest in a number of U.S. ports. Congress took these actions because of concerns about the national security implications. However, the U.S. deficit and debt problems, and the credit problems posed by the 2008 financial crisis show that the United States may be less able to choose from whom, and on what terms, it receives external finance. Both the global monetary regime and the U.S. dollar as the key international currency face an uncertain future.

**QUESTIONS**

1. What options does a country have in dealing with a balance-of-payments deficit, and what are the preferred options of the three main theoretical perspectives?
2. When did the United States first have a balance-of-trade deficit? Why was the Bretton Woods monetary regime unsustainable in the long term, and what role did the “Triffin Dilemma” play in the breakdown of the regime?
3. How much influence have DCs and LDCs had in the IMF decision-making structure? Do you think this is likely to change in the future?
4. What have the IMF’s functions been in the global monetary regime? How did the shift from pegged to floating exchange rates affect the role of the IMF vis-à-vis the G7? How has the role of the G20 changed in relation to the G7/G8, and what is the reason for this change?
5. What are the characteristics of the current global monetary regime, and in what ways has it contributed to instability? What is the “Unholy Trinity,” and does it limit the changes that IMF members could make in the current monetary regime?
6. Why was the EMU formed, and how successful has it been?
7. Is the euro likely to pose a challenge to the U.S. dollar as the key currency? What are SDRs, and could they pose a challenge to the U.S. dollar? What role do you think the Japanese yen and Chinese yuan will have in the future?
8. Do you think the U.S. deficit and debt problems pose an economic and geopolitical threat to the country? Is external financing through sovereign wealth funds and other sources a good solution for U.S. debt problems?

KEY TERMS

appreciation 139  
balance of payments 133  
capital account 133  
conditionality 142  
current account 133  
depreciation 139  
devaluation 139  
Economic and Monetary Union 154  
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FURTHER READING


### NOTES


47. Williamson and Henning, “Managing the Monetary System,” p. 100. On the difficulties in bringing about policy coordination, see Webb, The Political Economy of Policy Coordination.

48. The Nobel laureate economist Robert Mundell has been a strong (and controversial) defender of fixed exchange rates and the gold standard.


Trade relations have aroused strong positive and negative emotions from the earliest times. Whereas proposals linking free trade with world peace can be traced back to the seventeenth century, trade conflicts have been common since the Middle Ages. The conflicts are often limited in scope, but sometimes escalate and become “trade wars.” Societal groups today often express strong views about trade. For example, internationalist firms that depend on exports, imports, and multinational production pressure for trade liberalization agreements; but domestically oriented firms threatened by import competition oppose these agreements. Civil society groups also often oppose efforts to expand the authority of the World Trade Organization (WTO) and regional trade agreements (RTAs). Trade is a contentious issue because interest groups and the broader public view their welfare as being more affected by trade policy than by monetary, investment, or financial policy. Thus, business, labor, agricultural, consumer, environmental, and cultural groups try to influence government trade policies.

The forces of globalization have had a major effect on trade relations. From 1950 to 1973, world economic output (or GDP) grew at an average annual rate of 5.1 percent while trade increased on average by 8.2 percent. From 1974 to 2007, the figures were 2.9 percent for GDP growth and 5.0 percent for trade growth. The growing interdependence of states has also made trade relations more vulnerable to economic downturns. Thus, the 2008 global financial crisis precipitated “drops in global production and trade, first in the developed economies and then in developing countries.” In efforts to promote their exports, many countries began to engage in the “competitive undervaluation” of their currencies, and this raised the possibility of a trade war. Trade and foreign investment are closely related. MNCs have considerable influence on trade issues, and *intrafirm trade* within MNCs accounts for about one-third of total world trade. As a former WTO director general stated, “businesses now
trade to invest and invest to trade—to the point where both activities are increasingly part of a single strategy to deliver products across borders." This chapter discusses the postwar global trade regime and the changing role of the North and South in the regime. A major theme relates to the competing pressures for trade liberalization and protectionism.

TRADE THEORY

Liberal theorists view trade as a positive-sum game that provides mutual benefits to states, whereas realists see trade as more competitive, with each state striving to increase its exports and decrease its imports. Historical materialists view trade as a form of unequal exchange, in which advanced capitalist states in the core export manufactured and high-technology goods and import raw materials and less processed goods from the periphery. Although liberal trade theory has evolved, the ideas of Adam Smith and David Ricardo are still central to the defense of free trade. Smith argued that the gains from free trade result from **absolute advantage**, in which all states specialize in the goods they produce best and trade with each other. For example, if France produces wine more cheaply than England and England produces cloth more cheaply than France, both states can benefit from specialization and trade. Ricardo’s theory of **comparative advantage** is less intuitive and more powerful because it indicates that trade is beneficial even in the absence of absolute advantage. In his *Principles of Political Economy and Taxation*, Ricardo argued that England and Portugal could gain from trading wine for cloth even if Portugal produced both goods more cheaply than England. Central to Ricardo’s argument is the concept of **opportunity cost**, which refers to the cost of producing less of one product in order to produce more of another product. If Portugal produces wine more efficiently than cloth, it has a lower opportunity cost if it produces more wine and trades it for cloth. If England produces cloth more efficiently than wine, it has a lower opportunity cost if it produces more cloth and trades it for wine. This is the case even if Portugal produces both wine and cloth more efficiently than England.

Tables 7.1 and 7.2 use arbitrary figures to demonstrate Ricardo’s theory of comparative advantage. Table 7.1 shows the bottles of wine and yards of cloth that England and Portugal produce in one day using the same number of labor hours for wine and cloth production. Ricardo assumed that labor productivity

<table>
<thead>
<tr>
<th>TABLE 7.1</th>
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</thead>
<tbody>
<tr>
<td><strong>Production of Wine and Cloth in One Day Without Trade</strong></td>
</tr>
<tr>
<td>Bottles of Wine</td>
</tr>
<tr>
<td>England</td>
</tr>
<tr>
<td>Portugal</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

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was the only factor determining comparative advantage. As Table 7.1 shows, Portugal produces 16 bottles of wine and 8 yards of cloth, while England produces 3 bottles of wine and 6 yards of cloth. Portugal produces more of both products than England; but Portugal is relatively more efficient in wine (16) than cloth (8) production, and England is relatively more efficient in cloth (6) than wine (3) production. Table 7.2 shows how many bottles of wine and yards of cloth England and Portugal can produce if each specializes in producing the product with the lowest opportunity cost (wine for Portugal and cloth for England), and engages in trade. As Table 7.2 shows, if England produces two less bottles of wine, it can produce four more yards of cloth; if Portugal produces two less yards of cloth, it can produce four more bottles of wine. By specializing and engaging in trade, England and Portugal can produce two more bottles of wine (21) and two more yards of cloth (16) using the same number of labor hours. Thus, countries can benefit from specializing according to comparative advantage and engaging in trade.

Although Ricardo provided a powerful argument for free trade, he assumed that comparative advantage results only from differences in labor productivity. In the 1920s, the Swedish liberal economists Eli Heckscher and Bertil Ohlin developed a theory to show that comparative advantage also results from other factors of production such as capital and natural resources. The Heckscher–Ohlin theory posits that a state has a comparative advantage in producing goods that involve intensive use of its most abundant factor of production. For example, labor is a less expensive input in a state with an abundant supply of labor and this gives labor-abundant states a cost advantage in producing labor-intensive goods; capital-rich DCs have a comparative advantage in producing capital-intensive goods, and states rich in arable land have a comparative advantage in agriculture. Building on the Heckscher–Ohlin theory, two U.S. economists (Wolfgang Stolper and Paul Samuelson) developed a theory to explain why some domestic groups are protectionist and others are free-trade oriented. According to the Stolper–Samuelson theory, trade liberalization benefits abundantly endowed factors of production and hurts poorly endowed factors. For example, if state A has an abundance of labor, workers in A will favor freer trade because A is competitive in producing labor-intensive goods for export. Although workers’ wages in A will initially be low because of the abundant labor supply, as A shifts its production toward labor-intensive goods the demand and wages for labor will increase. If state A has a shortage...
of arable land, farmers in A will favor agricultural protectionism vis-à-vis states where arable land is more abundant. Thus, owners of abundant factors of production in a state support freer trade and owners of scarce factors oppose it. The Stolper–Samuelsonian theory helps explain why U.S. and Canadian blue-collar labor opposed NAFTA (Mexico has many more less skilled workers) and why French wheat farmers oppose agricultural trade liberalization in the WTO (the United States, Canada, Australia, and Argentina have more land for wheat production).8

Although the theory of comparative advantage and its offshoots provide powerful arguments for interindustry trade, they do not explain the rapid increase of intraindustry and intrafirm trade. For example, the Heckscher–Ohlin assumption that trade is most beneficial between states with different factor endowments does not explain the rapid rise of intraindustry trade among DCs with similar factor endowments. Whereas traditional trade theory assumes that goods are homogeneous, in intraindustry trade differentiated products are traded within the same industry group. For example, Germany and Japan produce automobiles and trade with each other because consumers value product differentiation and have product preferences.9 Liberals theorize that intraindustry trade provides benefits such as economies of scale, the satisfaction of varied consumer tastes, and the production of sophisticated manufactured products. The Stolper–Samuelsonian theory is also less applicable to intraindustry trade. It is harder to find owners of scarce factors opposing intraindustry trade because DCs often trade products that use similar factor intensities. Thus, trade negotiations have been most successful for manufactured products in which DCs engage in intraindustry trade. Trade barriers are more persistent for agricultural products traded between DCs and LDCs with different factor endowments. Much present-day trade is also intrafirm trade between MNC parent companies and their subsidiaries. Theories of the firm best explain why trade occurs between MNC affiliates (see Chapter 9).

The liberal theories to explain interindustry, intraindustry, and intrafirm trade are prescriptive as well as descriptive, because they assume that all states benefit from specialization and trade (even if they do not benefit equally). However, realists and historical materialists do not accept this assumption. Although realists accept trade liberalization as a part of the capitalist system, they assert that free trade is not beneficial if it jeopardizes a state’s national security. Dependence on foreign states for imports of strategic goods or basic foodstuffs can become a national security threat, especially if the imports come from unfriendly or nonallied states. The national security concern is evident in practice as well as theory. For example, Article 21 of the GATT provides an exception to trade obligations for certain national security reasons such as the regulation of traffic in arms; and U.S. law permits the president to limit imports of products for national security purposes.10 Realists also argue that free trade may prevent LDCs from promoting industrialization. Because LDCs are late industrializers, they must limit DC industrial imports until their infant industries become
more competitive internationally. Looking at the *relative gains* of trade based on comparative advantage, realists also believe that Ricardo’s advice to Portugal did not serve its long-range interests. Portugal may have gained some short-term advantages from specializing in wine, but it became less competitive than England in the long term because cloth production was a higher-growth, higher-technology industry. In the realist view, Portugal should have *created* a comparative advantage for itself in cloth through government assistance, even if it had a “natural” comparative advantage in wine. *Strategic trade theory* focuses on a state’s creation of comparative advantage, referred to as *competitive advantage*, through industrial targeting. Although efforts to gain competitive advantage in trade are not new, the growing emphasis on high-technology industries provides “a fertile breeding ground for interventionist policies.” Strategic trade theorists argue that interventionist policies can improve a state’s economic position, and they point to Japan and the East Asian NIEs as states that mobilize a limited amount of resources to create competitive advantage. However, liberals see the risks of strategic trade policy as outweighing the benefits. When *individual* rationality causes a state to increase its competitive advantage at the expense of others, other states retaliate and everyone is worse off as a result (see prisoners’ dilemma in Chapter 4). Despite the liberal warnings, the temptation to engage in strategic trade policy remains strong in an age of global competition.

Historical materialists have stronger objections to free trade than realists. As discussed in Chapter 5, Raúl Prebisch argued that LDCs in the periphery suffer from declining terms of trade with DCs in the core because of their dependence on agricultural and raw material exports. He advised LDCs to adopt import substitution policies, imposing trade barriers and producing manufactures domestically to satisfy demand previously met by imports. Dependency theorists go further, arguing that DCs either underdevelop LDCs or prevent them from achieving genuine, autonomous development; thus, LDCs should decrease or sever trade ties with the core. Arghiri Emmanuel also critiques free trade in his theory of unequal exchange. He argues that wages are higher in the core because labor is not internationally mobile and DCs specialize in producing higher value-added goods. The higher wages in DCs create a larger local market for goods, encourage mechanized production, and elevate the prices for DC goods. Thus, North–South trade is an unequal exchange, with LDCs paying more for imports from high-wage DCs than they receive for their exports; that is, there is a transfer of surplus from peripheral to core countries. Although Emmanuel provides some insights on the effects of a lack of labor mobility on international prices, he fails to consider the effects of different productivity levels between core and peripheral labor or to explain why capital does not flow to low-wage areas.

Despite the wide range of theoretical perspectives on trade, most DC economists and international economic organizations have adhered to liberal trade theories.
GLOBAL TRADE RELATIONS BEFORE WORLD WAR II

Throughout history, states have shifted between trade liberalization and protectionism. In the nineteenth century, mercantilist trade restrictions gave way to freer trade: Britain lowered its import duties in 1815 and opened its borders to food imports by repealing its Corn Laws in 1846; Britain and France then signed the Cobden–Chevalier Treaty in 1860, which resulted in a network of treaties lowering tariff barriers throughout Europe. However, Britain’s declining hegemony, France’s defeat in the Franco-Prussian War, and the 1873–1896 depression lowered the enthusiasm for free trade; and the outbreak of World War I completely disrupted the European trade treaties. After World War I, efforts to remove trade restrictions were unsuccessful as states reacted to harsh economic conditions by increasing their tariffs, or taxes on products that pass through a customs border. Tariffs rose not only in European states recovering from the war but also in the United States, which had become a net creditor nation and the world’s largest industrial power. Thus, the U.S. Congress increased import duties with the 1922 Fordney–McCumber Tariff, and after the stock market crash Congress passed the 1930 Smoot–Hawley Tariff Act, which increased average ad valorem rates on dutiable imports to 52.8 percent, the highest U.S. tariffs in the twentieth century.

The question arises as to why the United States as the top economic power did not stem the rise of protectionism. Some hegemonic stability theorists argue that the United States was able but unwilling to become a hegemon until its position became more firmly established after World War II. Others point to Britain’s continuing influence and question whether the United States was able to establish an open economic system during the interwar period. Some theorists explain U.S. protectionism in terms of domestic rather than global politics. Although the United States was the largest industrial power during the interwar period, U.S. industries feared a renewal of European competition, and U.S. agricultural groups were concerned about lower agricultural prices. The U.S. Constitution gives Congress the sole power to regulate commerce and impose tariffs, and members of Congress were susceptible to protectionist pressures from these groups because (unlike the president) they do not have national constituencies. Protectionist producer groups were politically organized and concentrated in specific industries, whereas consumer groups benefiting from freer trade were more diffuse and had little influence. Party politics also played a role in the Smoot–Hawley tariff because the Republicans who were more protectionist than the Democrats had a Senate majority at the time.

The Smoot–Hawley tariff had disastrous results as other states retaliated with their own import restrictions: World trade declined from $35 billion in 1929 to $12 billion in 1933, and U.S. exports fell from $488 million to $120 million. To reverse this damage, the U.S. Congress passed the 1934 Reciprocal Trade Agreements Act (RTAA), which transferred tariff-setting authority to the president who could lower tariffs by up to 50 percent in bilateral trade negotiations with other countries. The RTAA was significant because for the first time it linked U.S. tariff levels to international
negotiations instead of having Congress set tariffs on a unilateral, statutory basis.\textsuperscript{20} From 1934 to 1945, the United States concluded bilateral trade agreements with 27 countries and lowered its tariffs by an average of 44 percent; but tariffs were so high in the early 1930s that these agreements mainly corrected earlier excesses. The Roosevelt administration’s decision to lower tariffs only in exchange for similar concessions by other states (hence the name \textit{Reciprocal Trade Agreements Act}) also limited the scope of the agreements, and many states refused to lower their tariffs. Thus, protectionism continued to affect trade relations throughout the interwar period.\textsuperscript{21}

\section*{GATT AND THE POSTWAR GLOBAL TRADE REGIME}

To prevent a recurrence of the protectionism of the interwar period, the United States and Britain began bilateral discussions in 1943 to lay the groundwork for postwar trade negotiations. In 1945, a U.S. State Department document formed the basis for multilateral negotiations that resulted in the \textit{Havana Charter}, or charter for an international trade organization (ITO) in 1948. In addition to trade policy, the charter dealt with economic development, full employment, international investment, international commodity arrangements, restrictive business practices, and the functions of an ITO.\textsuperscript{22} However, the Havana Charter negotiations were protracted, and 23 states began negotiations to lower tariffs before the charter was approved and ratified; in October 1947, these states signed the final act of the \textit{General Agreement on Tariffs and Trade} (GATT). It was assumed that GATT would simply be folded into the ITO when it was formed, but the Havana Charter did not satisfy either U.S. protectionists or free traders. Whereas protectionists feared that the ITO would permit low-cost imports and threaten U.S. ability to form its own trade policy, free traders believed that the charter’s numerous escape clauses and exceptions would hinder trade liberalization. Thus, the U.S. Congress never ratified the Havana Charter, and GATT became an informal, global trade organization by default.\textsuperscript{23} Unlike the proposed ITO, GATT did not require ratification by the U.S. Congress because it was simply a trade agreement. Thus, GATT signatories were \textit{contracting parties} rather than members. (We use the term \textit{GATT members} for the sake of brevity.) Whereas the ITO would have been a UN-specialized agency like the IMF and World Bank, GATT never gained specialized agency status; it was mainly a written code of behavior on international trade that had more limited legal obligations than the planned ITO.

Despite its informal origins, GATT gradually developed characteristics of an IO; for example, it had committees, working parties, and a small secretariat, and it made decisions that were binding on members. Some analysts even argue that GATT became more effective than the IMF and World Bank because of its informality. Whereas “the strength of a formal arrangement such as the IMF is its rigidity; that of an informal, ideas-based institution such as the GATT is its adaptability.”\textsuperscript{24} GATT’s strengths included its negotiations to reduce tariffs and nontariff barriers, and its steadily growing membership.
However, GATT’s informality also resulted in several weaknesses. First, some trade sectors were largely exempt from GATT regulations. Agriculture was treated as an exception to GATT restrictions on import quotas and export subsidies, and the North imposed textile import quotas that contravened the spirit and rules of GATT. Second, GATT was more like a club than a formal organization, and its members could easily waive some regulations. For example, states circumvented the GATT ban on import quotas through voluntary export restraints (VERs), or pressure on others to “voluntarily” decrease their exports. Third, GATT’s dispute settlement procedures often did not resolve trade conflicts. Fourth, growing U.S. balance-of-trade deficits caused the United States to charge that others were unfair traders. Only by enhancing GATT’s authority could the United States be deterred from taking unilateral measures to ensure fair trade. Fifth, as globalization increased, many DCs wanted GATT rules to extend beyond trade in goods to trade in services, intellectual property, and investment.

By the mid-1980s, a number of trade experts therefore warned that GATT had to upgrade its rules and dispute settlement procedures; extend its discipline to agriculture and textiles; and begin to focus on newer areas such as services and intellectual property. 25 Although the Uruguay Round negotiations began with plans to simply upgrade GATT, the decision was made during the round to replace it with the WTO. (GATT continues to exist as the largest trade agreement under the WTO.)

PRINCIPLES OF THE GLOBAL TRADE REGIME

The GATT–based trade regime marked a critical turning point because it relied on multilateral negotiations and the embedded liberal compromise. The major trading nations agreed to liberalize trade, but they also supported safeguards and exemptions to protect countries’ social policies and balance of payments. 26 Despite its informal origins, GATT provided the basis for a highly developed trade regime in terms of principles, norms, rules, and decision-making procedures. The following sections discuss the trade regime principles.

Trade Liberalization

In the earlier years, GATT promoted the trade liberalization principle mainly by lowering tariffs (taxes on products passing through customs borders). Although GATT permitted tariffs, it lowered them through eight rounds of multilateral trade negotiations (MTNs), as indicated in Table 7.3. Members negotiated item-by-item tariff reductions in the first five rounds, but these negotiations became too time-consuming as GATT membership increased, and the sixth round—the Kennedy Round—therefore shifted to linear or across-the-board tariff reductions (there was an average 35 percent tariff reduction on all industrial goods). 27 Tariffs are preferable to import quotas because reasonable tariffs permit efficient
CHAPTER 7  Global Trade Relations

TABLE 7.3
The Rounds of GATT and WTO Negotiations

<table>
<thead>
<tr>
<th>Name</th>
<th>Years</th>
<th>Subjects Covered</th>
<th>Countries Participating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geneva</td>
<td>1947</td>
<td>Tariffs</td>
<td>23</td>
</tr>
<tr>
<td>Annecy</td>
<td>1949</td>
<td>Tariffs</td>
<td>13</td>
</tr>
<tr>
<td>Torquay</td>
<td>1951</td>
<td>Tariffs</td>
<td>38</td>
</tr>
<tr>
<td>Geneva</td>
<td>1956</td>
<td>Tariffs</td>
<td>26</td>
</tr>
<tr>
<td>Dillon</td>
<td>1960–61</td>
<td>Tariffs</td>
<td>26</td>
</tr>
<tr>
<td>Kennedy</td>
<td>1964–67</td>
<td>Tariffs and antidumping measures</td>
<td>62</td>
</tr>
<tr>
<td>Tokyo</td>
<td>1973–79</td>
<td>Tariffs, nontariff measures, multi-lateral agreements</td>
<td>102</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1986–93</td>
<td>Tariffs, nontariff measures, rules, services, intellectual property, dispute settlement, trade-related investment, textiles, agriculture, creation of World Trade Organization</td>
<td>123</td>
</tr>
<tr>
<td>Doha</td>
<td>1999–</td>
<td>Agriculture, services, tariffs, nontariff measures, intellectual property, dispute settlement</td>
<td>153</td>
</tr>
</tbody>
</table>


producers to increase their exports, whereas quotas set an arbitrary limit on imports. Thus, GATT Article 11 called for the “general elimination of quantitative restrictions” or import quotas. However, GATT permitted a number of exceptions to Article 11, especially for agriculture; GATT members could impose import quotas on agricultural products when they were needed to enforce domestic supply management measures. U.S. insistence on this exception stemmed from the influence of domestic agricultural groups. Viewing trade negotiations as a two-level game (see Chapter 4), DCs have often insisted that agriculture be an exception to trade liberalization agreements.\(^{28}\)

As the first five GATT rounds gradually lowered tariffs, members turned to non-tariff barriers (NTBs) as an alternative means of protecting their producers. NTBs include a wide array of measures that restrict imports, assist domestic production, and promote exports, and they are often more restrictive, ill defined, and inequitable than tariffs. NTB negotiations are also more problematic than tariff negotiations because it is difficult to measure their impact, and states tend to view NTBs as adjuncts to their domestic policies (and therefore not subject to international regulation).\(^{29}\) The Kennedy Round had limited NTB negotiations, but the Tokyo Round NTB negotiations were far more extensive and resulted in NTB codes dealing with technical barriers to
trade, government procurement, subsidies and countervailing duties, customs valuation, and import licensing. Unlike multilateral agreements, the NTB codes were plurilateral; that is, they bound only the signatories because most LDCs were not willing to participate. The Uruguay Round widened the negotiations to include not only trade in goods but also services trade, intellectual property, and trade-related investment measures; and it also began focusing on sensitive areas such as agriculture and textiles. The effects of globalization on trade were evident in the broader scope of the Uruguay Round and the increased number of participants. Table 7.3 shows that the number of participants rose from 23 in the first GATT round (Geneva) to 123 in the eighth round (Uruguay). Table 7.3 also shows that after the Dillon Round, the rounds became more lengthy and complicated. The Uruguay Round involved seven years of difficult negotiations, but it resulted in the establishment of the WTO.

IPE scholars ask why trade liberalization continued, despite the decline in U.S. trade hegemony. In 1953, the United States accounted for almost 30 percent of all manufactured exports, but by the late 1970s it accounted for only 13 percent. West Germany had moved into first place with 16 percent, and Japan was close behind the United States with 11 percent. Although NTBs increased during the late 1970s, trade liberalization was not as seriously threatened as it had been in the 1920s when Britain’s trade hegemony was declining. Indeed, the Tokyo Round (1973–1979) reduced industrial tariffs to low levels and developed the NTB codes. Some scholars explain the difference between the 1920s and 1970s in terms of the role the GATT-centered global trade regime played in upholding the trade liberalization principle even as U.S. trade hegemony declined. Others point to domestic politics to explain the differences in the 1920s and 1970s. As discussed, the U.S. Congress has the power to regulate commerce, and in the 1920s it increased tariffs in response to interest group pressures. By the 1970s, however, Congress was transferring its tariff-making authority to the president, who was more insulated from interest group pressures (this transfer began with the 1934 RTAA). Another important domestic factor stems from the forces of globalization. In the 1920s, most industries had few international ties and favored protectionism to limit competition. By the 1970s, “increased economic integration of advanced industrial states into the world economy . . . altered the domestic politics of trade.” More business firms in the 1970s depended on multinational production, exports, imports, and intrafirm trade, and they resisted protectionism despite the decline in U.S. trade hegemony.

Nondiscrimination
The first GATT director general referred to the nondiscrimination principle, as “the fundamental cornerstone” of the global trade organization. The nondiscrimination principle has both external (most-favored-nation treatment) and internal (national treatment) dimensions. The unconditional most-favored-nation (MFN) principle in Article 1 of the General Agreement
stipulates that every trade advantage or privilege a GATT member gives to any state must be extended, immediately and unconditionally, to all other GATT members. The equal treatment of imports from different origins helps ensure that imports come from the lowest cost foreign suppliers. Although MFN treatment extends back to fifteenth-century Europe, the GATT-centered MFN principle is different because it is based on multilateral commitments and negotiations. GATT permitted several exceptions to MFN treatment, the most important being the acceptance of regional trade agreements. Members of RTAs such as the EU and NAFTA abolish tariff barriers among themselves and thus give each other more favorable treatment than they give to other GATT/WTO members. As Chapter 8 discusses, the proliferation of RTAs poses a major threat to the MFN principle.

Whereas MFN treatment prevents discrimination at a country’s border, national treatment counters internal discrimination. The national treatment provisions in GATT Article 3 require members to treat foreign products—once they have been imported—at least as favorably as domestic products with regard to internal taxes and regulations. This provision is designed to prevent states from using domestic measures to limit foreign competition as their tariffs and other external trade barriers decline. The national treatment provision has often been tested in dispute settlement cases; for example, in 1988, a GATT panel found that the pricing and listing practices of Canadian provincial liquor boards discriminated against foreign wines and were inconsistent with Canada’s national treatment obligations.33

Reciprocity

The reciprocity principle stipulates that a state benefiting from another state’s trade concessions should provide roughly equal benefits in return. By ensuring that the exchange of concessions is balanced, reciprocity limits free riding under the unconditional MFN principle. Liberal economists argue that a state gains by liberalizing its trade unilaterally as well as through negotiation. However, protectionist producers are often well organized and able to mobilize domestic opposition to unilateral trade liberalization. In reciprocal trade agreements, by contrast, governments can rely on support from export-oriented domestic industries that expect to gain from the agreements. The reciprocity principle also applies to new WTO members, who obtain the market access benefits resulting from earlier negotiating rounds and are expected to provide reciprocal benefits in return.

In practice, the reciprocity principle ensures that tariff negotiations reflect the interests of the major trading powers. WTO members with the largest domestic markets and highest trade volumes have the most leverage because they have the greatest reciprocal concessions to offer. The United States and the EU (and to a lesser extent, Japan) were the leading powers in the GATT because of the reciprocity principle. Thus, the Kennedy Round was not completed until the United States and the EU reached a compromise on key issues, and in the Tokyo Round they initiated agreements before other states became involved in
reaching a broader consensus. LDCs had more influence during the Uruguay Round, but even in this case U.S. agreements with the EU and Japan on agriculture were critical to ultimate success. However, some emerging economies are now posing a major challenge to the United States, the EU, and Japan in the WTO. As Table 7.4 shows, in 2008, China was the second largest merchandise exporter after the EU. In 2009, China surpassed Germany as the world’s largest single-country merchandise exporter. Table 7.4 shows that the Russian Federation was the fifth largest merchandise exporter in 2008, because of its large sales of oil and natural gas. In terms of merchandise imports, China ranked third after the EU and the United States, and South Korea ranked fifth. As the largest single-country market for merchandise imports, the United States has considerable influence under the reciprocity principle; but its lower ranking as an exporter has resulted in its large balance-of-trade deficits. Although the emerging economies continue to rank lower than the EU, the United States, and Japan as exporters and importers of commercial services, countries such as China and India have made impressive gains in services trade. In sum, during the years of the GATT the reciprocity principle gave the major DCs the most influence in trade negotiations. However, since the WTO replaced the GATT as the global trade organization in 1995, some emerging economies have gained considerable influence. Despite the gains of some emerging economies, the reciprocity principle continues to limit the ability of many smaller, poorer LDCs to exert influence and protect their interests.

Reciprocity may be either specific or diffuse. Specific reciprocity refers to a simultaneous exchange of strictly equivalent benefits or obligations. Diffuse reciprocity does not require an immediate response to an action; instead it imposes a more general obligation on the recipient for repayment in the future. Diffuse reciprocity can coexist with unconditional MFN treatment; for example, the United States and EU offered more MFN concessions than some smaller states to reach an agreement in the Kennedy Round, and did not expect repayment for these concessions until the Tokyo Round. Specific

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**TABLE 7.4**

Leading World Merchandise Traders (Excluding Intra-EU Trade), 2008 (US $ Billions)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Exporters</th>
<th>Value</th>
<th>Rank</th>
<th>Importers</th>
<th>Value</th>
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<td>Extra-EU(27)a</td>
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<td>2166</td>
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<tr>
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<td>782</td>
<td>4</td>
<td>Japan</td>
<td>762</td>
</tr>
<tr>
<td>5</td>
<td>Russian Federation</td>
<td>472</td>
<td>5</td>
<td>South Korea</td>
<td>435</td>
</tr>
</tbody>
</table>

aExcludes intra-EU trade.

Source: Derived from World Trade Organization Secretariat, World Trade Report—2009 (Geneva: WTO, 2009), Appendix Table 4, p.16.
(or aggressive) reciprocity is more like conditional MFN treatment, in which state A grants concessions to state B only if B promptly offers equivalent concessions to A. Realists concerned with relative gains prefer specific reciprocity, whereas liberals concerned with absolute gains accept diffuse reciprocity. Specific reciprocity is less conducive to cooperation because it is difficult to determine whether concessions are exactly equivalent; if states always demanded specific reciprocity it would be impossible to conduct multilateral negotiations. However, the United States responded to its growing balance-of-trade deficits with claims that specific reciprocity is sometimes necessary to prevent others from acting as free riders. In the 1980s, for example, the United States claimed that Japan had hidden trade barriers and demanded “results-oriented” agreements that would give it a specified share of the Japanese market in return for access to the U.S. market. However, Japan argued that its trade surpluses resulted from its competitive advantage and not from unfair trading practices.37

Safeguards

When GATT/WTO members negotiate reciprocal tariff reductions, the lower tariffs are “bound,” that is, they cannot unilaterally raise them at a later date (there are some exceptions for LDCs). However, the GATT/WTO includes safeguards that permit members to temporarily raise a duty above the maximum tariff binding to limit imports that may harm domestic producers. Safeguards were part of the embedded liberal compromise after World War II, because they allowed states to sign international agreements without jeopardizing domestic stability. Indeed, states would not agree to trade commitments if rigid adherence was necessary in all circumstances. Safeguards also permit a state to temporarily increase protectionism without withdrawing entirely from a trade agreement.38 Three prominent safeguard measures are the safeguards agreement, antidumping duties, and countervailing duties.

Article 19 of the 1947 GATT included a safeguards clause which was replaced by the WTO Agreement on Safeguards in 1995. The 1947 safeguards clause permitted a state to raise import barriers in response to “import surges” that caused, or were likely to cause, serious injury to a domestic industry. However, the state had to apply the safeguard action to all GATT members in accordance with MFN treatment, and affected states could request compensation and retaliate if compensation was not considered adequate. In view of these stringent requirements, states turned to remedies targeted at specific exporters such as voluntary export restraints and antidumping actions. The WTO safeguards agreement makes it easier to take safeguard actions, but countries are still reluctant to invoke the agreement because the WTO has retained two major GATT requirements: First, the state must claim there is serious injury to its domestic producers, which is difficult to prove in WTO dispute settlement cases; second, the import barriers must be imposed on all WTO members, and this can lead to serious disputes and threats of retaliation. For example, the United States invoked the safeguards provision for certain
steel products in 2001, but the EU threatened retaliation and requested that a WTO dispute settlement panel be formed. The panel ruled against the U.S. safeguards and the United States withdrew them.

Because it is difficult to invoke the safeguards agreement, states have been more inclined to use antidumping and countervailing duties. Whereas safeguard provisions deal with import surges even when other states engage in fair trade, ADDs and CVDs are imposed to counter allegedly unfair trade practices. Dumping occurs when a firm sells products in an export market at a lower price than it charges in the home market or below the cost of production. The WTO permits a state to impose antidumping duties (ADDs) if foreign goods are dumped and the dumping causes or threatens material injury to its domestic producers. Whereas ADDs are oriented toward private corporate practices, countervailing duties (CVDs) are a response to subsidies provided by foreign governments. The WTO permits a state to impose CVDs if another state provides trade-distorting subsidies that produce or threaten material injury to domestic producers. Unlike safeguard actions, a state imposes ADDs and CVDs in response to material injury (which is easier to prove than serious injury), and targets only states charged with engaging in unfair trade. A state may impose ADDs and CVDs as a legitimate response to unfair foreign trade practices, but it may also use them to justify protectionist trade policies. Thus, ADD and CVD actions are highly controversial, and WTO dispute settlement panels often examine complaints about such actions. For example, the United States and Canada have been involved in many disputes over Canadian softwood lumber exports. The United States has imposed CVDs, claiming that the fees some Canadian provincial governments charge private firms to harvest trees on public lands constitute a subsidy to Canadian lumber; but Canada disagrees and GATT/WTO dispute settlement panels have offered several judgments on this issue.³⁹ In sum, safeguards are an essential GATT/WTO principle, but they are controversial because a state’s measures to protect its domestic producers are often viewed by others as an unjustifiable trade barrier.⁴⁰

Development
The failed Havana Charter contained provisions on economic development that did not become part of the 1947 General Agreement, and GATT had little involvement with development issues during the 1940s and 1950s. As more LDCs joined GATT, a “development principle” began to emerge and several new GATT provisions gave LDCs special treatment that diverged from the nondiscrimination and reciprocity principles. However, development remained a subsidiary trade regime principle because the major trading nations agreed to only limited concessions to promote LDC interests.⁴¹ LDCs were more involved in the GATT Uruguay Round than in previous rounds, and the WTO Doha Round, which began in 2001, was called the Development Round; but North–South divisions were a major factor leading to suspension of the Doha Round (see discussion later in this chapter).
FORMATION OF THE WTO

The trade regime principles were all in flux by the early 1980s, and many GATT achievements were in jeopardy. Although the GATT rounds had lowered tariffs, the liberalization principle was threatened because states were using NTBs that were not even covered by GATT rules. Furthermore, liberalization did not extend to textiles and agriculture, and GATT dispute settlement procedures were inadequate. RTAs that did not adhere to MFN treatment were also posing a threat to the nondiscrimination principle. As for the reciprocity and safeguard principles, the United States and the EC were demanding specific rather than diffuse reciprocity from some trading partners, and countries were resorting to unilateral protectionist actions. LDCs had little involvement with GATT, and most of them refused to sign the Tokyo Round NTB codes. In view of GATT’s shortcomings, the United States pressured for a new round of negotiations and GATT members agreed to launch the Uruguay Round in 1986. Although the negotiators at first focused on extending GATT’s jurisdiction, in April 1990 Canada proposed that a formal WTO should replace the informal GATT, and the EC supported this idea. However, U.S. negotiators believed that plans to create a WTO would detract from the Uruguay Round’s substantive negotiations and that Congress would oppose the WTO just as it had opposed the ITO in the 1940s. In the end, the United States altered its view, and the WTO replaced GATT in 1995 as the main global trade organization.

In contrast to GATT, the WTO is a formal, legally constituted organization like the IMF and World Bank. GATT has reverted to its original status as an agreement for trade in goods, which the WTO oversees along with several new treaties negotiated during the Uruguay Round: the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Intellectual Property Rights (TRIPs), and the Agreement on Trade-Related Investment Measures (TRIMs). GATT is the most important of these agreements because trade in goods is the largest aspect of international trade. The DCs supported the GATS, TRIPs, and TRIMs agreements for several reasons. First, the United States wanted to redress its merchandise trade deficits by extending rules to services trade and intellectual property where it was more competitive. Second, the DCs wanted to regulate services because services trade had a 19 percent annual growth rate from 1970 to 1980 while merchandise trade grew by only 5.4 percent. Third, DCs would benefit most from the new rules because they were the major exporters of services, intellectual property, and investment. Most LDCs did not want the GATS, TRIPs, and TRIMs, and the DCs agreed to trade-offs so they could be created (see discussion later in the chapter).

The WTO’s highest authority is the Ministerial Conference, which includes all members and can make decisions on all matters under the multilateral trade agreements (see Figure 7.1). Whereas GATT normally met at the ministerial level only to launch or conclude new rounds of trade negotiations, the WTO Ministerial Conference meets at least every two years to increase the WTO’s profile and provide guidance at a higher political level. Between the Ministerial
Conference meetings, the General Council manages WTO affairs and oversees the Councils for Trade in Goods, Trade-Related Aspects of Intellectual Property Rights, and Trade in Services (see Figure 7.1). The General Council also convenes as the Trade Policy Review Body and the Dispute Settlement Body when necessary. The Trade Policy Review Body conducts regular reviews of WTO members’ trade policies to increase transparency and promote trust that agreements are being enforced. The Dispute Settlement Body forms panels to investigate complaints and adjudicate trade disputes. A WTO member may invoke the dispute settlement procedures if another member has broken a WTO regulation or reneged on previous agreements. Dispute settlement procedures are more binding and timely under the WTO than they were under GATT. Whereas a single member (including a party to a dispute) could block the adoption of a GATT panel report, a consensus of member states is required to block a WTO panel report, a highly unlikely occurrence. A WTO member may appeal a dispute settlement decision to the Appellate Body, but if the Appellate Body agrees with the panel report, the member must implement the recommendations or provide compensation. If a member fails to implement a report or provide compensation, the Dispute Settlement Body can authorize the complainant to retaliate.45

The director-general is the chief administrative officer of the GATT/WTO. Unlike the tacit agreement that the World Bank president would be American and the IMF managing director European, there was no agreement for GATT.
For years, the selection of GATT directors-general generated little controversy. However, the issue became contentious when the WTO was formed for several reasons: the higher profile of the WTO; the tendency for politicians to become WTO directors-general (unlike the case of GATT); greater U.S. assertiveness in response to its declining trade hegemony; increased rivalry among Europe, the United States, and Japan; and the South’s unwillingness to accept the North’s dominance in the GATT/WTO. As Table 7.5 shows, all GATT directors-general from 1948 to 1995 were European. The United States reluctantly agreed to the selection of the former Italian foreign trade minister Renato Ruggiero as the first WTO director-general, but it insisted that Ruggiero serve only one four-year term and that the next WTO head be non-European. When it came to select the next WTO director-general, most DCs other than Japan supported Mike Moore of New Zealand, and most LDCs supported Supachai Panitchpakdi of Thailand. After a protracted dispute, WTO members finally agreed that Moore and Supachai should each serve three-year terms. The current WTO director-general is Pascal Lamy from France. In 2009, WTO members reappointed Lamy for a second four-year term. In contrast to the IMF and World Bank, the WTO (like GATT) is a one-nation, one-vote institution. Depending on the issue, WTO votes require a simple majority, a special majority of two-thirds or three-quarters, or unanimity. The one-nation, one-vote system gives LDCs less influence than one might expect because most decisions are made by consensus, and trade negotiations do not depend on vote-taking.46

**TABLE 7.5**

<table>
<thead>
<tr>
<th>Directors-General of GATT* and WTO</th>
<th>Years in Office</th>
<th>Nationality-Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eric Wyndham-White</td>
<td>1948–68</td>
<td>Britain</td>
</tr>
<tr>
<td>Olivier Long</td>
<td>1968–80</td>
<td>Switzerland</td>
</tr>
<tr>
<td>Arthur Dunkel</td>
<td>1980–93</td>
<td>Switzerland</td>
</tr>
<tr>
<td>Peter Sutherland</td>
<td>1993–95</td>
<td>Ireland</td>
</tr>
<tr>
<td>Renato Ruggiero</td>
<td>1995–99</td>
<td>Italy</td>
</tr>
<tr>
<td>Mike Moore</td>
<td>1999–2002</td>
<td>New Zealand</td>
</tr>
<tr>
<td>Supachai Panitchpakdi</td>
<td>2002–2005</td>
<td>Thailand</td>
</tr>
<tr>
<td>Pascal Lamy</td>
<td>2005–</td>
<td>France</td>
</tr>
</tbody>
</table>

*The name of GATT’s chief administrative officer was changed from secretary-general to director-general in 1965.

**THE WTO AND THE GLOBAL TRADE REGIME**

The WTO was designed to be more effective and authoritative than GATT, and in some respects it has succeeded: It is a formal IO comparable in status with the IMF and World Bank; members use its binding dispute settlement system more often than they used GATT dispute settlement; it is a more genuinely
The WTO and the Global Trade Regime

The World Trade Organization (WTO) is a global trade organization with 153 members as of October 2010; it oversees GATS and TRIPs as well as GATT; it has made greater efforts to integrate LDCs and transition economies into the global trade regime, and it has dialogued with a number of NGOs and civil society groups. However, the WTO also has serious shortcomings, and many problems that plagued GATT continue to affect the WTO. After the GATT Uruguay Round, liberal economists argued that a WTO round was essential for several reasons. First, liberals believe that “the bicycle must keep moving. Forward momentum is essential to avoid backsliding into protectionism and mercantilism.”

Second, GATT members agreed to conduct further negotiations on services and agriculture after the Uruguay Round, but negotiations on specific issues rarely succeed because trade-offs across issues are needed to reach agreements. Thus, a comprehensive WTO round was necessary. Third, U.S.–EU conflicts over bananas, beef hormones, and the U.S. Foreign Sales Corporation program indicated the need to improve WTO dispute settlement procedures. Fourth, negotiations were needed to ensure that the growing number of RTAs were compatible with the WTO. Finally, both the South and the North had a “wish list” for changes in the global trade regime.

The initial plans were to launch a new round at the Third WTO ministerial meeting in Seattle, Washington, in November 1999; but the growing scope of WTO activities elicited a strong negative reaction from civil society groups. Pre-negotiations were also inadequate, and the Seattle ministerial failed mainly because the United States, the EU, and LDCs had widely divergent views on critical issues. However, the September 11, 2001, terrorist attacks on the World Trade Center had a unifying effect on the United States and the EU, and under their leadership members agreed to launch the Doha Round at the fourth WTO ministerial in Doha, Qatar, in November 2001. In view of the South’s disillusionment with the Uruguay Round (see the following discussion), the North agreed to the idea that the Doha Round would be “the development round.” Although launching the Doha Round was a major achievement, “this first step . . . [was] in fact the smallest one.” WTO members papered over serious differences in launching the round, and LDCs were skeptical of assurances that this would be the “development round.” The Doha Round was originally scheduled for completion in January 2005, but it was stalled by serious North–South differences, and by October 2010 there was still no Doha Round agreement. A major problem confronting the Doha Round is that the WTO membership has become so large and diverse that it is difficult to reach a consensus on contentious issues. The Doha Round’s failure to this point and increased trade protectionism since the 2008 global financial crisis are posing serious problems for the global trade regime. Most issues of the Doha Round cannot be neatly categorized as North–South, North–North, or public–private because there are major differences within each of these groups. However, North–South differences pose the most serious obstacle to a Doha Round agreement. These differences can be best understood after providing some background on the South and global trade issues.
THE SOUTH AND GLOBAL TRADE ISSUES

DCs were the main participants in postwar trade negotiations, and LDCs were largely uninvolved. Although the Havana Charter gave some attention to LDC issues, most of these provisions were not incorporated into GATT. LDCs were also wary of participating in GATT, because it did not recognize their need for special and differential treatment (SDT). For many years, the South therefore sought special access to DC markets and exemptions from trade regime principles and rules. In the 1980s, however, the South became more accepting of GATT’s liberal economic orientation and more actively involved in the global trade regime. The following discussion identifies five stages of LDC participation in the regime:

- 1940s to early 1960s. LDCs had limited involvement in GATT.
- 1960s to early 1970s. LDCs increased their GATT membership and sought special treatment.
- 1980s to 1995. LDCs were more willing to accept GATT’s liberal economic principles.
- 1995 to the present. LDCs were disillusioned with the Uruguay Round and demand changes in the Doha Round.

1940s to Early 1960s: Limited LDC Involvement

LDCs were less involved in the global trade regime during the early postwar years because of their limited numbers (many were still colonies), their protectionist trade policies, and GATT’s inattention to development issues. Raúl Prebisch, an Argentinian economist, argued that LDCs could not achieve high economic growth rates if they depended on exports of primary products. Thus, in an effort to replace industrial imports with domestic production, most LDCs in the 1950s adopted protectionist import substitution industrialization (ISI) policies (see Chapter 10). LDCs with these inward-looking policies did not participate actively in GATT. GATT also devoted little attention to LDCs; the only major provision dealing directly with the South was GATT Article 28, which gave LDCs some flexibility in imposing import quotas to protect their infant industries and balance of payments. Although the LDCs insisted that GATT should do more to give them special treatment, they had little influence during this period.

1960s to Early 1970s: Growing Pressures for Special Treatment

Two changes contributed to growing LDC pressures for special treatment: Some LDCs modified their ISI policies, and the South’s bargaining power increased. By the 1960s, ISI policies resulted in serious problems, including decreased exports, dependence on intermediate imports for the production of industrial goods, and balance-of-payments deficits (see Chapter 10).
Thus, LDCs became more outward-looking and demanded special treatment to promote their exports. As their numbers increased with decolonization, LDCs were also better able to press their demands. In 1961, the UN General Assembly declared the 1960s to be the UN Development Decade, in 1963 the South established the G77, and in 1964 UNCTAD was formed. UNCTAD never posed a serious challenge to GATT as the main global trade organization, but it introduced a number of influential ideas directing attention to the role of LDCs in the global trade regime. For example, UNCTAD provided the first systematic analyses of tariff escalation, trade in services, and skilled migration flows; and an understanding reached in UNCTAD led to the introduction of a generalized system of preferences (GSPs) for LDCs (see discussion below). In 1965 (shortly after UNCTAD was formed), GATT members added a new Part IV to the General Agreement calling for special treatment for LDCs. Part IV was largely symbolic because it only recommended that DCs reduce their import barriers to LDCs, and the North actually raised its barriers to some LDC exports. For example, the North violated GATT Article 11’s ban on import quotas and imposed “voluntary” restraints on the South’s textile and clothing exports. A 1961 Short-Term Arrangement on Cotton Textiles was followed by several Long-Term Arrangements and Multi-Fiber Arrangements (MFAs).52

The LDCs did gain a more concrete concession in 1971 when the North established GSPs for the South through a 10-year renewable waiver from the MFN clause.53 The GSP refers to the preferential lowering of DC tariffs for certain LDC imports. Although some LDCs have benefited from these preferences, the North refused to accept a legal obligation to provide preferences or to bind itself to an international GSP plan. Instead, each DC established its own GSP, limited the amount of imports that could enter at lower duties, excluded sensitive products such as textiles, and reduced or eliminated preferences for LDCs that were especially successful in increasing their exports. In view of the complexities of GSP schemes, more competitive LDCs such as the East Asian NIEs have benefited most, and the GSP has offered very few benefits to poorer LDCs. One study found that Hong Kong, South Korea, and Taiwan accounted for 44 percent of the total gains from GSP tariff reductions.54

1970s to 1980: Increased North–South Confrontation

OPEC’s success in raising oil prices in 1973 encouraged the South to issue calls in the United Nations for a New International Economic Order, in which LDCs would gain sovereignty over their natural resources, more control over foreign investment, more development assistance, greater influence in the international economic organizations, and higher prices for their commodity exports. The North agreed to negotiate these demands because of its concerns about the price of oil, and the United Nations passed some NIEO-related resolutions.55 However, most of these resolutions were not implemented, largely because the 1980s foreign debt crisis decreased the South’s ability to influence the North (see later discussion). While the South was confronting the North in the United Nations, it participated in the 1973–1979 GATT Tokyo
Round. One result of the Tokyo Round was the enabling clause, which “established for the first time in trade relations . . . a permanent legal basis for preferences” for LDCs.\textsuperscript{56} The clause gave permanent legal authorization for the GSP and for preferential RTAs among LDCs. Although the North agreed to the enabling clause, it insisted on a “graduation” principle for states that had notable progress in development. More advanced LDCs (e.g., South Korea, Taiwan, and Brazil) whose exports threatened DC producers would have to give up special treatment and accept greater GATT discipline.\textsuperscript{57} As discussed, most LDCs refused to participate in the Tokyo Round NTB codes for government procurement, subsidies, dumping, technical barriers to trade, and import licensing; but the South would become much more involved in GATT in the 1980s.

1980s to 1995: More LDC Participation in GATT

LDCs initially opposed the idea of a GATT round in the 1980s because of global trade inequities and DC efforts to include services, intellectual property, and investment in the negotiations. However, their opposition softened when the North agreed to include issues of interest to them such as trade in textiles and agriculture. Unlike earlier periods, LDCs liberalized their trade policies during the 1980s and actively participated in the Uruguay Round. LDCs were also more willing to accept the reciprocity principle, and they agreed to treat the round as a single undertaking: Acceptance of the Uruguay Round accord meant acceptance of all its agreements. The single undertaking was a marked contrast to the Tokyo Round's NTB codes, in which most LDCs did not participate.\textsuperscript{58} Although LDCs continued receiving some SDT during the Uruguay Round, they accepted “a dilution of special and differential treatment in exchange for better market access and strengthened rules.”\textsuperscript{59} LDCs also functioned less as a bloc in the Uruguay Round and joined several North–South coalitions such as the Cairns Group of agricultural exporters that first met in Cairns, Australia, in 1986. The Cairns Group added a powerful new voice, ensuring that GATT—and the EC, the United States, and Japan—would have to deal with agriculture. The founding members of the Cairns Group included eight LDCs, three DCs (Australia, Canada, and New Zealand), and an Eastern European country (Hungary). The Cairns Group continues to function and currently has 18 members.\textsuperscript{60}

Liberals and historical materialists cite different reasons for the South’s policy shift. According to liberals, LDCs shifted toward liberal economic policies for several reasons: GSP tariff preferences for the South were eroding because tariffs declined with each GATT round; the North viewed LDCs as free riders receiving special treatment and therefore marginalized them in trade negotiations; and LDCs recognized the failure of inward-looking ISI policies and began to emulate the successful East Asian export-led growth strategies (see Chapter 10).\textsuperscript{61} Historical materialists by contrast argue that LDCs were forced to alter their policies. The IMF and World Bank provided structural adjustment loans to LDCs in response to the 1980s foreign debt crisis, on the condition that they decrease government spending, liberalize trade, and
privatize their economies (see Chapter 11). Thus, one critic argues that “the current rush toward free trade follows on the heels of 10 years of structural adjustment, a logical ‘next step’ in the overhaul of the global economy.”

1995 to the Present: LDC Disillusionment with the Uruguay Round and Demands in the Doha Round

Theorists also differ regarding the Uruguay Round’s effects on the South. Liberals concede that the North gained concessions from the South in intellectual property and services trade, and that DCs should do more to open their markets to LDC exports, but they argue that the Uruguay Round on balance benefited the South. LDCs gained advantages in textiles and agriculture; benefited from liberalizing their policies; and retained some special treatment such as flexibility in fulfilling their commitments, longer transition times to implement agreements, and technical assistance from the North. Historical materialists and some interventionist liberals by contrast argue that the South gave up more than it received in the Uruguay Round. The inclusion of services trade and intellectual property was a major loss for LDCs because they are less competitive in these areas; and the South’s “gains” from the agreements for agriculture and textiles were limited.

The outcome of the Uruguay Round in fact proved to be quite unbalanced, and the South received less than it had expected. Although the Uruguay Round provided some “fairly significant benefits” to LDCs, they realized belatedly “that they had accepted fairly weak commitments in agriculture and textiles while making substantially stronger ones, especially in . . . intellectual property.”

Many LDCs depend on agricultural exports and wanted significant cutbacks in the North’s support for their farmers, but the Uruguay Round did little to reduce agricultural subsidies and trade barriers. In view of the South’s disillusionment with the Uruguay Round, it has demanded change in the Doha Round in three main areas: agriculture, SDT, and technical assistance and capacity building. First, a Group of 20 LDCs (the G20) led by Brazil, China, and India has called for an end to EU and U.S. agricultural export subsidies and for lower agricultural import barriers in Japan, Canada, and other DCs. (This G20 of LDCs in trade should not be confused with the G20 of DCs and LDCs in finance discussed elsewhere in this book!) The G20 has more influence than earlier LDC groups, especially because China has now joined the WTO. Second, the South wants clarified and strengthened SDT provisions that are monitored and enforced. The SDT issue is contentious because LDCs found it difficult to implement their Uruguay Round obligations. Third, trade negotiations for newer issues such as services trade and intellectual property rights are more complicated, and the South wants more technical and capacity building assistance from the North before it agrees to new commitments in the Doha Round. Although the North had promised technical assistance to help the South fulfill its Uruguay Round commitments, the amount it provided was disappointing. The North is also demanding changes in the Doha Round. It wants reduced LDC barriers to nonagricultural imports and stronger agreements for services trade and intellectual property rights.
After seven years of sporadic negotiations, the Doha Round talks were suspended in July 2008 without an agreement. The WTO director-general Pascal Lamy later called on the chairs of the WTO negotiating groups to resume negotiations, but this renewed effort ended in failure again in December 2008. Lamy has summed up the obstacles to the completion of the Doha Round by stating that “three major actors in this cycle, the United States, the European Union and the G20 (emerging countries) each has a pebble in its shoe.” In other words, major players in both the North and the South must make some significant concessions to avoid failure in the Doha Round or a limited agreement that is of little value.

Making a breakthrough in the Doha Round is especially difficult because issues such as agriculture and services trade are highly susceptible to a “two-level game,” in which domestic interests have considerable influence over negotiators (see Chapter 4). Furthermore, trade protectionism has also increased since the 2008 global financial crisis because countries try to bolster their economies and domestic employment with trade barriers when economic conditions deteriorate. The G20 financial group, composed of 20 industrial and developing countries, responded to the financial crisis by pledging to refrain from raising new trade barriers; but most G20 members have broken this pledge! A number of G20 members have also engaged in “competitive undervaluation” of their currencies to artificially promote their exports. As a result, the prospects of reaching a meaningful WTO Doha Round agreement are dimmer. At the end of this chapter, we discuss competing theoretical views of the reasons for the problems with the Doha Round.

THE TRANSITION ECONOMIES AND GLOBAL TRADE RELATIONS

The Soviet Union did not attend the Havana Charter negotiations, and most centrally planned economies were not GATT members for many years. The General Agreement also devoted little attention to state trading and central planning, because it was assumed that GATT members would be free market economies. Indeed, GATT was committed to limiting government actions that interfered with market forces. As Table 7.6 shows, Czechoslovakia was a founding member that remained in GATT even after it became communist, but its membership was largely inactive. Other Eastern European states (Yugoslavia, Poland, Romania, and Hungary) joined GATT in the 1960s and 1970s. GATT admitted these CPEs under special provisions, because they excluded foreign products through administrative controls over prices and purchasing. In the late 1980s and 1990s, the membership requirements became more rigorous, and nonmarket economies had to institute specific reforms as a condition for admission. The more stringent requirements stemmed from concerns about the possible admission of China and the Soviet Union (later Russia), the revival of orthodox liberalism, and the creation of the more formal WTO. GATT’s problems with its Eastern European members had only a limited
effect on the global trade regime; but Chinese and Russian membership could have significant economic and political consequences. The IMF and World Bank accepted China and Russia as members because they were loan recipients and had little influence in these weighted-voting institutions. However, the major trading nations were concerned that these two states could shift the balance of power in the GATT/WTO.\textsuperscript{69} The following sections examine GATT/WTO relations with Eastern Europe, China, and the FSU countries.

### Eastern Europe and the GATT/WTO

The IMF and the Bank ousted Czechoslovakia shortly after it became a nonmarket economy, but it was able to remain an inactive member of GATT for many years because of GATT’s informality. Table 7.6 shows that Yugoslavia, Poland, Romania, and Hungary joined GATT in the 1960s and 1970s, because of the GATT secretariat’s goal of universal membership and the Western policy of differentiation. The differentiation strategy sought to contain the Soviet Union by rewarding Eastern European states that adopted more independent foreign or domestic policies. After its break with the Soviet bloc in 1948, Yugoslavia began to engage in economic decentralization, and it became a GATT member in 1966 when it moved from protectionist policies toward the GATT model; this showed that a CPE that liberalized its policies

### TABLE 7.6
Membership of Transition Economies in the GATT/WTO

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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</thead>
<tbody>
<tr>
<td>1948</td>
<td>Czechoslovakia and China (founding members)</td>
</tr>
<tr>
<td>1950</td>
<td>Republic of China (Taiwan) withdraws from GATT</td>
</tr>
<tr>
<td>1966</td>
<td>Yugoslavia</td>
</tr>
<tr>
<td>1967</td>
<td>Poland</td>
</tr>
<tr>
<td>1971</td>
<td>Romania</td>
</tr>
<tr>
<td>1973</td>
<td>Hungary</td>
</tr>
<tr>
<td>1990</td>
<td>East Germany accedes to GATT due to German reunification</td>
</tr>
<tr>
<td>1993</td>
<td>Czech Republic, Slovak Republic</td>
</tr>
<tr>
<td>1994</td>
<td>Slovenia</td>
</tr>
<tr>
<td>1996</td>
<td>Bulgaria</td>
</tr>
<tr>
<td>1997</td>
<td>Mongolia</td>
</tr>
<tr>
<td>1998</td>
<td>Kyrgyz Republic</td>
</tr>
<tr>
<td>1999</td>
<td>Latvia, Estonia</td>
</tr>
<tr>
<td>2000</td>
<td>Albania, Croatia, Georgia</td>
</tr>
<tr>
<td>2001</td>
<td>Lithuania, Moldova, China</td>
</tr>
<tr>
<td>2002</td>
<td>Taiwan</td>
</tr>
<tr>
<td>2003</td>
<td>Armenia, Macedonia</td>
</tr>
<tr>
<td>2008</td>
<td>Ukraine</td>
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Source: http://wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm
could participate in GATT under conditions similar to those for a market economy. Unlike Yugoslavia, Poland and Romania applied to GATT when they were not yet moving toward market reform. Tariffs have little influence over the import decisions of CPEs, so they had to commit to increasing their imports in return for GATT membership. When Poland joined GATT in 1967, it agreed to increase its imports from GATT members by 7 percent (by value) per year, and in return it received limited MFN treatment. GATT agreed to classify Romania as an LDC, and it was therefore subject to less rigid requirements. Instead of making a specific commitment, Romania expressed a “firm intention” to increase its imports from GATT members by a specific amount, but this condition was unenforceable. Hungary was able to provide tariff concessions rather than commitments to increase its imports when it joined GATT in 1973, because it had instituted liberal economic reforms under its New Economic Mechanism. Bulgaria’s efforts to join GATT failed because it was a close Soviet ally during the Cold War, and its case became enmeshed with the issue of membership for China and Russia. It was not until 1996 that the WTO finally admitted Bulgaria.

Despite GATT’s admission of Eastern European states, their acceptance was conditional and in some respects they were second-class citizens in GATT. For example, the accession agreements for Poland, Romania, and Hungary permitted the EC to impose quantitative restrictions on imports from these states; and their trade with the United States was subject to special restrictions under U.S. law. With the breakup of the Soviet bloc, the terms of participation for Eastern Europe were gradually normalized.70

China

China followed autarkic policies in 1966–1969 during the Cultural Revolution, but in the 1970s it occupied the “China seat” in the United Nations (which Taiwan had held) and expanded commercial contacts with the West. In 1982, GATT gave China observer status, and in 1986 China indicated that it wanted to “rejoin” GATT as a full member. Compared with its rather easy takeover of the China seat in the IMF and World Bank, China’s accession to the GATT/WTO was a protracted affair. The delay stemmed partly from China’s ambivalence. As a member, China would have to submit to GATT rules and open its market, and it already received de facto MFN treatment from most states. Although the U.S. Congress held an annual vote on this issue, it had renewed China’s MFN status every year. However, China decided that GATT membership would consolidate its liberalization measures and give it legal access to export markets and the GATT dispute settlement system. China had been a founding member of GATT in 1948, and it wanted to simply renew its membership. In 1950, the Chiang Kai-shek government had sent a cable from Taiwan where it had fled withdrawing China from GATT membership, but China argued this had no legal effect because Chiang Kai-shek was no longer leading the Chinese government. However, China had not abided by GATT obligations for 35 years, and it eventually had to agree to detailed negotiations as a new member.71
China was never admitted to GATT, and it did not join the WTO until December 2001. Several issues were central to China’s accession negotiations. First was the requirement that China liberalize its economy. Although China had introduced a number of market reforms, government intervention continued to produce major trade distortions. The United States strongly criticized these distortions because its trade deficit with China increased from $17.8 billion in 1989 to $90.2 billion in 2001. Others also argued that China’s trade policies were not based on comparative advantage, and the WTO refused to accord China the same terms as it gave to market economies. A second issue was China’s status as an LDC. China wanted special treatment given to LDCs at similar levels of economic development, including protection for its infant industries, the GSP, and longer transition times to implement WTO agreements. However, many WTO members argued that China should meet the same reciprocity conditions as DCs because of its size and status as a world exporter. The WTO refused to treat China as a “normal” LDC, but permitted it to phase-in reforms in some areas as a transition economy. A third issue was China’s past record in implementing agreements. In 1992, for example, the United States and China agreed to improve protection of intellectual property. Despite some changes in China’s policies, pirated intellectual property continued to be readily available in major Chinese cities. After years of negotiation on these issues, China joined the WTO in December 2001, and Taiwan (“Chinese Taipei”) was permitted to join in January 2002.

As is the case for most countries, accession to the WTO has had mixed effects on China—but the positives for China have outweighed the negatives. For example, China’s automobile industry showed new signs of vitality as some of the world’s top automakers moved to establish new plants there; in 2002, Japan’s Honda announced it would build a plant in China to produce cars specifically for export to Asian and European markets. Another important benefit of accession is in clothing and textile exports. DC quotas on textiles and clothing were abolished in January 2005, although high tariffs remained and safeguards could be used vis-à-vis Chinese exports until 2008. In 2005, China’s textiles and clothing exports to the United States and the EU increased by 43 and 44 percent, respectively. The United States also can no longer threaten China with a loss of MFN treatment, and China can use WTO dispute settlement to protect its commercial interests.

China’s membership in the WTO has a major effect on global trade relations, because of the massive size and growth of the Chinese economy. As mentioned, China has become the world’s largest single-country merchandise exporter. China’s membership is also changing the balance of power in the WTO. China has new respectability as a trading partner and ally on some issues in Asia, the EU, and other regions, despite ideological differences. For example, it has closer relations with the Association of Southeast Asian Nations (ASEAN), and the EU joined with China and other steel producers to challenge U.S. import levies on steel in the WTO. As discussed, China is one of the leaders in the G20, an important LDC bloc in the Doha Round.
However, China’s membership has also raised concerns among WTO members. The most damaging conflicts for the WTO have been between China (the world’s largest merchandise exporter) and the United States (the world’s largest merchandise importer). As Table 7.7 shows, the United States had a negative merchandise trade balance with 9 of its top 10 trading partners in 2009; so China is not the only country with which the United States has trading problems. However, the U.S. merchandise trade deficit with China was 226.8 billion dollars, much higher than its deficit with any other country. The second highest U.S. trade deficit, with Mexico, was 47.5 billion dollars. Trade and monetary issues are often closely linked, and the United States and others charge that China’s manipulation of its currency, the yuan or renminbi, gives it unfair advantages in trade (see Chapter 6).

Questions have also been raised about how far China is willing to go in liberalizing its economy; in 2003, the Deputy U.S. Trade Representative charged that some Chinese ministries “spend as much energy avoiding China’s WTO obligations as living up to them . . . and intervention by Chinese government officials in the market is largely unchecked.” Although such criticisms may result partly from the dramatic growth of China’s economy, WTO members have difficulty gaining access to the Chinese market. China applies trade barriers to many industries such as intricate registration and certification requirements for imported cosmetics, food, pharmaceuticals, and chemicals, which do not apply to local firms. Chinese exports have also been a source of concern to some LDCs. Whereas China’s clothing and textile exports to the United States grew by 43 percent in 2005, U.S. imports from South Korea and Sub-Saharan Africa declined by 24 and 17 percent, respectively. China’s clothing and textile exports to the EU grew by 44 percent in 2005, while EU imports from Sub-Saharan Africa, South Korea, Bangladesh, Indonesia, and Pakistan declined.

TABLE 7.7
Top U.S. Merchandise Trading Partners—2009 (US $ Billions)

<table>
<thead>
<tr>
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</tr>
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<tbody>
<tr>
<td>1</td>
<td>Canada</td>
<td>204.7</td>
<td>224.9</td>
<td>-20.2</td>
</tr>
<tr>
<td>2</td>
<td>China</td>
<td>69.6</td>
<td>296.4</td>
<td>-226.8</td>
</tr>
<tr>
<td>3</td>
<td>Mexico</td>
<td>129.0</td>
<td>176.5</td>
<td>-47.5</td>
</tr>
<tr>
<td>4</td>
<td>Japan</td>
<td>51.2</td>
<td>95.9</td>
<td>-44.7</td>
</tr>
<tr>
<td>5</td>
<td>Germany</td>
<td>43.3</td>
<td>71.3</td>
<td>-28.0</td>
</tr>
<tr>
<td>6</td>
<td>Britain</td>
<td>45.7</td>
<td>47.5</td>
<td>-1.8</td>
</tr>
<tr>
<td>7</td>
<td>South Korea</td>
<td>28.6</td>
<td>39.2</td>
<td>-10.6</td>
</tr>
<tr>
<td>8</td>
<td>France</td>
<td>26.5</td>
<td>34.0</td>
<td>-7.5</td>
</tr>
<tr>
<td>9</td>
<td>Netherlands</td>
<td>32.3</td>
<td>16.1</td>
<td>16.2</td>
</tr>
<tr>
<td>10</td>
<td>Taiwan</td>
<td>18.4</td>
<td>28.4</td>
<td>-10.0</td>
</tr>
</tbody>
</table>

Thus, there are mixed effects of China’s membership for other economies in the WTO. Liberal economists would argue that China’s membership is essential because it is a major actor in the global trade regime; without China, the WTO would not be a global trade organization. In contrast to China, Russia is still a nonmember of the WTO.

**Russia**

Russia is the only major economy that is not yet a WTO member. In the 1980s, the Soviet Union reacted to its growing economic problems by seeking GATT observer status and quietly exploring possible membership. However, the major trading nations viewed the Soviet economic system as incompatible with the trade regime principles and rules, and feared that the Soviets would politicize GATT and make it difficult to conduct trade negotiations. After the breakup of the Soviet Union, Russian leaders realized that a transition to market orientation would require more integration with the global economy. Thus, Russia lowered tariffs, quotas, and subsidies and applied for GATT membership in 1993; but the negotiations have been difficult.\(^78\)

Russia’s membership in the WTO was initially delayed because of its declining economic conditions. In the first five years after the Soviet Union’s collapse, the Russian economy contracted to about half its former size. High unemployment, depreciation of the Russian rouble, and a decline in public sector spending severely affected the social safety net. The socioeconomic insecurity has taken its toll on the population, and in 2003 the male life expectancy at birth was lower in Russia than in China, Brazil, and India. Although Russia had a setback in 1997 when a financial crisis forced it to default on its international obligations, since that time the economy has expanded because of a substantial rise in global energy prices. However, the years of economic turmoil have delayed Russia’s entry into the WTO. A second factor delaying membership relates to Russia’s domestic policies and capacities to conclude an agreement. The number of Russians with training to deal with trade technicalities is limited, and this has lengthened the negotiations. Russian federal and regional officials also have conflicting views regarding who has authority to liberalize trade, the possible results of freer trade, and the need for structural reform. Furthermore, some powerful private groups fear that WTO accession would increase competition and reduce their protection and profits. A third factor delaying membership is the policies of the major trading nations. As Table 7.6 shows, the WTO admitted eight FSU states from 1998 to 2008 (the Kyrgyz Republic, Latvia, Estonia, Georgia, Lithuania, Moldova, Armenia, and Ukraine). However, as was the case for China, WTO members have imposed more stringent conditions for Russian accession because of its size and importance.\(^79\)

A major source of friction with the West has been Russia’s pricing policies for its energy exports, which can have a significant effect on competitiveness and world commodity markets. Russia has the eighth-largest proven oil reserves in the world, but it ranks a close second in oil production to Saudi Arabia.
When we consider both oil and natural gas exports, Russia exports more hydrocarbons than Saudi Arabia. Thus, Russia’s policies as an energy supplier have a major effect on its relations with energy-consuming countries. The EU-27 today depends on Russia for a third of its crude oil imports and for a quarter of its gas needs; and Russia in turn is highly dependent on European markets. The trade is asymmetrical in that Russia exports raw materials and imports consumer goods, equipment, and high value-added products. Whereas privatization was common in the Russian oil sector in the 1990s, President Vladimir Putin has returned the sector back toward fuller state control and has been employing energy as a lever to extend Russia’s influence in FSU countries such as the Ukraine, and in Eastern and Western Europe. Russia’s energy relations with Western Europe are likely to affect the terms of its entry into the WTO as well as trade relations in general. The WTO cannot claim to be a truly global trade organization without Russia, because of its importance in both security and economic terms. Russia is also more likely to liberalize its economy within the WTO, and more likely to follow disruptive economic policies if it remains an outsider.

CIVIL SOCIETY AND GLOBAL TRADE RELATIONS

Civil society groups protested against the WTO even before it began operations, but the protests reached new levels at the 1999 WTO ministerial in Seattle. Whereas citizens can hold their national governments to account for the policies they follow, to whom is the WTO accountable? Global trade governance seems far removed from accountable government, and this results in a “democratic deficit” according to civil society groups. In response to NGO pressure, the WTO has adopted some policies to increase transparency; for example, it provides more information on its website and makes derestricted documents available to the public more promptly. However, NGOs are pressing for more significant changes, such as a role for themselves in decision making. Formally, WTO policy making operates according to a club model, in which only government officials and political leaders have the authority to make decisions. WTO agreements establish formal rights and obligations only for member governments, and WTO dispute settlement is formally open only to states. The club model rests on the realist view that the WTO functions best “when governments can speak clearly to each other without a cacophony of other voices.” Despite the formal limitation to governments, WTO policy making in fact operates according to an adaptive club model, in which governments regularly consult with private business groups. For example, although states are the only formal participants in WTO dispute settlement, trade ministries often lack the time, expertise, and resources to gather information for WTO investigations. Thus, MNCs give governments informal advice on legal matters, assistance in preparing written submissions to panels, and advice on responses to panel questions. In a U.S.–Japanese dispute over the photographic film industry,
Kodak performed these functions for the U.S. Trade Representative (USTR) office while Fuji assisted the Japanese government. Chiquita Brands International also helped the USTR develop its case in a U.S. dispute with the EU over its banana import regime. NGOs have argued that a multistakeholder model, in which all stakeholders have a role in the policy process, would be more democratic; this would provide alternative sources of advice and would decrease alienation from the WTO. Opponents of a multistakeholder model argue that NGOs can already participate at the domestic level, that they do not represent the national interest, and that many NGOs oppose trade liberalization. It is unlikely that the WTO will accept the multistakeholder model, because many member governments do not want their NGOs to participate independently.82

Some NGOs have developed innovative strategies such as the fair trade movement to alter global trade relations. Fair trade is a trading partnership that contributes to greater equity and sustainable development by securing more rights and better trading conditions for marginalized workers, especially in the South.83 The fair trade movement emerged when church organizations began marketing handicrafts from European communities recovering from World War II. In the 1960s, the movement came to focus on the unequal trade relations facing the world’s poor and branched out from handicrafts to food commodities such as coffee, tea, and cocoa. Alternative trading organizations such as Oxfam and Twin Trading, and cooperatives such as Equal Exchange carry out fair trade, but marketing success also depends on the willingness of large-scale retailers and corporations to bring fair trade to the mainstream public. A major challenge facing fair trade is the inherent contradiction between its role as a social movement against the market challenging conventional trade practices and North–South inequalities on the one hand, and its role within the market promoting trade between Southern producers and Northern consumers on the other. Critics warn that the expansion of fair trade as a marketing device is threatening fair trade as a social movement.84

TRADE AND THE ENVIRONMENT

Debates over trade and the environment are often framed by competing theoretical points of view. Orthodox liberals believe that free trade based on comparative advantage will have positive effects on the environment for several reasons. As wealth and prosperity increase, people will have the incentive and ability to improve the environment; states will be able to consume more goods with fewer resources; and DCs will diffuse cleaner technologies to LDCs. Orthodox liberals see efforts to inject the environment into trade discussions as interference with the market and an excuse for protectionism. For example, they oppose the use of the “precautionary principle” in trade negotiations, which would enable states to limit imports that pose a possible health risk, even in cases of scientific uncertainty. The EU has relied on the precautionary principle to limit imports of beef with certain
hormones, and genetically modified foods from the United States and Canada. Interventionist liberals also favor market-based policies, but view some environmental controls as necessary when markets function imperfectly; for example, governments should address the problems of trade in hazardous wastes, dangerous chemicals, and endangered species. Institutional liberals often accept the view that the WTO should devote more attention to environmental issues, and that the environment as well as trade require a degree of global governance. Some interventionist and institutional liberals accept the limited use of the precautionary principle, but warn that states could use it for protectionist purposes.

The greens (discussed in Chapter 5) see freer trade as a cause of global environmental problems for a number of reasons. First, global trade causes manufacturing to occur far from the point of consumption, which contributes to transportation and environmental costs. Second, trade burdens poorer states and people with serious environmental and social problems. Whereas LDCs produce the most polluting goods that depend on the unsustainable use of local natural resources, DCs benefit from importing these products. Third, trade contributes to the growth of consumption, which puts pressure on the sustainability of the planet. Fourth, trade causes states to lower their environmental standards to become more cost competitive; this leads to a “race to the bottom.” Thus, the greens advise states and global institutions to restrict trade when necessary to achieve environmental goals. Whereas liberals prefer voluntary environmental agreements, the greens favor trade sanctions to induce states to adhere to environmental standards. The greens also support the use of the precautionary principle to prevent possible environmental harm.85

The GATT/WTO gives priority to trade over environmental goals, but there has been some change over time. Environmental protection was not a major issue in the 1940s, and GATT did not even explicitly refer to the “environment.”86 GATT Article 20 permits exceptions to GATT rules “to protect human, animal or plant life or health,” and for “conservation of exhaustible natural resources.” However, GATT does not consider such measures necessary if other measures are available that do not restrict trade. Many environmental problems such as global warming or dumping at sea also do not qualify for GATT exceptions because they do not fit into the terms of Article 20. The environment is a more prominent issue in the WTO. For example, the WTO Preamble’s objectives include “sustainable development” and “seeking to protect and preserve the environment”; and the WTO sponsors a Public Forum with civil society and private sector participants in which environmental concerns are an important focus. The WTO focuses on trade and the environment through two main routes. First, the WTO’s Committee on Trade and Environment (CTE) tries to reach a consensus among WTO members on environmental issues. Second, environmental issues have been prominent in some WTO dispute settlement cases. Because the CTE’s efforts to forge a consensus have been unsuccessful, “the relationship between trade and environment in the WTO is, in effect, being created through disputes.”87
The GATT/WTO has had several important environmental dispute settlement cases. One of the most prominent was GATT’s decisions in the tuna–dolphin case in the early 1990s. Mexico complained that the United States refused to import its tuna because of claims that Mexico’s netting practices were harming dolphins, and the GATT panel decided against the United States for two major reasons. First, the national treatment obligation and GATT Article 20 indicate that states can only limit trade because of the material composition of the products (what is produced), and not because of the production and processing methods (how they are produced). The United States had not shown that the quality of Mexican tuna was inferior, and it was only objecting to the production and processing method (which it claimed was harming dolphins). Second, the GATT/WTO does not permit a state to use extraterritorial measures to protect natural resources outside its borders, and the United States was trying to impose its domestic measures on Mexico. Prominent WTO environmental disputes have been the U.S. gasoline imports case, the shrimp–sea turtle case, the EU hormone-treated beef case, the French asbestos case, and the EU genetically modified foods case. In only one of these cases did the WTO dispute settlement panel clearly give priority to the environment over trade: The WTO panel and Appellate Body decided that France could prevent imports of Canadian asbestos on health and safety grounds.\(^88\) (The decision in the shrimp–sea turtle case was a partial victory for environmentalists.)

Predictably, reactions to the WTO dispute settlement cases vary in accordance with the views of the observer. Whereas orthodox liberals believe that the market should always take priority to the environment in dispute settlement cases, institutional liberals see WTO dispute settlement as ushering in “an important period of reform” in “the interplay of trade and the environment.”\(^89\) Institutional liberals also argue that the judgments in dispute settlement cases have gradually shifted toward more recognition of the environment, and that Appellate Body decisions have “convinced many environmentalists that legitimate environmental measures would be permitted by the WTO.”\(^90\) Green theorists by contrast argue that when free trade and environmental regulation “come into conflict, the GATT/WTO dispute settlement system always found in favor of trade, and against national environmental regulation,” and that the dispute settlement panelists are “never environmentalists.”\(^91\) Thus, green theorists often see the WTO as unreformable and would like to replace it with a more environmentally friendly organization.

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**Considering IPE Theory and Practice**

This chapter shows that the forces of globalization strongly affect international trade. Internationalist firms have a major stake in an open trading system because of their reliance on exports, imports, and intrafirm trade. GATT was designed to deal mainly with trade in tangible goods, but this coverage proved to be too narrow.
Thus, the WTO is addressing additional areas such as services, intellectual property, foreign investment, and the environment, which are closely intertwined with trade issues. Foreign direct investment and trade, for example, are highly complementary because one-third of trade is conducted among affiliates of international firms. Membership in the WTO is also becoming truly global. For years, many LDCs either did not join GATT or did not fully participate in GATT negotiations. However, the 1980s foreign debt crisis marked a turning point, with 39 LDCs joining GATT from 1982 to 1994 (the year before the WTO was formed). The breakup of the Soviet bloc and Soviet Union were other major turning points, with many transition countries seeking membership in the GATT/WTO. As of October 2010, there were 153 members of the WTO; Russia is the only major economy that is still not a member. However, the inexorable growth of trade has also been marked by resistance and conflict, and there is still no Doha Round agreement. This section discusses the competing theoretical views regarding the problems with the Doha Round.

Realists attribute the Doha Round problems to the growing North–South struggle, in which the South seeks more wealth and power in the global trade regime. The balance of power in trade is shifting from “a bipolar system driven by the United States and Europe—to a multipolar one,” in which emerging economies such as China, India, and Brazil have growing influence. The United States, Europe, and Japan have been reluctant to accept this change in geopolitical power relationships, and China, India, and Brazil have been equally adamant in demanding change. As U.S. trade hegemony has declined, it has had fewer “options in providing leadership in the trading system. Yet, this lack of leadership has not been replaced by any efforts on the part of other major players.” Realists also note that this is still a world of states looking after their national interest and that trade negotiations are now more complicated with 153 diverse states in the WTO. To expect such a diversity of states to achieve a consensus on all major issues is unrealistic.

Most liberals do not view the problems with the Doha Round as a disaster, because interdependent ties among states are not easily broken. However, failure to complete the round is a serious problem; if the bicycle does not keep moving forward, there will be a reversion to protectionism. The 2008 global financial crisis is yet another major setback, because so many countries are under the illusion that protectionism and other trade-distorting policies will help them recover from the crisis. Many states are also signing more modest bilateral free trade agreements as a result of the Doha Round problems. As we discuss in Chapter 8, many liberals view RTAs as a “second-best option” after global free trade. However, some liberals warn that regional trade blocs are a divisive force in the global trade regime; the noted trade specialist Jagdish Bhagwati refers to preferential trade agreements as “termites in the trading system.” Liberal pluralists are also attuned to the important role of domestic factors in the Doha Round problems. The Doha Round negotiations have been a “two-level game,” in which delegates have had to negotiate not only with each other but with their own domestic groups. It is no accident that
agriculture is a major sticking point, because protectionist groups continue to have considerable influence in this area. Domestic skepticism about the advantages of freer trade has grown in a number of countries, and this has been especially evident in the United States because of its traditional role as a leader in free trade.

Historical materialists attribute the breakdown of the Doha Round to the realization that the WTO trade principles and rules benefit DCs and private corporations at the expense of LDCs and workers. For example, the WTO dispute settlement system in fact only protects the rights of the strong. The high costs of litigation preclude the use of the system by many LDCs, and trade retaliation, which is the only means of enforcing a finding, is of little use to an LDC in a dispute with a more powerful DC.\textsuperscript{95} The TRIPs agreement is another example of the differing views of liberals and historical materialists. The Uruguay Round agreement requires signatories to protect intellectual property rights; for example, WTO members must develop legislation that provides patent protection for at least 20 years. Liberals argue that most innovation occurs privately, and individuals have little incentive to engage in research and development if they do not have sufficient patent protection. Historical materialists, by contrast, argue that more than 80 percent of patents in the South are owned by foreigners, mainly by MNCs headquartered in the North. Thus, the TRIPs agreement limits and distorts trade, hinders the transfer of technology to the South, and transfers resources from the South to the North.\textsuperscript{96} Some critical theorists argue that the WTO must become a broader, more democratic organization that addresses concerns of labor, the environment, civil society groups, and LDCs. Others believe that the WTO is incapable of change, and that it should be abolished.

The breakdown of the Doha Round and the divergent views of theorists demonstrate that trade is one of the most contentious areas of IPE. Chapter 8 deals with regional trade agreements, which are of growing importance.

QUESTIONS

1. How has liberal trade theory evolved over time? (Discuss the theories of absolute and comparative advantage, and the Heckscher–Ohlin and Stolper–Samuelson theories.)
2. How do the realist concepts of competitive advantage and strategic trade theory differ from the liberal concept of comparative advantage? How do historical materialists view the liberal free trade ideas and why?
4. Why are safeguards an essential part of most trade agreements? What are countervailing and antidumping duties, and what must a country demonstrate to impose them?
5. How has the South’s role in the GATT/WTO changed over time? Do you think that it is meaningful to group emerging economies such as China, India, and Brazil together with LLDCs—all as part of the South—today?
6. What were the terms of China’s admission to the WTO, and has its admission been good for China and the WTO? Why is Russia still not a WTO member? What are some of China’s and Russia’s trade conflicts with the West today?
7. How much priority have GATT and the WTO given to the environment? Is free trade compatible with protection of the environment?

8. What are the similarities and differences between GATT and the WTO? What are the competing explanations for the Doha Round problems, and which explanations do you think are the most plausible?

**KEY TERMS**

- absolute advantage 169
- antidumping duties 181
- Cairns Group 188
- comparative advantage 169
- countervailing duties 181
- diffuse reciprocity 179
- dumping 181
- fair trade 197
- General Agreement on Tariffs and Trade 174
- General Agreement on Trade in Services 182
- Group of 20 189
- Heckscher–Ohlin theory 170
- intrafirm trade 171
- intraindustry trade 171
- most-favored-nation principle 177
- national treatment 178
- nontariff barriers 176
- opportunity cost 169
- Reciprocal Trade Agreements Act 173
- specific reciprocity 179
- Stolper–Samuelson theory 170
- strategic trade theory 172
- tariffs 173
- Trade-Related Investment Measures 182
- voluntary export restraints 175
- World Trade Organization 168

**FURTHER READING**


**NOTES**

1. A trade war is an “intense international conflict where states interact, bargain, and retaliate primarily over economic objectives directly related to the traded goods or service sectors of their economies, and where the means used are restrictions on the free flow of goods or services.” John A. C. Conybeare, *Trade Wars: The Theory and Practice of International Commercial Rivalry* (New York: Columbia University Press, 1987), p. 3.


34. WTO, World Trade Report—2009 (Geneva: WTO, 2009), Appendix Table 5, p. 17.


57. Hudec, *Developing Countries in the GATT Legal System*, pp. 70–91.


86. Esty, *Greening the GATT*, p. 9.


96. For contending views on this issue, see Krueger, Trade Policies and Developing Countries, pp. 52–54; Raghavan, Recolonization: GATT, the Uruguay Round and the Third World, pp. 114–141; and Croome, Reshaping the World Trading System, pp. 130–138.
The major trading nations demonstrated support for multilateral trade liberalization by signing the GATT in 1947, but regionalism also emerged as a significant force with the creation of a number of regional trade agreements (RTAs). Some scholars see RTAs as “stepping stones” while others see them as “obstacles” to global free trade. The first part of this chapter examines why RTAs are formed and how they affect the global trade regime; the second part of the chapter focuses on the four largest RTAs. Economists describe RTAs as existing at five stages or levels of integration (see Figure 8.1):

1. **Free trade area.** Member states eliminate tariffs and other restrictions on substantially all trade with each other, but each member can retain its own trade policies toward nonmember states. Thus, a free trade area poses less of a threat to national sovereignty and is more acceptable to states with politically sensitive relationships. More than 90 percent of RTAs today are free trade agreements (FTAs). The **North American Free Trade Agreement (NAFTA)** is an important example of an FTA.

2. **Customs union (CU).** A CU has the same characteristics as a free trade area plus a common external tariff (CET) toward outside states. A CU normally creates institutions to administer the common tariff, and the CU members have less ability to make independent decisions. When six states (France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg) formed the **European Community (EC)** as a CU in 1957, Britain was unwilling to join because it wanted to retain its Commonwealth preference system. To join the EC, Britain would have to raise its tariffs with Commonwealth countries to the same levels as the CET. Instead, Britain formed an FTA—the **European Free Trade Association (EFTA)**—with six other states in 1960 (Austria, Denmark, Norway,
Portugal, Sweden, and Switzerland) and retained its Commonwealth preferences. However, Britain’s trade gradually became more oriented toward EC members, and in 1973 it joined the EC and agreed to phase out its Commonwealth preferences. Compared with FTAs, the number of CUs is relatively small; the most important CU is the European Union (EU). (We use the term EC from 1957 to 1992, and EU after 1992 to reflect the name change in 1993.)

3. **Common market.** A common market has the same characteristics as a CU plus the free mobility of factors of production (labor and capital) among members. The increased labor mobility induces members to establish similar health, safety, educational, and social security standards so that no country’s workers have a competitive advantage. Successful common markets are rare because they require high levels of integration; the EU is a common market.

4. **Economic union.** An economic union has the characteristics of a common market, and it harmonizes members’ industrial, regional, transport, fiscal, and monetary policies. A full economic union also includes a monetary union with a common currency. As discussed, 16 EU members have joined the Economic and Monetary Union (EMU) and adopted the euro as their common currency.

5. **Political union.** A political union has the characteristics of an economic union and also harmonizes members’ foreign and defense policies. A fully developed political union is more like a federal political system than an agreement among sovereign states.

It is important to note that these stages of integration are models that do not fully describe reality. NAFTA, for example, is at stage 1 as an FTA; but its provisions also require more openness toward foreign investment identified with stage 3 (a common market). Furthermore, some RTAs in the South that describe themselves as CUs and common markets have not actually reached those levels. FTAs are much more common than CUs, because they do not require difficult negotiations over a common external tariff. Although these stages are only models, they provide general guidance to the process by which states become more integrated. This is especially true for the EU, the most advanced of the RTAs.

**REGIONALISM AND THE IPE THEORETICAL PERSPECTIVES**

In some cases multilateralism and regionalism are competing approaches to trade. Whereas multilateralism contributes to global trade liberalization, regionalism may divide the world into competing trade blocs. However, “open regionalism” can break down national trade barriers and serve as a stepping stone rather than an obstacle to global free trade. RTAs following open regionalism abolish barriers on substantially all trade within the RTA and
lower trade barriers to outsiders. MNCs often use open regionalism and multilateralism as complementary strategies to promote market forces and increase their competitiveness in the global economy.

Liberal economists see multilateralism as the best possible route to freer trade because it breaks down regional as well as national barriers. Liberals often support open RTAs as a “second-best” route to trade liberalization when global trade negotiations fail, but they consider closed RTAs as a threat to global free trade. Liberals are also concerned that the recent trend toward forming numerous bilateral FTAs is producing overlapping FTAs that undermine “transparency and predictability in international trade relations.”

Although liberals acknowledge that open regionalism may harm some groups such as displaced workers, they believe that the efficiency gains outweigh the costs incurred. Liberals do not view power disparities as a problem for smaller states in RTAs because they assume that all states benefit from open RTAs. Indeed, liberals argue that small states benefit more than large states because of economies of scale and increased demand for their exports. In contrast to liberals, realists and historical materialists believe that RTAs have important distributional effects, with some states and groups benefiting at the expense of others. Realists argue that a larger member of an RTA either does not permit a smaller member to receive greater benefits or expects “side payments” in return. These side payments exceed any economic benefits the smaller member receives from gains in market access and economies of scale. For example, Canada and Mexico sought free trade with the United States partly to gain more assured access to the large U.S. market. The United States, however, expected side payments in such areas as foreign investment, services trade, and access to natural resources—especially energy. Thus, realists expect the distribution of benefits in RTAs to reflect the asymmetries of power, wealth, and technology among member states. Historical materialists see MNCs and transnational capital as the main beneficiaries of RTAs, and the working class and poorest states as the main losers. MNCs locate

<table>
<thead>
<tr>
<th>Stages of Regional Economic Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Free trade area (FTA)</strong></td>
</tr>
<tr>
<td>Removal of all tariffs among members</td>
</tr>
<tr>
<td>Common external tariff</td>
</tr>
<tr>
<td>Free movement of factors (labor and capital)</td>
</tr>
<tr>
<td>Harmonization of economic policies</td>
</tr>
<tr>
<td>Political unification</td>
</tr>
</tbody>
</table>
their production in states with the lowest wages, environmental standards, and taxes and export freely to other states in the RTA.

This chapter begins with a discussion of the relationship between regionalism and globalization. It then examines the historical development of RTAs; the reasons states form RTAs; the relationship between the WTO and RTAs; and trade regionalism in Europe, the Western Hemisphere, and East Asia.

 REGIONALISM AND GLOBALIZATION

Regionalism is a difficult term to define because it connotes both geographic proximity and a sense of cultural, economic, political, and organizational cohesiveness.³ To compound the confusion, about one-third of the FTAs currently being negotiated are cross-regional, and the WTO includes these in its list of RTAs. For example, the EU has bilateral FTAs with Mexico, Chile, South Africa, and some Middle Eastern states; the United States has bilateral FTAs with Singapore, Chile, Israel, and Jordan; and Singapore has bilateral FTAs with Japan, Australia, and the United States. Some scholars argue that the term preferential trade agreements better captures this wide range of agreements among states in different geographic regions.⁴ However, we use “RTAs” for cross-regional as well as regional agreements because it is the preferred term of the WTO. Some Asian countries have strong regional economic ties that are not associated with RTAs; thus, we also discuss trade regionalism that is not limited to RTAs.

In some respects, globalization limits the growth of regionalism. As interdependence increases, financial crises, trade wars, and environmental degradation require management at the global level. Multilateral institutions such as the WTO, IMF, and World Bank are better equipped than regional organizations to deal with these problems. Globalization also promotes linkages among regions as well as states, and in this sense it can undermine both national and regional cohesiveness. However, globalization may also stimulate the growth of regionalism. States often rely on institutions above the national level to deal with global interdependence issues, but IOs with large, diverse memberships may be unable to identify common interests and sanction defectors.⁵ Thus, regional institutions composed of like-minded states may be more effective than larger multilateral institutions in dealing with cross-national problems. Globalization also contributes to increased competition, and states and MNCs can often improve their global competitiveness by organizing regionally. For example, European MNCs have improved their global competitiveness by using the EU as a regional platform, and U.S. MNCs have benefited from the existence of NAFTA. Finally, globalization is closely associated with neoliberalism, which favors a shift in authority from the state to the market. The market pressures weaken state barriers and contribute to the growth of private and public linkages at both the regional and global levels. Thus, regionalism and globalization can be both conflictual and complementary.⁶
A HISTORICAL OVERVIEW OF RTAs

RTA proposals extend back to at least the seventeenth century, and some of the agreements resulted in political as well as commercial unions. Examples of early integration efforts were an 1826 CU between England and Ireland; an 1833 treaty establishing a Zollverein or CU among German states; and an 1854 Canada–U.S. Reciprocity Treaty removing all tariffs on natural products. Early agreements in the South included a 1910 South African Customs Union among the Union of South Africa, Bechuanaland, Basutoland, and Swaziland, and a 1917 CU between the British colonies of Kenya, Uganda, and Tanganyika.7 However, regional integration in its modern form did not develop until after World War II with the creation of the EC. This chapter deals with the two major waves of regionalism during the postwar period.

The First Wave of Regionalism

In 1949 the Soviet Union signed a treaty with Bulgaria, Czechoslovakia, Hungary, Poland, and Romania establishing the Council for Mutual Economic Assistance (CMEA). Although CMEA members engaged in technical cooperation and joint planning, state-centered central planning precluded any moves toward regional economic integration.8 Thus, most writers view the first wave of regionalism as beginning with the formation of the EC in 1957 and EFTA in 1960.9 Regionalism then spread to Latin America and Africa during the 1960s. However, RTAs in the South were designed mainly to provide larger markets and economies of scale for LDC production of industrial goods through import substitution policies. By the early 1970s the first wave of regionalism proved to be largely unsuccessful outside Europe, because the South’s attempts to promote import substitution at the regional level led to numerous problems. Only a limited number of industries were willing to locate in Southern RTAs, and they were concentrated in the larger, more advanced LDCs. This unequal distribution of benefits led to disputes among member states; in the East African Common Services Union, for example, Tanzania and Uganda were resentful that most industries were concentrated in Kenya. Some Southern RTAs tried to allocate industries among members by bureaucratic means, but this led to economic inefficiencies and further conflict.

RTAs in the first wave (the 1950s to 1960s) also had some other characteristics. First, they were plurilateral rather than bilateral; that is, they were formed among at least three states. Second, all members of an RTA were from the same geographic region. Third, the RTAs were either among DCs (North–North) or among LDCs (South–South). For example, six European states formed the EC, and four Central American states formed the Central American Common Market. Fourth, the United States as global hegemon firmly supported multilateral trade, generally opposed RTAs, and would not join them. The United States made an exception in supporting the EC because it saw an economically strong Western Europe as essential to the Cold War struggle with the Soviet Union.10
The Second Wave of Regionalism

The second wave of regionalism, which began in the 1980s, is much more widespread and durable than the first wave. The most notable part of the second wave has been the proliferation of RTAs since the creation of the WTO. GATT/WTO members are to notify the organization of all RTAs in which they participate. Notifications refer to both the creation of new RTAs and the accession of new states to an RTA (e.g., the 2007 accession of Romania and Bulgaria to the EU). From 1948 to 1994 GATT received 123 notifications of RTAs covering trade in goods, and from 1995 to 2009 the WTO received over 300 additional notifications of RTAs covering trade in goods or services. Many states view RTAs as the centerpiece of their commercial policy, and for some WTO members preferential trade now accounts for more than 90 percent of their total trade.

What accounts for the importance of the second wave? First, the EU has broadened and deepened the integration process. Table 8.1 shows that the number of EU members increased to 27 in 2007. The EU also created a monetary union, and 16 EU members have adopted the euro as a common currency. Second, the United States reversed its policy and has formed FTAs with a growing number of countries. Third, NAFTA was the first reciprocal RTA between DCs (the United States and Canada) and an LDC (Mexico). This marked a change from the RTAs in the first wave which were all either North–North or South–South. Fourth, the second wave is marked by a proliferation of bilateral RTAs, unlike the plurilateral RTAs of the first wave. Fifth, many of the bilateral RTAs are between states that are not in the same geographic region. Finally, about 35 percent of RTAs currently in force are among LDCs. These RTAs are no longer based on import substitution policies and are more open to global market forces.

EXPLANATIONS FOR THE RISE OF REGIONAL INTEGRATION

Realists, liberals, and historical materialists emphasize different factors in explaining the rise of regional integration. Whereas realists look to security and power relationships, liberals focus on the growth of interdependence, and historical materialists emphasize the role of transnational capital.

Realist Explanations

Some realists see regional integration as a response to changing security and power relationships. For example, the U.S.–Soviet bipolar system after World War II was conducive to European regional integration for several reasons. First, European integration progressed because most EC members were also members of the NATO alliance, and “tariff cuts are more likely between allies than between states belonging to different military coalitions.” Second, the U.S. and Soviet superpowers assumed the main responsibilities in the security sphere under the bipolar system, and this enabled Western Europe to focus on
regional economic integration.\textsuperscript{15} Third, the emergence of the United States and Soviet Union as the only superpowers gave Europeans an incentive to form the EC. With European states facing the loss of their colonies, integration was necessary if they were to retain some influence in the bipolar world. Fourth, although the United States generally opposed RTAs during the 1950s and 1960s, it supported the EC because it viewed economic recovery in Western Europe as essential to meeting the Soviet security threat. Indeed, U.S. insistence that Europeans jointly administer U.S. Marshall Plan aid resulted in the formation of the \textbf{Organization for European Economic Cooperation (OEEC)} in 1948. The OEEC also oversaw moves toward the convertibility of European currencies and the integration of West Germany in Western Europe; this laid the foundations for the eventual formation of the EC.\textsuperscript{16}

When the Soviet Union collapsed and the Cold War ended in the early 1990s, the realist writer John Mearsheimer argued that cooperation among EU members would no longer be necessary to counter the Soviet threat. Thus, EU integration would decline and each EU member would begin to focus on its relative gains vis-à-vis the other members. However, the formation of the Economic and Monetary Union (EMU) and the expansion of the EU to 27 members raised doubts about Mearsheimer’s prediction (see discussion in this chapter).\textsuperscript{17} Furthermore, realists looking at some other states and regions in the 1980s and 1990s predicted that regional integration would increase. After World War II, the United States as global hegemon used its power and resources to support the GATT-based multilateral trade regime. As U.S. economic hegemony declined, it was less willing to continue providing this support, and it sought to regain its economic leverage by joining RTAs such as NAFTA. U.S. participation in RTAs was a major factor contributing to the rise of regional integration in the second wave.\textsuperscript{18} Some realists also point to security considerations in explaining the formation of North–South bilateral FTAs in recent years. For example, Singapore and South Korea sought bilateral FTAs with the United States partly to maintain a continued U.S. presence in East Asia as a counterbalance to China, Japan, and North Korea.\textsuperscript{19}

\section*{Liberal Explanations}

Liberals have been the main contributors to regional integration theory. We discuss liberal theory on the deepening of integration from a free trade area to a CU, common market, and economic union in the section of this chapter on Europe. Liberal views concerning the reasons that states form RTAs include the following:

\begin{itemize}
  \item International institutions at the regional and global levels are created to support a liberal economic order. Liberalism in the postwar era was closely linked with the creation of the IMF, World Bank, GATT, and RTAs.
  \item RTAs are created to promote regional peace among countries. For example, France, West Germany, Italy, the Netherlands, Belgium, and Luxembourg formed the \textbf{European Coal and Steel Community (ECSC)} in 1951. The ECSC’s main purpose was to integrate France and West Germany’s
coal and steel resources and prevent them from renewing their age-old conflicts. (The six ECSC members expanded their agreement in 1957 to form the EC.) These views draw on David Mitrany’s theory of functionalism, which states that “international economic and social cooperation is a major prerequisite for the ultimate solution of political conflicts and the elimination of war.”

- RTAs are formed to provide a larger market for member countries’ products. The agreement to form the EC was based partly on an understanding that it would provide a regional market for France’s agricultural goods and West Germany’s industrial products. A major attraction of NAFTA for the two smaller partners (Canada and Mexico) was the free trade access they would have to the much larger U.S. market for their exports.

- RTAs are formed to promote freer foreign investment flows. For example, a major reason Mexico joined NAFTA was its need for more foreign investment from the United States; and the United States supported NAFTA partly to liberalize foreign investment flows in the region.

- RTAs are sometimes formed to compensate for the inadequacies of the multilateral trade regime. RTA negotiations are often a more feasible route to freer trade than GATT/WTO negotiations because they involve smaller groups of like-minded states. Thus, the number of RTAs increase rapidly when there are problems with global trade negotiations (e.g., during the Uruguay and Doha Rounds). States also may seek RTAs that can provide a positive demonstration effect for the GATT/WTO; for example, the 1988 Canada–U.S. Free Trade Agreement (CUSFTA) included provisions on trade in services and agriculture before GATT addressed these issues.

- RTAs are formed because of pressures from domestic groups. Interdependence and globalization have caused many private firms to become more dependent on trade and shift their operations from the national to multinational level. These internationalist firms pressure for more regional as well as global trade. Regionalism often improves the competitiveness of international firms, because they can develop economies of scale and benefit from “the larger regional markets as their base rather than just the home market.”

- RTAs are formed as part of a “two-level game,” in which political leaders use the RTA regulations to bring about domestic changes. For example, one reason Canada sought the CUSFTA was “to constrain the more subtle new instruments of protectionism. More open borders would expose Canadian firms to greater international competition and encourage them to restructure and modernize.”

**Historical Materialist Explanations**

Historical materialists, like liberals, see MNCs and other sources of transnational capital as having a central role in the creation of RTAs. Unlike liberals, however, historical materialists believe that RTAs permit MNCs to locate their production facilities in states with the lowest taxes, wages, and environmental
standards and then export freely within the RTA. Whereas the capitalist class benefits from the growth of regionalism, domestic labor suffers because capital can move more easily to low-wage regions and states. Historical materialists also attribute the development of RTAs to the desire of powerful states to seek regional hegemony. As its global economic hegemony declined, the United States sought to recoup its losses by establishing its hegemony more firmly on a regional basis. Thus, some critics charge that NAFTA was “designed to fit Canada and Mexico into the American model of development, on terms amenable to American corporations.”

**THE GATT/WTO AND RTAs**

The United States as the postwar global hegemon opposed preferential agreements that would interfere with an open multilateral trade regime. However, Britain wanted to preserve its discriminatory imperial preferences, and a number of states wanted to establish RTAs. The U.S. views largely prevailed, and GATT Article 1 calls for unconditional MFN treatment. However, **GATT Article 24** permits countries to form FTAs and CUs that do not adhere to MFN treatment, as long as these agreements meet specific conditions. In line with the liberal view that open RTAs offer a second-best route to freer trade, Article 24 sanctions the formation of CUs and FTAs but seeks to ensure that they are more trade creating than trade diverting. An examination of the rationale for Article 24 is crucial to understanding the WTO’s relationship with RTAs. Before discussing Article 24, it is necessary to describe the ways in which RTAs are trade creating and trade diverting.

**Trade Diversion**

RTAs produce some trade diversion because the elimination of intraregional trade barriers shifts some imports from more efficient outside suppliers to less efficient regional suppliers. Furthermore, the freeing of trade within an RTA increases competition in member countries’ markets. Inefficient industries may lobby for increased external trade barriers to shift the adjustment burden onto countries outside the RTA. Thus, trade diversion can result when RTAs raise protectionist barriers against outsiders. Investment diversion may also occur when MNCs put branch plants inside an RTA to take advantage of the tariff-free zone instead of producing in the least-cost location and shipping goods to the region.

A CU is more trade diverting in some respects than an FTA. Even if external tariffs do not increase when a CU is formed, protectionism may increase if the CU imposes antidumping and countervailing duties in response to pressure from import-competing industries. These duties limit imports to the entire CU area because of the common external tariff. Antidumping and countervailing duties pose less of a problem for outsiders
in an FTA because each FTA member levies its own tariffs, and industries cannot pressure for areawide protection. However, FTAs are more trade diverting than CUs in terms of rules of origin, because each FTA member has its own external tariffs. FTAs require rules of origin to prevent importers from bringing goods in through the lowest duty member and then shipping them duty-free to other FTA members. The rules of origin determine whether products have undergone enough processing within the FTA to qualify for the trade preferences. It is difficult to formulate these rules because many goods are manufactured with components from a number of countries. Domestic firms often pressure FTAs for stiffer rules of origin which are more protectionist against outsiders. Rules of origin are a less significant issue for CUs because of the common external tariff. Trade diversion depends on external as well as internal political dynamics. When an RTA is formed, nonmember states have an incentive to establish their own RTAs to “better defend themselves against the discriminatory effects of other regional groups.” Furthermore, regional trade blocs such as the EU become larger when pressure from nonmember firms triggers “membership requests from countries that were previously happy to be nonmembers.” This proliferation of regionalism fragments the global trade regime.

**Trade Creation**

The main source of trade creation in RTAs is the increased trade among members, which shifts demand from less efficient domestic suppliers to more efficient regional suppliers. When firms within the region become more competitive as a result of the RTA, they are also more likely to support freer trade at the global as well as regional levels. Furthermore, RTAs often achieve a deeper level of integration than multilateral trade agreements because negotiations occur among a smaller number of like-minded partners. RTAs may therefore have a positive demonstration effect on multilateral trade negotiations. For example, the inclusion of agriculture, services, and intellectual property in the NAFTA provided a stimulus for negotiating these issues in the GATT Uruguay Round.

**GATT Article 24 and RTAs**

GATT Article 24 seeks to ensure that RTAs result in more trade creation than trade diversion. To increase trade creation, Article 24 stipulates that FTAs and CUs are to eliminate tariffs on “substantially all” trade among the members within a “reasonable” time period. (GATT granted waivers from the substantially all trade requirement for the ECSC in 1952 and the Canada–U.S. Auto Pact in 1965.) This requirement limits preferential agreements with only partial trade liberalization such as those that contributed to protectionism during the 1930s. RTAs that remove all internal trade barriers are also more likely to serve as stepping stones to multilateral free trade. To decrease trade diversion, Article 24 stipulates that an RTA should not raise tariffs on the average to countries outside the agreement. Whereas individual members of an FTA are
not to raise their average level of duties, the common external tariff of a CU may not “on the whole” be higher than the duties of the member states before the CU was established. These provisions are designed to limit reductions in imports from nonmembers as a result of the RTA. However, GATT Article 24 has been more effective in theory than in practice.

TheEffectivenessofGATTArticle24

When countries formed an RTA, GATT established a working party to determine whether it met the Article 24 conditions; but these working parties had only limited influence over RTAs. GATT’s regulations for RTAs were drafted with smaller agreements in mind, such as the Benelux CU negotiated by Belgium, the Netherlands, and Luxembourg in 1944. In 1957, however, the EC members were unwilling to wait for GATT approval before proceeding with economic integration because of the size and importance of the EC. Negotiating the Treaty of Rome had been a difficult process, and EC members would not readjust the treaty to satisfy GATT. In the end, GATT acceded to the EC demands and never finished examining the Treaty of Rome, even though it had reached no consensus on the treaty’s consistency with Article 24. GATT’s acquiescence in this case limited its authority over subsequent RTAs, and its working parties could do little to change RTAs after member states had negotiated them. Whereas GATT was notified about early agreements such as the EC before they entered into force, some later agreements such as NAFTA entered into force before a working party was even formed to examine them.

It is not surprising that GATT had little influence over RTAs after they were negotiated. Governments had already engaged in extensive bargaining and were reluctant to reopen negotiations in response to outside criticism. GATT working parties could only try to embarrass RTA members with allegations of noncompliance and encourage them to comply with the guidelines in the future. However, GATT did influence decision making at earlier stages by setting broad parameters for conducting the regional negotiations. For example, the diplomats negotiating RTAs often operated

under instructions to make maximum efforts to comply with GATT rules, and the actual results of these negotiations testify that a quite important degree of GATT compliance was achieved. Except for agriculture...and except for the EC’s relationship with former colonies, the...developed-country agreements...were essentially GATT-conforming. To be sure, GATT was unable to do anything further once the agreements were signed and deposited in Geneva.

Some analysts note that GATT was less effective because Article 24 requirements that RTAs cover “substantially all” trade, do not become more restrictive “on average” to outsiders, and be fully implemented in a “reasonable length of time” are subject to multiple interpretations. In view of the imprecise wording, working parties were reluctant to give RTAs unqualified
approval. By 1994, only 6 of 69 working parties had reached a consensus that particular RTAs conformed to Article 24, and only 2 of these 6 RTAs are still operative. In most cases, working parties simply noted that members had divergent views regarding the RTA’s conformity with GATT. However, GATT never explicitly concluded that an RTA did not meet the legal requirements! Article 24 also does not adequately address such issues as rules of origin and antidumping and countervailing duties, which may increase regional protectionism toward outsiders.\textsuperscript{34} To improve the regulation of RTAs, the GATT negotiated an Understanding on the Interpretation of Article 24 (UR Understanding) and a GATS article on regional trade in services (Article 5) in the Uruguay Round, and the WTO established a Committee on Regional Trade Agreements (CRTA).\textsuperscript{35} Although the Uruguay Round agreements and CRTA have dealt with some GATT Article 24 shortcomings, many problems remain. For example, divisions persist on the interpretation of the “substantially all trade” requirement (many RTAs exclude agriculture), and the Uruguay Round negotiators did not decide how to deal with restrictive rules of origin in FTAs. In 2006 a negotiating group agreed on a mechanism to ensure that the WTO receives early notification of new RTAs; but this mechanism may not become permanent because of the breakdown of the Doha Round.\textsuperscript{36}

**Special Treatment for LDCs**

Although GATT Article 24 was to apply to all RTAs, LDCs receive special treatment.

**RTAs Among LDCs** The GATT/WTO is more lenient in its approach to RTAs among LDCs. For example, GATT did not object to the formation of the Latin American Free Trade Association in 1960, even though it “did not even approach the requirements of total integration.”\textsuperscript{37} After Part IV on trade and development was added to GATT in 1965, LDCs sometimes invoked it to justify forming RTAs that did not meet Article 24’s substantially all trade requirement. When the 1979 enabling clause established a permanent legal basis for LDC preferences, it became the main legal basis for LDCs forming questionable RTAs. The enabling clause permits LDCs to form RTAs that include a limited range of products and lower rather than eliminate tariffs. Any RTA is eligible for special treatment under the enabling clause as long as it does not include any DC members. For example, Mercosur was notified to GATT under the enabling clause, not Article 24 (see discussion below).\textsuperscript{38} Despite the GATT/WTO’s permissiveness, recent LDC moves toward freer trade have inevitably affected their RTAs. The negative experience of LDCs with import substitution policies, combined with IMF and World Bank pressure on LDC debtors to liberalize, have caused RTAs among LDCs to become more outward looking.

**EU Association Agreements With LDCs** As discussed in Chapter 7, DCs unilaterally established a generalized system of preferences (GSPs) for LDCs. EU association agreements with LDCs by contrast are jointly negotiated
preferential agreements. When the EC was formed in 1957, the Treaty of Rome provided associate status to France’s African Overseas Territories. The EC’s enlargement when Britain, Denmark, and Ireland joined in 1973 (see Table 8.1) necessitated a change because of Britain’s relationship with Commonwealth LDCs. In 1975, the nine EC members concluded the first Lomé Convention (Lomé I) with 46 African, Caribbean, and Pacific countries (the ACP states); three more Lomé Conventions followed in 1979, 1984, and 1989 (eventually with 71 ACP states). The Lomé Conventions offered preferential access for ACP goods to the EC market without requiring reciprocity for EC goods. A number of GATT members argued that the Lomé system was not a genuine FTA because it was nonreciprocal. GATT Article 24 provides an exception to MFN treatment only for RTAs that follow the reciprocity principle. Furthermore, the 1979 enabling clause permits DCs to provide trade preferences only if all LDCs have access to these preferences. The enabling clause does not sanction EU discrimination in favor of its ex-colonies at the expense of other LDCs.

Although the EU argued that the nonreciprocal association agreements contributed to LDC economic development, external events increased the pressures for change. In 1994 Mexico formed the NAFTA with the United States and Canada, showing that LDCs could join in reciprocal FTAs with DCs. Analysts

<table>
<thead>
<tr>
<th>Year of Membership</th>
<th>Members</th>
<th>GDP(^a) (PPP(^b)) Percentage Addition</th>
<th>GDP per Capita as Percentage of Existing Average</th>
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</thead>
<tbody>
<tr>
<td>1957</td>
<td>France(^c), West Germany, Italy(^c), Belgium(^c), the Netherlands(^c), Luxembourg(^c)</td>
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<td>1973</td>
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<td>95.5</td>
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<td>1979</td>
<td>Greece(^c)</td>
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<td>Spain(^c), Portugal(^c)</td>
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</tr>
<tr>
<td>1990</td>
<td>Germany unified(^c)</td>
<td></td>
<td></td>
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<td>1995</td>
<td>Austria(^c), Finland(^c), Sweden</td>
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<td>103.6</td>
</tr>
<tr>
<td>2004</td>
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</tr>
<tr>
<td>2007</td>
<td>Bulgaria, Romania</td>
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<td>33.3</td>
</tr>
</tbody>
</table>

\(^a\)Gross domestic product
\(^b\)Purchasing power parity
\(^c\)Members of the European Economic and Monetary Union.

also began to question the value of the Lomé Conventions to ACP states because ACP benefits from the EC trade preferences declined as MFN tariffs were reduced in the GATT negotiations, the EC limited imports of some ACP products, and the nonreciprocal preferences enabled ACP states to maintain inefficient production structures. Thus, the ACP states’ share of the EU market fell from 6.7 percent in 1976 to 3 percent in 1998, with more than 60 percent of ACP exports concentrated in only 10 primary products. Historical materialists described EU nonreciprocal preferences “as a form of neocolonialism that perpetuates the production of . . . products not compatible” with the long-term interests of the ACP states. Even in the EU there were pressures for change because the nonreciprocable tariff preferences with ACP states complicated the EU’s relations with other LDCs. In view of the pressures for change, the EU and ACP states negotiated the more WTO-compatible Cotonou Agreement (or New Partnership Agreement) in 2000. The Cotonou Agreement stipulates that, beginning in 2008, ACP–EU reciprocal “economic partnership” agreements will gradually replace the nonreciprocal preferences over a 10- to 12-year period. Although supporters of this change believe that the ACP states will benefit by liberalizing their trade policies, critics argue that EU–ACP nonreciprocal relations must continue because the ACPs have a lower level of development.

The following sections focus on the four largest RTAs today: the EU, NAFTA, the ASEAN or Association of Southeast Asian Nations FTA (AFTA), and Mercosur.

**THE EUROPEAN UNION**

Postwar regional integration has been mainly in Europe, with European states as parties to 76 of the 109 RTAs formed from 1948 to 1994. In 1951, six states (Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands) formed the ECSC and then established the EC and the European Atomic Energy Community (Euratom) in 1957 (see Table 8.2). In 1959, seven states (Austria, Britain, Denmark, Norway, Portugal, Sweden, and Switzerland) formed the EFTA instead of joining the EC, because the EC required a degree of policy coordination that threatened Britain’s Commonwealth preference system and the nonaligned policies of states such as Sweden and Switzerland. As Table 8.1 shows, the EC gradually added some former members of EFTA. In 1993 the EC’s name was changed to the EU to symbolize the extension of the community from trade and economic matters to a much broader range of activities under the Maastricht Treaty. Thus, the term “EC” is used when discussing events from 1957 to 1992, and “EU” is used for events from 1993 to the present.

As discussed, the EU is an economic union, and 16 of the 27 members have discarded their national currencies and adopted the euro (see Table 8.1). The EU’s institutional structure differentiates it from RTAs at lower levels of integration. The European Commission represents general EU interests rather than those of any particular member state, and the powers of the European Court of Justice (ECJ) are greater than those of other international courts.
The EU is therefore a “supranational” organization that operates above the level of the nation-state in some areas. However, the Council of Ministers (or Council of the European Union) is the EU’s primary decision-making body and the most powerful EU institution in day-to-day politics. The fact that the Council of Ministers is composed of foreign ministers representing their governments is a reminder that the EU (despite its supranationality) is still beholden to its member states. Other important institutions of the EU are the European Parliament and European Council (of Heads of State and Government). In sum, the EU’s unique institutional structure gives it more authority than other IOs, but the EU remains subject to considerable control by its member states.44

The Deepening of European Integration

The EC began its operations with considerable enthusiasm in 1957. However, the integration process slowed in the 1960s and 1970s because of actions of France’s president Charles de Gaulle, and international events such as the collapse of the Bretton Woods monetary regime, the OPEC oil crisis, and the onset of recession. Although Britain joined the EC in 1973, it opposed the development of strong EC supranational institutions; thus, the 1970s were marked by “Eurosclerosis” (i.e., stagnation) and a loss of faith in the EC’s vitality. In the early 1980s, EC members became acutely aware of their lack of competitiveness vis-à-vis the United States and Japan. Divisions within the EC as a result of differential taxation, border inspections, domestic subsidies, and limits to market access were a major source of the problem. Thus, the EC sought to create a unified European market with more competitive firms based on specialization and economies of scale. The EC Commission president Jacques Delors was a significant force behind the negotiation of the 1986 Single European Act (SEA), which was designed to abolish nontariff barriers, liberalize trade in services, and facilitate the movement of capital and labor by 1992 (see Table 8.2). The SEA also included a commitment to monetary union, and the European Council established the Delors Committee to implement this goal. The committee proposed a three-stage process toward a monetary union, and negotiations resulted in the Treaty on European Union or Maastricht Treaty in 1992 (see Table 8.2).

The Maastricht Treaty changed the name of the EC to the EU because the first pillar—the EC—was joined by two new pillars: one for a common foreign and security policy, and another for a common social policy. Whereas supranational decision making is sometimes used for the first pillar (the EC), intergovernmental decision making is the norm for the second and third pillars (foreign/security and social policy). The most important element of the EC pillar was the Maastricht Treaty’s plans for the EMU. The treaty outlined a timetable for setting up the EMU, criteria for joining the EMU (e.g., a budget deficit of less than 3 percent of GDP, and public debt of no more than 60 percent of GDP), and functions the EMU would perform (e.g., the European Central Bank’s role in the process). For further discussion of the EMU see Chapter 6. On security (the second pillar), the Treaty reflected a balance between France’s desire for a security policy in the EU through the European...
Commission and Britain’s preference for enhancing the Western European Union in order to strengthen NATO. Although long-term cooperation between the EU and NATO on security and defense policy will depend on future negotiations, the EU will depend on NATO in the near to medium term. Divisions on security issues ranging from the former Yugoslavia to the Middle East and the response to terrorism raise questions as to whether the EU can in fact develop a common security policy. The third pillar of the Maastricht Treaty involves social policy regarding organized labor, a welfare state, and migration into the EU. For example, the EU Council of Ministers was given authority to make decisions by qualified majority vote on working conditions and worker health and safety. Social issues are highly sensitive because of political divisions in Europe between conservatives and social democrats, and management has occurred more through informal agreements.45

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>European Coal and Steel Community (ECSC)</td>
<td>6 states integrate their coal and steel resources</td>
</tr>
<tr>
<td>1957</td>
<td>Treaty of Rome</td>
<td>Establishes the European Economic Community (EC)</td>
</tr>
<tr>
<td>1986</td>
<td>Single European Act (SEA)</td>
<td>To free the movement of goods, services, and labor; Commitment to form a monetary union (EMU)</td>
</tr>
<tr>
<td>1992</td>
<td>Treaty on European Union (or Maastricht Treaty)</td>
<td>Commitment to form an EMU, common foreign and security policy, common social policy; Renames the EC the European Union (EU)</td>
</tr>
<tr>
<td>1999</td>
<td>Creation of the Euro</td>
<td>11 EU states adopt the euro as a common currency. The number increases to 16 states by 2010</td>
</tr>
<tr>
<td>2009</td>
<td>Lisbon Treaty</td>
<td>Establishes an EU high representative; Gives new powers to European Commission, Parliament, and Court of Justice; Removes national vetoes in some areas; Redistributes voting weights among member states</td>
</tr>
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</table>
The ratification of the Maastricht Treaty was a more contentious process than many EU leaders expected, and this was an indication of the difficulties that would arise in carrying the integration process further. We discuss attempts to advance the integration process with the Constitutional Treaty and the Lisbon Treaty after examining the widening of European integration in the next section.

The Widening of European Integration

As Table 8.1 shows, the EU expanded from 6 to 27 members in several enlargements. While increasing its membership, the EU also extended associate linkages with the ACP states and other LDCs. Whereas the deepening of integration has often been a response to economic conditions, the recent widening was “thrust on the EU by the failure of communism in Europe.”

This section focuses on the accession of 12 Central and Eastern European countries (CEECs) to the EU in 2004 and 2007.

The Soviet Union was hostile to the EC when it was formed in 1957, and it insisted that the Council for Mutual Economic Assistance (CMEA) be the vehicle for EC economic contacts with Eastern Europe. However, the EC preferred to negotiate bilateral agreements with Eastern European states and some of them broke ranks with the Soviet position. For example, the EC granted the GSP to Romania in 1972, and signed a trade and cooperation agreement with Romania in 1980. As economic conditions in the East worsened, the Soviets became more dependent on economic linkages with the West and softened their position; thus, a 1988 EC–CMEA agreement sanctioned EC negotiations with individual Eastern European states. After the breakup of the Soviet bloc, the EU negotiated a number of “Europe agreements” with Eastern European states. However, the EU offered them only limited trade concessions, and they began to apply for full membership in the EU.

An obstacle to admitting the Eastern Europeans was the wide disparity in economic development between the CEECs and most EU members. Ten CEECs that signed Europe agreements with the EU had only one-fourth of the purchasing power of the EU average, and about 20 percent of their workers had agricultural jobs compared with only 6 percent of EU workers. Thus, an EU Commission report warned that admission of the CEECs would cause migration from the CEECs to Western Europe, an eastward movement of firms because of lower labor costs in Eastern Europe, and a sharp increase in the population eligible for EU social and economic development funds. However, official EU statements described enlargement as “a political necessity and a historic opportunity.” Both the CEECs and the EU saw some advantages from enlargement. The CEECs felt that EU and NATO membership would give them security vis-à-vis Russia and that access to EU capital, technology, and markets would help close the economic gap with the West. EU members believed that stable CEECs would provide a buffer against political instability, the CEECs would provide the EU with cheaper workers and investment opportunities, and enlargement would enhance the EU’s external influence.
Ten CEECs were admitted to the EU in May 2004. Although this was the largest expansion in the number of states, Table 8.1 shows that it was not the most important in GDP terms. Whereas the 1973 accession of Britain, Denmark, and Ireland added 31.9 percent to the EC’s GDP, the 2004 accession of the 10 CEECs added only 9.1 percent to the EU’s GDP. A major factor accounting for this difference is the lower incomes of the 10 CEECs. As the last column of Table 8.1 shows, the per capita GDP of Britain, Denmark, and Ireland was 95.5 percent of the EC average when they joined in 1973. The per capita GDP of the 10 CEECs was by contrast only 46.5 percent of the EU average when they joined in 2004. When Bulgaria and Romania joined the EU in 2007, their incomes were only 33.3 percent of the EU average. The CEECs have also had greater difficulties than the Western European EU countries in responding to the 2008 global financial crisis.50

Widening need not hinder the deepening of integration, and sometimes they occur together. However, the large number of states involved in the 2004 and 2007 enlargements and their lower level of economic development contributed to a diversity of interests that was “harder to contain within a single framework.”51 Many European leaders believed that the enlarging EU required major institutional reforms. To this end, a Convention in Brussels produced a draft Constitution for Europe that was signed in October 2004. The supporters of the Constitutional Treaty argued that it would make the EU more democratic, transparent, and efficient, and would better delineate the distribution of powers between the EU and its member states. However, the term “constitution” along with references to the EU flag, anthem, and motto contributed to fears of greater central authority, and the 341 pages and 488 articles of the Constitutional Treaty made it incomprehensible to most individuals. Citizens in the EU countries also had a wide variety of concerns, and the majority of voters in the Netherlands and France rejected the Constitutional Treaty in referenda. French voters rejected the treaty because of economic insecurity and unemployment, hostility to political leaders, and concerns that the constitution would move the EU further toward liberal orthodoxy. French voters were also concerned that the large EU bureaucracy was removed from the populace, that they would lose jobs to lower cost labor in the CEECs, and that France’s influence in the EU was declining.

The rejection of the Constitutional Treaty created a crisis for the EU, but three years later a consensus emerged on a new accord—the Lisbon Treaty—which preserves many of the changes the Constitutional Treaty tried to introduce. However, negotiators believed the Lisbon Treaty would be more acceptable because it deleted the constitutional language and all reference to the EU symbols—the flag, the anthem, and the motto. Whereas the Constitutional Treaty was designed to replace all earlier EU treaties, the Lisbon Treaty simply amends the Treaty of Rome and the Maastricht Treaty. The provisions of the Lisbon Treaty are too numerous to outline, but they are designed to enable the EU to formulate internal and external policies with its enlarged membership. As Table 8.2 shows, the Lisbon Treaty establishes a new position called high representative to give the EU more influence in international fora;
The European Union gives new powers to the European Commission, Parliament, and Court of Justice; removes national vetoes in a number of areas; and redistributes voting weights among the member states.

Despite the approval of the Lisbon Treaty, many uncertainties remain. First, the treaty is complex and difficult to read, and its effects remain to be seen. Second, Ireland was the only EU country to hold a referendum on the treaty. Other EU leaders argued that there was no need for referenda because Lisbon simply amended earlier treaties. Thus, they circumvented ambivalent attitudes in many EU member states. Third, the fallout from the 2008 financial crisis in Greece, Spain, Portugal, and Ireland has raised serious questions about the future of the euro and the EMU, which many consider to be the centerpiece of the EU. In sum, the EU is the most advanced economic integration movement, but its internal and external political presence is not comparable with the economic strength of its member states.  

Theoretical Perspectives and the EU

Theory on the deepening of integration is most relevant to the EU, because of its advanced level of integration. We discuss here three theoretical approaches: neofunctionalism, liberal intergovernmentalism, and constructivism.

Neofunctionalism  Theorists generally ask why European states have chosen to pool substantial elements of their sovereignty in the EU. Neofunctionalism describes integration in one economic sector as creating pressures for further integration. For example, the six ECSC members found that the integration of their coal and steel resources would have only limited benefits without also coordinating their transportation systems for moving the coal and steel. Thus, neofunctionalists believe that regional integration has an expansive logic, in which integration of one economic sector creates pressures for spillover into related sectors. Spillover can also contribute to the deepening of integration from an FTA to a CU, common market, and economic union. Whereas functionalists see spillover as an automatic process, neofunctionalists see political activism by interest-driven actors as also necessary. First, integration in an area (in this case coal and steel) results in increased transactions and in new interest organizations (representing business, labor, and consumer groups) at the regional level. These interests exert political pressure for deeper integration. Second, the supranational bureaucracy (the High Authority in the ECSC or the European Commission in the EU) has a vested interest in expanding its authority through the deepening of integration over a wider range of sectors. Thus, Ernst Haas describes integration as “the process whereby political actors in several distinct national settings are persuaded to shift their loyalties, expectations and political activities toward a new center, whose institutions possess or demand jurisdiction over the pre-existing national states.”

Neofunctionalism had considerable influence on the study of regional integration, but its influence varied over the years. The expansion of integration from the ECSC to the EC seemed to support neofunctionalism, but numerous
problems during the 1960s and 1970s (De Gaulle’s actions and Eurosclerosis) raised questions about the expansive logic of the theory. Neofunctionalist ideas such as “spillover” had somewhat of a revival in the 1990s with the SEA, the Maastricht Treaty, and the creation of the EMU, but the newer neofunctionalists viewed it as a less ambitious theory that only explained some aspects of the integration process. Few scholars call themselves neofunctionalists today because the theory has been subject to numerous criticisms. First, the tortuous path of European integration demonstrates conflicting pressures for integration and diversity, and there is no certainty that “spillover” will occur. Second, neofunctionalists tended to ignore the growing gap between elites on the one hand and voters and consumers on the other. The average citizen has been more skeptical of European integration than the elites; contrary to what Haas predicted, citizens have not shifted their “loyalties, expectations and political activities toward a new center.” Third, critics argue that the member states, rather than interest groups and the EU institutions, have the main power in the EU. States resist further integration when it does not fit with their national objectives.54

Liberal Intergovernmentalism Whereas neofunctionalists emphasize societal interests and supranational institutions, liberal intergovernmentalists consider states (central governments) to be the most important actors. For liberal intergovernmentalists, member states remain free to choose how the EU functions. Andrew Moravcsik is the founder of liberal intergovernmentalism, which is “liberal” in its view of governments as bringing together domestic interest groups within a state, and “intergovernmentalist” in its emphasis on the central role of states (which also shows the influence of realism). According to this theory, the EU rests on a series of bargains between member states, which are self-interested and rational in pursuing outcomes that serve their economic interests. Major policy decisions reflect the preferences of national governments rather than supranational institutions, and each state’s preferences reflect the balance of its domestic economic interests. Conflict may arise between states with different preferences, and the status quo changes only when states (especially the largest ones) agree to acceptable compromises. Intergovernmentalists seek to explain how national interests are reconciled in intergovernmental bargains, and they see the EU as occupying “a permanent position at the heart of the European landscape” only because of decisions by member states.55 The members support the EU supranational institutions as a means of enforcing intergovernmental bargains. Thus, European integration is reversible in many respects, and always will be. While neofunctionalists are criticized for underemphasizing the role of national governments, liberal intergovernmentalists are criticized for overemphasizing their role. Moravcsik focuses on a series of “grand bargains” between governments but devotes less attention to the EU’s day-to-day politics. Because governments cannot monitor daily activities, institutions such as the EU commission have considerable discretion in making decisions that may differ from government preferences. Neofunctional theorists argue that state bargains may have “unintended consequences” in giving more
discretion than expected to the supranational institutions. Liberal intergovernmentalism devotes too little attention to these unintended consequences.

**Constructivism** Neofunctionalists and liberal intergovernmentalists emphasize the role of material factors such as interests in the integration process. Constructivists by contrast focus on the role of ideas, norms, and identity. In studying European integration, we need to understand not only the interactions of the EU with member states and interest groups, but also the effects of national self-image, identity, and views of the integration process. For example, compliance with EU principles and rules often depends less on EU sanctions and rewards than on whether a country sees itself as law abiding. Some EU states are noted for implementing EU laws even when there is strong domestic opposition to them. Compliance with EU rules also depends on the development of a European identity within societies of the member states, and this can only occur if there is some EU compatibility with the core elements of national identity. Furthermore, assessments of the integration process require some understanding of the developing European identity. If various European groups do not view some states such as Turkey as being “European,” they might oppose their joining the EU even if they meet the objective criteria for membership. Although constructivists correctly alert us to the importance of ideas, norms, and identities, critics argue that they have not yet developed shared theoretical principles and research strategies for studying the integration process. 

**THE NORTH AMERICAN FREE TRADE AGREEMENT**

Regionalism in the Western Hemisphere is more heterogeneous than it is in Europe. Efforts to form a Free Trade Area of the Americas for the entire hemisphere were a failure, and the most important RTAs in the Western Hemisphere are NAFTA and Mercosur. As discussed, the United States would not participate in comprehensive RTAs from the 1940s to the early 1970s, and it focused instead on developing a strong GATT-based multilateral trade regime. However, a reversal of U.S. policies combined with greater openness to free trade in Canada and Mexico resulted in the creation of the Canada–U.S. Free Trade Agreement (CUSFTA) in 1988 and the North American Free Trade Agreement (NAFTA) in 1994.

**The Formation of NAFTA**

Moves toward Canada–U.S. free trade have a long history, and a noted historian observed that one economic issue in Canada “comes close to rivalling the linguistic and race question for both longevity and vehemence, and this is, of course, the question of free trade with the United States.” In 1854, the two countries concluded a Reciprocity Treaty providing for free trade in natural products such as grains, meat, dairy products, and fish. However, the United States abrogated the treaty in 1866 because of its negative trade balance with
Canada, increased Canadian duties on U.S. manufactures, and the British role in the U.S. Civil War. Efforts to revive free trade in 1911 and 1948 were unsuccessful, but the 1965 Canada–U.S. Auto Agreement provided for free trade in automobiles and parts (the two states received a GATT waiver from the Article 24 requirement that FTAs should cover substantially all trade). In 1988 the two states established their first comprehensive FTA, the CUSFTA; when Mexico, the United States, and Canada signed NAFTA in 1992, it superseded CUSFTA.

The question arises as to why these FTAs were formed after so many years. The United States reversed its policy on RTAs with the 1974 U.S. Trade Act, which permitted the president to “initiate negotiations for a trade agreement with Canada to establish a free trade area.” However, Canada and Mexico requested the negotiations that resulted in CUSFTA and NAFTA. Canada and Mexico had become more dependent on trade with the United States and cross-border production with U.S. companies, and both countries viewed freer trade as a means of increasing their competitiveness. When the United States responded to its balance-of-payments deficits in the mid-1980s with increased protectionism, Canada and Mexico viewed an FTA as necessary to gain more assured access to the U.S. market and solidify their domestic reforms. Mexico was also concerned about Canada’s favored position as a U.S. trader in the Canada–U.S. FTA, and as an LDC Mexico viewed an FTA as essential for attracting more U.S. foreign investment. The United States as a major economic power was more concerned about global trade linkages, and it concluded the CUSFTA and NAFTA largely because of frustration with the slow pace of the GATT Uruguay Round. Negotiating RTAs, in the U.S. view, would induce the EU and Japan to offer concessions in the GATT negotiations. Regionalism also has a tendency to breed more regionalism, and the EU’s enlargement and consolidation gave the United States another reason to join RTAs. Furthermore, the United States became less committed to multilateralism as the sole option and more open to participating in RTAs as its trade hegemony declined. The United States also wanted Canada and Mexico to ease their regulations on foreign investment and natural resources, and it was willing to open its market to Canadian and Mexican goods in return. The private sector in all three countries also provided a major impetus for the formation of NAFTA. Cross-border intraindustry trade and gains from economies of scale induced producers in key sectors such as computers, autos, electronics, and machinery to pressure for an RTA.

**NAFTA as a Free Trade Agreement**

Unlike the EU, NAFTA has remained a free trade agreement. All three countries have been skeptical of EU-type supranational institutions that would impinge on national sovereignty, and the U.S. Congress has resisted agreements that interfere with U.S. trade policy (see Chapter 7 on the planned ITO). However, Mexico and Canada as the two smaller NAFTA members realized that integration in some areas was necessary to protect their interests, even if it infringed on their sovereignty. For example, Canada views U.S. antidumping and countervailing duty laws as protectionist, and favors either the elimination
of ADDs and CVDs among NAFTA members or a common code to define which subsidies are permissible. However, the United States sees the use of ADDs and CVDs as its sovereign prerogative, and NAFTA dispute settlement panels can only decide whether a country’s decision to levy a CVD is made in accordance with its own law; the panels cannot assess the fairness of each country’s laws. As the less-developed member, Mexico wanted NAFTA to decrease the asymmetries in wealth and power. When Vicente Fox became Mexico’s president in 2000, he proposed that NAFTA extend to the free movement of labor as well as goods and services, and that a development fund be established to upgrade North American infrastructure. However, the United States and Canada did not support these proposals, and the NAFTA approach depends on the market to facilitate integration and decrease inequalities. Although the NAFTA negotiators included some innovative features in services, agricultural trade, investment, and dispute settlement, it has remained an FTA with a minimal degree of institutionalization.

How successful has NAFTA been as an FTA? NAFTA has succeeded in increasing North American trade and investment flows and improving profitability for large MNCs. For example, by 2009 about 99 percent of goods and services in the sectors covered by NAFTA were flowing duty-free among the three countries. However, there is now rather widespread agreement that “NAFTA has fallen short of its original expectations.”

We can only briefly outline some shortcomings here:

- NAFTA has not promoted a convergence of incomes, wages, and standards. For example, NAFTA has had harmful effects on the many smallholder Mexican corn (maize) producers due to U.S. agricultural subsidies and the development gap with the United States.
- Since 2000, North America as a region has lost more than 25 percent of its manufacturing jobs, and it has lost competitiveness with other exporters, especially China.
- NAFTA’s Chapter 11 gives private investors access to binding international arbitration in disputes over a host government’s investment measures. (This contrasts with WTO dispute settlement cases where only states are directly involved in dispute settlement.) Chapter 11 has resulted in some high-profile investor suits against government efforts to implement environmental and health regulations.
- NAFTA has side agreements on the environment and labor, but critics argue that these agreements have not been effective in enforcing environmental regulations or in promoting an upward convergence of labor standards.
- NAFTA was supposed to promote economic prosperity so that Mexico would export more goods rather than people. However, the U.S. and Canadian markets continue to attract Mexican workers in large numbers, and about 4 1/2 million Mexicans migrated to the United States during the 1990s.
- Increased protectionism has been a problem in NAFTA as in many other areas of the globe as a result of the 2008 global financial crisis.
The IPE Theoretical Perspectives and NAFTA

NAFTA is controversial in all three countries, and the controversy is reflected in the divisions among and within the IPE theoretical perspectives.

Liberalism  Liberal economists often see NAFTA as an open FTA that serves as a stepping stone to multilateral free trade. The NAFTA negotiations showed that the United States viewed regionalism as an alternative to multilateralism, and the EU and Japan were therefore willing to compromise during the GATT Uruguay Round. NAFTA also had a positive demonstration effect on the WTO in services trade, investment, and intellectual property rights, and it goes beyond the WTO in these areas. For example, NAFTA follows a “negative list” approach to national treatment for trade in services, which puts the onus on each member to list services it wants to exclude from national treatment; all services a country does not list are automatically included. The General Agreement on Trade in Services (GATS), by contrast, takes a “positive list” approach; that is, national treatment applies only to sectors included in a member’s list of commitments. Liberals acknowledge that NAFTA has produced both winners and losers. However, they assert that the rewards from NAFTA greatly exceed the costs.\(^\text{64}\)

Despite this generally positive assessment, liberals also point to NAFTA problems. For example, liberals criticize restrictions that continue to limit trade and investment, and increased security measures since September 11, 2001, that interfere with the timely delivery of goods across borders. Liberals also consider rules of origin to be a common protectionist device in FTAs and they note that NAFTA has highly restrictive rules of origin for such products as automobiles, textiles and apparel, and color televisions. Recognizing that interdependence requires more policy coordination, many liberals favor a deepening of the integration process; for example, some liberals propose that NAFTA should become a customs union.\(^\text{65}\)

Differences, of course, exist between liberals. Orthodox liberals often praise NAFTA for its market orientation and for being the first North–South FTA that does not give special treatment to LDC members (Mexico). Interventionist liberals by contrast argue that some measures should be taken to deal with the wide disparity between incomes, wages, and standards in NAFTA; and institutional liberals call for more institutions to address NAFTA’s internal and external shortcomings. Orthodox liberals also view NAFTA’s environmental and labor side agreements as nontrade issues that can be used to impose protectionist trade barriers, whereas interventionist liberals see these agreements as necessary to correct market imperfections. Finally, some liberals such as Jagdish Bhagwati are more critical of the proliferation of RTAs than others. Despite these differences, most liberals generally favor NAFTA as an open RTA. For example, one liberal study concludes that “NAFTA remains vital to maintaining trade and investment in the three countries and helps anchor the economic health of the North American marketplace.”\(^\text{66}\)

Realism and Historical Materialism  Realists and historical materialists emphasize NAFTA’s asymmetries in power and levels of economic development. Realists reject the liberal view that smaller states often benefit from FTAs more
than larger states because of increased exports and economies of scale. As the larger partner, the United States expects its benefits from free trade to outweigh those of the smaller partners. For example, Canada sought free trade with the United States to gain more assured access to the U.S. market; but the United States expected various side payments in return such as less regulation of U.S. foreign investment, greater U.S. access to Canadian energy, and a services trade agreement. The United States also expected Mexico to grant access to its market for U.S. agricultural goods and to give up claims as an LDC to special treatment.\textsuperscript{67} Realists also see NAFTA as a threat to national sovereignty. Whereas liberals view NAFTA Chapter 11 as an innovative mechanism that permits foreign enterprises to prevent states from discriminating against them, realists see it as “a vehicle for investors to harass governments whose policies they dislike.”\textsuperscript{68} Realists also argue that the benefits of NAFTA are over-rated, because RTAs are “no substitute for a coherent national development strategy.”\textsuperscript{69}

Historical materialists argue that NAFTA is shifting power to the capitalist class and against labor groups. For example, NAFTA enables MNCs to avoid labor and environmental standards in Canada and the United States by relocating production in Mexico. As capital leaves the United States and Canada, wages and employment in these countries decline. Some historical materialists use the terms \textit{core} and \textit{periphery} to designate social position and class rather than geographic location, arguing that NAFTA has relegated many U.S. and Canadian workers to peripheral status. For example, one study concludes that Mexico’s emergence as a clothing exporter “to the United States as a result of NAFTA has been accompanied by dramatic growth of garment maquiladora employment south of the border and a dramatic decline in the garment industry north of the border, especially among manual, direct production workers.”\textsuperscript{70} The losses for U.S. and Canadian workers, according to historical materialists, do not result in comparable gains for Mexican workers. For example, NAFTA is destroying the livelihoods of Mexican peasants because U.S. corn, which benefits from government subsidies, is being freely exported to Mexico. Historical materialists therefore argue that NAFTA is increasing poverty and inequality between the rich and poor in all three states. Some Gramscian theorists assert that a coalition of labor, environmental, consumer, and women’s groups could form a counterhegemonic bloc against the domination of corporate capital in NAFTA. This bloc would replace the corporate view of liberalization in North America with a more democratic, participatory model.\textsuperscript{71}

\textbf{Environmentalism} NAFTA was the first significant trade agreement to include an environmental side agreement and establish institutions for monitoring and finance. During the negotiation of NAFTA, there were serious disagreements over the environmental provisions. The environmental greens (discussed in Chapter 5) such as Greenpeace, Public Citizen, and the Sierra Club argued that the NAFTA provisions favored corporate interests and trade liberalization over environmental concerns. For example, the greens charged that NAFTA’s Chapter 11 opened a new legal channel for private investors to contest a state’s environmental policies, and they dismissed the environmental side agreement as ineffective and
Some business groups argued that the side agreement would interfere with free trade and result in costly new regulations. Liberal environmental groups such as the World Wildlife Fund, Environmental Defense, and National Resources Defense Council took a position between these extremes. Although they were disappointed that the side agreement did not have procedures to encourage the upward harmonization of environmental standards, they viewed trade liberalization as a positive objective and generally supported the efforts to include environmental provisions in NAFTA.

The NAFTA environmental provisions in fact have been mixed but in need of improvement. Although Mexico has not become a haven for U.S. firms that seek weaker environmental regulations, the economic costs of environmental degradation have continued to amount to about 10 percent of Mexico’s GDP. Mexico’s governments have lacked commitment to environmental protection in the post-NAFTA era, and spending and inspection levels have declined. Whereas more critical greens see NAFTA as beyond repair, interventionist liberals believe that the NAFTA environmental provisions can be upgraded by adopting stronger provisions. For example, some interventionists argue that the environmental provisions should be subjected to the same enforcement and dispute resolution provisions as the commercial parts of NAFTA. In the view of two noted liberals, “it makes more sense to tackle the shortcomings than to lament the existence of an FTA, as many environmentalists do, or to overlook the problems, as a very few diehard free trade advocates might. With the necessary tuning, NAFTA can become a trade agreement that both environmentalists and free traders appreciate.”

In sum, NAFTA remains highly contentious in all three member states. However, NAFTA is likely to remain a central agreement in view of the high degree of interdependence in the region, the importance of the EU, the growing trend toward regionalization, and the failure to conclude the WTO Doha Round.

**MERCOSUR**

Although RTAs in Latin America during the 1960s and 1970s were inward looking, there was a revival of Latin American regionalism in the mid-1980s on a more open basis. The largest of these newer RTAs is Mercosur, or the “Common Market of the Southern Cone.” As of October 2010, Mercosur had four members (Argentina, Brazil, Paraguay, and Uruguay), five associate members (Chile, Bolivia, Peru, Colombia, and Ecuador), and one country with its membership pending (Venezuela). Venezuela signed a membership agreement in 2006, but Paraguay has not yet ratified the agreement.

In 1991 Argentina, Brazil, Paraguay, and Uruguay signed the Treaty of Asunción (TOA) to establish Mercosur. The TOA timetable included the formation of an FTA from 1991 to 1994, a CU in 1995, and eventually a common market; this schedule was unusual for Latin America, where most integration plans included only vague promises. Mercosur’s significance also stemmed from the importance of its two largest members, Brazil and Argentina.
The population of Mercosur’s full members is more than 270 million people, and the collective GDP is about $2.4 trillion (if Venezuela, which is not yet a full member, is included). Many observers were skeptical about Mercosur because of Latin America’s history of inward-looking development policies and the long-term enmity between Brazil and Argentina. However, most Latin American LDCs were active participants in the GATT Uruguay Round, and the Argentine and Brazilian presidents supported integration because of their neoliberal economic strategies and their belief that integration would strengthen their position vis-à-vis the United States and the EU.\textsuperscript{74}

The integration process was quite dynamic from 1991 to 1995 as tariffs were gradually eliminated and some business firms began to organize their production and sales on a regional basis. However, Brazil and Argentina introduced new tariffs and NTBs after 1995, and intra-Mercosur exports as a share of total exports declined. Although most merchandise trade within Mercosur is now duty-free, rules do not extend to services trade, government purchases, and many NTBs and administrative barriers. The automotive sector, which accounts for about 25 percent of intra-Mercosur trade, is subject to managed trade in which a Mercosur state can export only as much as it imports from a partner state. Mercosur has also not yet established a CU with a common external tariff. To maintain a CET, no member state can negotiate bilaterally with outside states. However, in 2007 Uruguay signed a trade and investment agreement with the United States that could lead to a bilateral FTA.\textsuperscript{75}

International, regional, and national factors account for Mercosur’s problems. First, Mercosur members as LDCs are highly vulnerable to international developments. Latin American LDCs had the highest debts during the 1980s foreign debt crisis, and in 1997 the combined debt of the four Mercosur states amounted to 29 percent of their GNPs. The Mexican and East Asian financial crises in the 1990s also contributed to the loss of markets for Latin American exports and a marked decrease in the prices of primary commodities (see Chapter 11). Second, in 2005 intra-Mercosur trade accounted for only 13 percent of the members’ total trade. The dependence on trade with external actors such as the United States and the EU limits Mercosur’s importance. Third, there is a high level of asymmetry, with Brazil accounting for about 70 percent of Mercosur’s GDP. Although Brazil has been a strong force behind Mercosur, it is less dependent than other members on the regional market. To ensure that Mercosur does not infringe on its sovereignty, Brazil has opposed a strong dispute-settlement body.\textsuperscript{76} Fourth, Mercosur has done little to harmonize the members’ macroeconomic policies. In 1991 Argentina pegged its peso to the U.S. dollar, whereas Brazil adjusted its exchange rate. After Brazil devalued its currency in 1999, Argentina’s trade balance with Brazil sharply deteriorated and many companies moved from Argentina to Brazil. By 2001, Argentina had a massive foreign debt and defaulted on its loans partly because its peso was pegged to the U.S. dollar. When Argentina devalued its currency in 2002, this eliminated a major source of trade conflict with Brazil.\textsuperscript{77}
Fifth, ongoing differences over Venezuela’s admission as a full member have also caused tensions, demonstrating that it is difficult to separate economic from political issues. Although the leaders of Argentina, Brazil, Uruguay, and Paraguay endorsed Venezuela’s request to become a full member of Mercosur in 2006, Paraguay’s Congress has still refused to ratify the pact. Paraguayan opposition legislators (with a majority in the Senate) point to Venezuela president Hugo Chavez’s efforts to limit democracy and silence the independent media, and to his “imperial attitude” toward Paraguay. Many officials in Brazil and other Mercosur countries realize that admitting Venezuela could have economic rewards because of its oil wealth, but moderate politicians in several countries fear that Chavez would further politicize Mercosur and open up divisions. Since Venezuela signed the membership agreement in 2006, Chavez has advocated a shift in the focus of Mercosur from free trade to prioritizing social concerns, and there are concerns that he would use Mercosur as a platform for anti-Americanism.\(^78\)

Realists see Mercosur as contributing to security as well as economic ties; Argentina and Brazil have upgraded their military cooperation, with joint military exercises and annual meetings between their joint chiefs of staff. Realists also argue that Mercosur strengthens its members’ bargaining power vis-à-vis the United States and the EU.\(^79\) Liberals favor widening the scope of Mercosur’s trade liberalization and predict that domestic business groups will continue to see Mercosur as a means of attracting foreign investment. Historical materialists argue that Mercosur resulted from IMF pressure on Latin Americans to liberalize their policies and that Mercosur incorporates its members “within the world capitalist system while preserving their subordinate status in the system.”\(^80\) Mercosur’s future depends partly on whether it prioritizes economic or political issues, and that in turn will depend on whether Venezuela’s president Chavez gains full admission. Furthermore, the Union of South American Nations (Unasar) is a new regional organization created in 2008, and some question whether it will eventually replace Mercosur. Although Mercosur was designed to promote economic integration throughout South America, it still has only four full members.

**EAST ASIAN REGIONALISM**

East Asia was late in forming RTAs, and in 2000 preferential trade arrangements accounted for only 5.6 percent of merchandise imports in Asia, compared with 64.7 percent for Western Europe, 41.4 percent for North America, 37.2 percent for Africa, and 18.3 percent for Latin America (excluding Mexico).\(^81\) RTAs were less important because of the protectionist and interventionist industrial policies of many Asian states, East Asian memories of Japanese militarism in the 1930s, concerns about dominance by China, and U.S. military and economic influence in the region. However, East Asians have developed strong regional linkages without formal institutions. Intraregional trade has increased because many East Asian states have dynamic, rapidly growing economies, and because their diversity in size, per capita income, and
natural resources provides opportunities for specialization. Informal East Asian linkages also increase the competitiveness of the region’s firms in global markets, and the internationalization of the East Asian production process contributed to the region’s ability to market high-quality goods at competitive prices. Whereas Japan provided capital and high-technology goods, East Asian NIEs provided some highly sophisticated goods and services, and lower-wage countries such as China, Indonesia, and Vietnam provided labor-intensive assembly operations. Despite their preference for informal regionalism, East Asians became more interested in forming RTAs because of the exclusionary aspects of the EU and NAFTA, the 1997 East Asian financial crisis, and the problems in the WTO Doha Round.82

The ASEAN Free Trade Area (AFTA) was the first political attempt to form a plurilateral FTA (more than two countries) in Asia. Indonesia, Malaysia, the Philippines, Singapore, and Thailand established the Association of Southeast Asian Nations (ASEAN) in 1967 as a political organization to promote peace, stability, and economic growth. In 1992 these five states and Brunei (the ASEAN-6) formed the AFTA, and four more states joined later: Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1999. The goal was to achieve a free trade area by 2002 among the ASEAN-6 and to include the four newer members later. The ASEAN countries formed AFTA to increase their intraregional trade; to bargain as a bloc with the United States, China, Japan, and the EU; and to attract more foreign investment as a larger unified market.83 AFTA has lowered tariffs and has accelerated some of its trade liberalization objectives; for example, the ASEAN-6 moved their goal of achieving an FTA forward from 2008 to 2002. However, the AFTA provisions have loopholes and it is uncertain that all intra-AFTA tariff barriers will be eliminated. AFTA has four lists of products under its tariff reduction scheme: an inclusion list, a temporary exclusion list, a sensitive list, and a general exceptions list consisting of products that are permanently excluded. For example, on the sensitive list AFTA has accepted Malaysia’s delay in reducing tariffs on automobiles, the Philippines’ delay for petrochemical products, and Indonesia’s delay for some agricultural products. Furthermore, the four newest AFTA members are at a lower level of development and have left many products off the inclusion list.

Several factors explain AFTA’s delays in trade liberalization. First, like Mercosur, the AFTA members as LDCs are highly vulnerable to global changes, and the 1997 Asian financial crisis contributed to economic and political instability. Second, intra-AFTA exports accounted for only 23.5 percent of total AFTA exports (for the ASEAN-6) in 2005, and AFTA members’ largest markets are outside the RTA. Third, AFTA members range from high-income Singapore to upper-middle-income Malaysia, lower-middle-income Thailand, Philippines, and Indonesia, and low-income Laos, Cambodia, and Myanmar (Vietnam’s development is marginally higher). As Table 8.3 shows, there is a stark income divide between some of the original AFTA-6 members and the four countries that joined later. Whereas Singapore and Brunei had PPP-adjusted per capita GDPs of $51,392 and $45,817, respectively in 2009, the figures for Myanmar and Cambodia were
TABLE 8.3

Per Capita GDP of AFTA Members, 2009 (US$, PPP)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Per Capita GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brunei Darussalam</td>
<td>$45,817</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4,365</td>
</tr>
<tr>
<td>Malaysia</td>
<td>12,258</td>
</tr>
<tr>
<td>The Philippines</td>
<td>3,587</td>
</tr>
<tr>
<td>Singapore</td>
<td>51,392</td>
</tr>
<tr>
<td>Thailand</td>
<td>7,941</td>
</tr>
<tr>
<td>Cambodia</td>
<td>$1,789</td>
</tr>
<tr>
<td>Laos</td>
<td>2,396</td>
</tr>
<tr>
<td>Myanmar</td>
<td>1,095</td>
</tr>
<tr>
<td>Vietnam</td>
<td>3,081</td>
</tr>
</tbody>
</table>

\(^a\)ASEAN Free Trade Area
\(^b\)Purchasing Power Parity


$1,095 and $1,789 respectively. The low-income countries need more time to adjust to trade liberalization, and assistance to move toward market reform. Third, although the emphasis of many Asian states on informal procedures may contribute to solidarity, there is less political commitment to formal trade liberalization.84

Liberal economists disagree among themselves regarding AFTA’s progress toward free trade. Some liberals focus on AFTA’s accomplishments to date, arguing that “most of Southeast Asia is now close to full realization of free trade.”85 Others focus on the development divide among AFTA members and on the products excluded from tariff reductions, and conclude that AFTA’s progress toward free trade is limited. Whereas some analysts blame the four less-developed members (Laos, Cambodia, Myanmar, and Vietnam) for the free trade obstacles, others argue that “what has slowed down ASEAN economic integration has been the foot-dragging by some of the ASEAN-6.”86 Thus, analysts within the same theoretical perspective can have major disagreements. Realists focus on ASEAN’s history before AFTA and point out that the ASEAN countries emphasize security as much as trade and finance. This explains the ASEAN-6’s willingness to accept Vietnam, Cambodia, Laos, and Myanmar, which have a minor economic role but can pose a serious risk to regional security. Realists also emphasize noninstitutional aspects of Asian regionalism, and note that Japan was less interested in creating an RTA than in “using its Asian production alliance in part as a platform from which to continue supplying high-technology products to
Western markets.” More recently, China “has become the center for assembling parts mainly manufactured in other Asian countries and transferred primarily through intra-industry trade, for export to extra-regional markets, especially the United States.”

Although AFTA has made some progress in liberalizing trade, it is too small by itself to be of major importance in an Asian context. ASEAN’s embryonic arrangement with Japan, China, and South Korea (referred to as ASEAN+3) seems to be “the most credible and realistic vehicle to advance the form and substance of regional cooperation in East Asia.” However, a region-wide FTA in Asia comparable with the EU and NAFTA is a possibility only in the distant future.

**Considering IPE Theory and Practice**

During the postwar period, there were two major waves of regionalism, the first in the 1950s and 1960s, and the second since the mid-1980s. Globalization has acted as a stimulus to the second wave, which has been more enduring than the first wave. The most contentious issue in the current wave is whether RTAs serve as stepping stones or obstacles to global free trade. This is a debate mainly within liberalism and shows that some major debates in IPE are among theorists within the same perspective. Liberals generally agree that multilateralism is the best route to trade liberalization and that open RTAs are a second-best option because they divert some imports from more efficient outside suppliers to less efficient regional suppliers. However, some liberals see RTAs today as a serious threat to an open multilateral trade regime while others believe that RTAs can coexist beneficially with multilateralism. The debate over the global effects of RTAs has been intensified by the proliferation of bilateral RTAs during the prolonged WTO Doha Round negotiations and the obstacles to completion of the Doha Round posed by the 2008 global financial crisis.

The most notable theorist taking the first position is Jagdish Bhagwati, who describes RTAs as “termites” that are “eating away at the multilateral trading system.” Bhagwati prefers the term *preferential trade agreements (PTAs)* to *free trade agreements (FTAs)*, because it highlights the discriminatory nature of these trade arrangements. (He also notes that *PTAs* is a more accurate term than *RTAs*, which are often between states in different geographic regions.) Bhagwati and others in the first group present a number of arguments to show that RTAs pose a threat to the global trade regime, including the following:

- RTAs are discriminatory and therefore incompatible with MFN treatment, a basic principle of the global trade regime.
- LDCs have a special exemption for RTAs under the enabling clause, which allows them to engage in discrimination without any discipline.
- The recent proliferation of bilateral FTAs is bringing chaos to the global trade regime, with different rules and tariff rates for each FTA; Bhagwati likens this to a “spaghetti bowl.”
FTA rules of origin are very complex, because states are members of overlapping FTAs, and MNCs source components from many different countries; the rules of origin are also a disguised form of protectionism.

Many bilateral FTAs are between poor and rich countries, and their “most troubling aspect . . . is the exercise of virtually unconstrained political and economic power by the United States and EU to secure concessions from developing (and developed) countries.”

RTAs divert valuable resources away from multilateral negotiations such as the Doha Round.

The second group of liberals agrees that RTAs sometimes create problems such as trade diversion. However, they see some plurilateral FTAs such as NAFTA as more trade creating than diverting, and they believe that trade regionalism can coexist beneficially with global trade liberalization. When NAFTA was formed, Gary Clyde Hufbauer and Jeffrey J. Schott concluded (in 1993) that “on balance . . . the trade created by growth in the NAFTA region should more than offset the trade diverted in particular sectors.” More than 10 years later, Hufbauer and Schott came to similar conclusions, pointing to empirical studies that “on balance . . . find that NAFTA tends to promote trade creation more than trade diversion.” Although the authors criticize NAFTA for its restrictive rules of origin, they conclude that the agreement has been a “success.” Theorists have also described some other FTAs in positive terms. For example, some observers found a “general increase in ASEAN exports to both ASEAN partners and the rest of the world after the AFTA implementation,” and concluded that “AFTA had been trade creating rather than trade diverting.” Arguments of theorists in the second group include the following:

- FTAs contribute to economies of scale and a division of labor based on comparative advantage.
- Trade creation is likely to be greater than trade diversion if the FTA members are already major trading partners.
- RTAs allow members to overcome regional disagreements, which helps reduce the complexity of the WTO negotiations.
- By promoting deeper integration at the regional level, RTAs lead the way for multilateral trade negotiations. For example, NAFTA liberalized trade in services and agriculture before the GATT/WTO.

How can liberal theorists have such divergent views regarding the effects of RTAs on the global trade regime? Although they often base their findings on empirical studies,

the recent literature on examining RTA trade impact shows that different studies come out with different trade effects for the same RTAs. This is due to
the use of different estimation methods, different databases and time periods to measure these trade effects.\textsuperscript{97}

Theorists also often use different methodologies. In the first group, Bhagwati uses historical analysis to show that political factors resulted in the exceptions the GATT/WTO provides to RTAs. In the second group, many analysts focus on specific RTAs for which they have a strong affinity. For example, Hufbauer and Schott believe that NAFTA should go beyond free trade to establish a CET, strengthen its institutions, and promote closer cooperation on monetary policy. In sum, empirical studies contribute greatly to our understanding of the effect of RTAs on multilateral trade. However, the diversity of findings cannot be explained only by differences in methodologies; they also depend on nonmaterial factors such as the assumptions and values of the theorists.

Chapters 7 and 8 have focused on trade, but the relationship between trade and investment is extremely close; for example, RTAs affect regional production, intraindustry specialization, and the location of firms.\textsuperscript{98} A former WTO director general notes that “businesses now trade to invest and invest to trade—to the point where both activities are increasingly part of a single strategy to deliver products across borders.”\textsuperscript{99} The next chapter deals with the issue of MNCs and foreign investment.

\begin{questions}
1. What are the differences between a free trade area, CU, common market, and economic union? Do any RTAs fit completely within one of these models of integration?
2. How do realists, liberals, and historical materialists explain the rise of regional integration?
3. In what ways can RTAs be trade diverting and trade creating? Do you think that RTAs are stepping stones or obstacles to global trade liberalization, and why do you think liberal theorists cannot agree on this issue?
4. What conditions does GATT Article 24 impose on RTAs? How successful has the GATT/WTO been in regulating RTAs?
5. In what ways do LDCs receive special treatment as members and associate members of RTAs? Does Mexico receive special treatment in NAFTA?
6. In what ways is the EU a unique RTA? What are the neofunctionalist, liberal intergovernmentalist, and constructivist theoretical approaches to economic integration, and why are they applied mainly to Europe? What are some of the problems confronting the EU today?
7. What are some of the problems confronting NAFTA today? What are the liberal, realist, historical materialist, and environmentalist views of NAFTA?
8. What special problems do FTAs among LDCs such as Mercosur and AFTA have in achieving regional integration? In what ways are politics and economics intertwined in Mercosur and AFTA? Why is East Asian regionalism less institutionalized than regionalism in Europe and North America?
\end{questions}
KEY TERMS

Association of Southeast Asian Nations (ASEAN) 222
Canada–U.S. Free Trade Agreement (CFTA) 229
Common Market 210
Cotonou Agreement 222
customs union 209
economic union 210
European Coal and Steel Community 215
European Community (EC) 209
European Free Trade Association (EFTA) 209
European Union (EU) 210
free trade area 209
GATT Article 24 217
liberal intergovernmentalism 227
Lomé Convention 221
Mercosur 220
neofunctionalism 227
North American Free Trade Agreement (NAFTA) 209
Organization for European Economic Cooperation (OEEC) 215
political union 210
rules of origin 218

FURTHER READING


NOTES

9. The European Economic Community’s name was changed, first to the European Community, and then to the European Union.


26. Although Jacob Viner coined the terms *trade creation* and *trade diversion* after GATT Article 24 was written, these terms summarize the article's intent. See Jacob Viner, *The Customs Union Issue* (New York: Carnegie Endowment, 1950), pp. 41–55.


85. Cabalu and Alfonso, “Does AFTA Create or Divert Trade?,” p. 5.


87. Walter Hatch and Kozo Yamamura, Asia in Japan’s Embrace: Building a Regional Production Alliance (New York: Cambridge University Press, 1996), p. 36; Eul-Soo Pang,


89. Quoted in Hellman, “A Decade After the Asian Financial Crisis,” p. 843.


97. Cabalu and Alfonso, “Does AFTA Create or Divert Trade?,” p. 3.


The largest multinational corporations (MNCs) are in many respects the main agents of globalization. They produce and distribute goods and services across national borders; plan their operations on a global scale; and spread ideas, tastes, and technology throughout the world. MNCs are normally considered to be firms that control productive assets in more than one country. MNC parent firms in home countries acquire foreign assets by investing in affiliate or subsidiary firms in host countries. This is foreign direct investment (FDI), which involves management rights and control. Portfolio investment, by contrast, is investment without control; it involves the purchase of bonds, money market instruments, or stocks simply to realize a financial return. A new aspect of foreign investment is the emergence of sovereign wealth funds. As discussed in Chapter 6, SWFs are government investment vehicles that are managed separately from a country’s official reserves. However, most SWFs have been invested in U.S. and European government bonds with ownership shares of less than 10 percent (only investment above the 10 percent level is classified as FDI). Because SWFs account for only 0.6 percent of total FDI flows, this chapter focuses on the role of MNCs in providing FDI. The growing presence of MNCs testifies to their role as agents of globalization. In 2008, 82,000 MNCs and their 810,000 foreign affiliates provided over $15 trillion in FDI stock. MNCs employed about 77 million people in 2008, and exports by foreign affiliates of MNCs account for about one-third of total world exports of goods and services. International production is also fairly concentrated. The world’s 100 largest MNCs represent 0.13 percent of the total number of MNCs, but they account for about 9 percent of the foreign assets, 16 percent of the sales, and 11 percent of the employment of all MNCs.¹

FDI has declined in some years (e.g., in 1982–1983 and 2000–2003), and global FDI inflows fell by about 14 percent from 2007 to 2008 due to the global financial crisis. MNCs can also decline. For example, no one would
have predicted that General Motors would have fallen to the level it did during the global financial crisis. One-third of the corporations in the Fortune 500 list of the largest U.S. corporations in 1980 were no longer on the list in 1990 because of decline, acquisition, or bankruptcy. Despite these reversals, FDI inflows have generally grown much faster than trade or income. From 1985 to 1999, the growth rates of global GDP, exports, and FDI inflows were 2.5, 5.6, and 17.7 percent, respectively.\(^2\) The growing importance of MNCs has caused some analysts to argue that the critical problem in IPE today “is the tension between states and multinationals, not states and markets.”\(^3\) However, MNCs receive less attention because most IR scholars place emphasis on relations among governments. Limited amounts of reliable data also pose an obstacle to the study of MNCs. As private enterprises, MNCs are reluctant to provide information about themselves and adept at obscuring their activities. This problem is compounded by the fact that IOs regulate monetary, trade, and development activities but not foreign investment. Furthermore, MNCs evoke strong positive and negative reactions; in debates about MNCs it is common for “anecdote to replace data” and “the witty phrase to replace analysis.”\(^4\)

In this age of globalization, liberals often view MNCs and private banks as “the major weavers of the world economy.”\(^5\) Liberals also believe that FDI increases efficiency by stimulating innovation, competition, economic growth, and employment, and that MNCs provide countries with many advantages such as capital, technology, managerial skills, and marketing networks. Historical materialists also refer to the growing power of MNCs, but they see corporate managers as a transnational class that maintains and defends the capitalist system. They also view MNCs as predatory monopolists that overcharge for their goods and services, limit the flow of technology, create dependency relationships with LDC host countries, and impose downward pressures on labor and environmental standards. Realists are more inclined to downgrade the political importance of MNCs; they see the most powerful states as having considerable control over their MNCs, and MNCs as retaining close ties with their home governments.\(^6\)

**DEFINITIONS AND TERMINOLOGY**

MNCs are usually defined as firms that control assets in at least two countries, but the Harvard Multinational Project in the 1960s limited the MNC label to firms with subsidiaries in at least six countries.\(^7\) Those who favor such restrictive definitions see the important investment issues as relating to the largest firms that establish a number of foreign affiliates as part of a global strategy; but restrictive definitions are problematic because they exclude enterprises on a rather arbitrary basis. This chapter adopts the more expansive definition of MNCs as firms that operate in two or more countries. An enterprise that does business in more than one country is not necessarily an MNC. To qualify, a firm must possess at least one FDI project in which it has a degree of management rights or control. A firm can undertake FDI in a host country in two forms: **greenfield investment**, or the
creation of new facilities and productive assets by foreigners; and mergers and acquisitions (M&As), or the purchase of stocks in an existing firm with the purpose of participating in its management. In a cross-border merger, the assets and operations of two firms belonging to different countries are combined to establish a new legal entity. In an acquisition, a local firm becomes an affiliate or subsidiary of a foreign firm. During the past decade, most growth in international production has occurred through M&As rather than greenfield investment, and acquisitions are much more common than mergers.\(^8\)

Although the definition of FDI may seem straightforward, there are disagreements over what constitutes “control.” Until the 1960s, the U.S. Department of Commerce defined FDI as involving an equity capital stake of at least 25 percent. However, the department subsequently lowered this to 10 percent, and IOs such as the IMF and OECD use the 10 percent figure for statistical purposes. In most countries, a foreign company with 10 percent ownership has some control over management decisions and can select at least one member of the board of directors. The important point is that a shareholder can exercise some control without holding a majority of shares, especially when the ownership of a firm is widespread among many shareholders. Foreign affiliates may be minority-owned (10–50 percent of equity), majority-owned (more than 50 but less than 100 percent), or wholly owned (100 percent) subsidiaries.\(^9\)

Differences exist not only over definitions but also over the use of the term MNC. The United Nations and a number of scholars prefer the term transnational to multinational because the ownership and control of most firms is not really multinational; a firm normally extends its operations from a single home country across national frontiers. Most MNCs are in fact ethnocentric or home country oriented, with directives flowing from the headquarters to the affiliates and much of the MNCs’ R&D located in the home country. However, a small but growing number of MNCs are geocentric or stateless; they adopt a worldwide approach and are not closely tied to a single state. Strategic alliances among MNCs from different states further complicate the task of associating an MNC with a home government; they may take the form of production-sharing agreements, or collaborative research and networking arrangements. Finally, MNCs can sometimes gain entry into a foreign country only by agreeing to form joint ventures with local firms; joint ventures are increasingly common in LDCs and transition states. This text uses the term MNC simply to signify that a firm has ongoing managerial and productive activities in more than one country.\(^10\)

**WHY DO FIRMS BECOME MNCs?**

John Dunning developed a seminal theory which explains that firms engage in FDI for reasons of ownership, location, and internalization, and the following discussion draws partly on his ideas.\(^11\) To understand why firms become MNCs, we must distinguish between horizontal and vertical integration. A horizontally integrated MNC extends its operations abroad by producing the same product or product line in its foreign affiliates. Firms engage in
horizontal integration to defend or increase their market share. Although a firm’s exports from the home country may initially meet the foreign demand for products and services, the firm may have to set up a subsidiary to compete with new local suppliers. The MNC can compete more effectively with local firms through its subsidiaries because they have lower transportation costs and become more aware of the market’s special characteristics; and labor costs are lower if a DC firm produces directly in LDC markets. Firms also engage in horizontal integration because of foreign government policies. When a government’s tariffs and NTBs limit exports from a firm’s home country, it may establish foreign operations to get behind the trade barriers. For example, Honda began to produce automobiles in the United States when the U.S. government imposed voluntary export restraints on Japanese auto imports in the 1980s. National and subnational governments also provide investment incentives to encourage firms to locate production facilities in their territories. A vertically integrated MNC geographically separates the different stages of production, with the outputs of some affiliates serving as inputs to other affiliates. Firms engage in vertical integration to gain the benefits of comparative advantage in the production process. For example, an electronics firm can lower production costs by locating assembly operations in low-wage LDCs, chip production in an NIE such as Singapore, and high-end R&D operations in California. Vertically integrated MNCs can also gain control of uncertain transactions with different owners at various stages of the production process by internalizing them within the firm. Firms opt for backward integration when raw materials and other production inputs they require are not readily available or have high transaction costs. Examples of backward integration include steel firm investments in iron ore operations, oil company investments in the extraction of crude oil, and rubber manufacturer investments in natural rubber plantations. Backward integration also enables MNCs to gain control over the quality of inputs. For example, three vertically integrated MNCs accounted for 60 percent of the banana export trade during the 1980s, because bananas are highly perishable and require specific handling and ripening conditions. MNCs also engage in forward vertical integration to reduce uncertainty and transaction costs, and to ensure the quality of goods and services that reach the consumer. Another reason firms engage in vertical integration is to limit competition. When a small number of MNCs control the raw materials for an industry, they can impose stiff barriers to the entry of new rival firms. MNCs also engage in vertical integration to limit government scrutiny of their activities. For example, MNCs sometimes manipulate their transfer prices (the prices an MNC’s affiliates charge for the internal sales of goods and services) without detection by governments. Transfer prices help an MNC efficiently manage its internal operations and monitor the performance of its affiliates; but they can also enable an MNC to shift its reported profits from high-tax to low-tax countries (and thus avoid paying some taxes) by raising or lowering the prices charged by each affiliate. In 1993 the U.S. Internal Revenue Service ruled that Nissan Motor Company used transfer prices to underreport its U.S. income, and Nissan had to pay the United States about $150 million.
Firms that become MNCs must have the ability as well as incentive to make the transition. Innovations in communications, transportation, and technology have enabled firms to internationalize, and they are more successful if they can “think globally” and “act locally.” On the one hand, large MNCs have advantages such as economies of scale, brand-name reputation, and access to global financing and inputs such as raw materials. On the other hand, MNCs operate in a world of states in which they must adhere to national laws and cater to the demands of local consumers.15

THE HISTORICAL DEVELOPMENT OF FDI

Although the rapid expansion of MNCs is a post–World War II phenomenon, some scholars trace the origin of MNCs to the transborder business operations of medieval banks in fifteenth-century Florence. During the sixteenth to eighteenth centuries, international trading companies such as the English, Dutch, and French East India Companies and the Hudson’s Bay Company also coordinated cross-border business activities. In the nineteenth century, firms that are commonly considered to be MNCs were investing in a number of countries; thousands of these MNCs existed by the time of World War II.16 A number of factors have affected the growth—and sometimes the contraction—of MNC activity:

- MNC activity increases when advances in communications, transportation, and technology facilitate MNC control over foreign operations.
- Rapid economic growth often stimulates MNC expansion, while depressed economic conditions have the opposite effect.
- MNC expansion depends on national and international rules and events. For example, the rules protecting private property encouraged FDI, whereas major wars had a depressing effect on FDI.
- Capital liberalization leads to increased FDI; capital and exchange controls discourage such activity.
- FDI often contracts in response to financial crises, but it may expand in response to trade protectionism because MNCs shift production abroad to circumvent the trade barriers.17

The following discussion focuses on three periods: pre–World War II, the mid-1940s to mid-1980s, and the mid-1980s to the present.

The Pre–World War II Period

According to earlier studies, portfolio investment accounted for most of the long-term capital flows during the nineteenth and early twentieth centuries. However, as economists refined their definitions, they upgraded their estimate of foreign direct investment flows. Indeed, some studies indicate that FDI accounted for up to 45 percent of British foreign investment in 1913 and 1914.18 As the first country to industrialize, Britain was the main force behind the growth of FDI during the nineteenth century. Although there were no
government guarantees or international institutions to provide safeguards, investments were fairly secure for several reasons: Economic risk was lower under the pre–World War I gold standard because currencies were convertible and exchange rates were fairly stable; political risk was lower because a large share of European investment was in colonial territories operating under home country rules; there were no major restrictions on capital flows; and wars during this period were limited in scope. The nineteenth century was also a period of rapid advances in rail and sea transport and communications, which facilitated the expansion of FDI. Although FDI continued to increase in the twentieth century, there was an investment downturn after World War I because of global economic and political instability. For example, a number of countries began to impose restrictions on inward FDI, the Soviet Union nationalized foreign property, and the gold exchange standard was suspended. FDI contracted further during the Great Depression and World War II, and MNCs accounted for a smaller share of world economic activity in 1949 than in 1929. It was not until after World War II that the vigorous growth of MNCs and FDI would resume.

The Mid-1940s to Mid-1980s
The United States overtook Britain as the leading source of FDI after World War II. As Table 9.1 shows, U.S. firms accounted for 47.1 percent of outward FDI stock in 1960, compared with Britain’s 18.3 percent. FDI rapidly expanded under U.S. leadership because the North experienced a sustained period of economic growth from 1950 to 1973; there were major improvements in international transportation and communications; and most DCs relaxed their controls over FDI after their currencies became convertible. (A notable exception was Japan, which continued to restrict foreign investment flows.) Since the late 1960s, the U.S. share of outward FDI has declined steadily, partly because of Japan and Germany’s rapid economic growth as they recovered from the war. Thus, Table 9.1 shows that the U.S. share of total outward FDI stock fell from 47.1 percent in 1960 to 32.3 percent in 1985, whereas Japan’s share rose from 0.7 to 6.0 percent, and West Germany’s share rose from 1.2 to 8.1 percent. Table 9.1 also shows that DCs were the source of most FDI flows: 99 percent in 1960 and 90 percent in 1985. However, MNCs based in the South increased their share of outward FDI stock from only 1 percent in 1960 to 10 percent in 1985. Most of this FDI came from more prosperous LDCs in Asia and Latin America and from OPEC states. The five largest LDC sources of outward FDI stock in 1985 were Brazil, South Africa, Argentina, Singapore, and Hong Kong.

Table 9.2 shows that the DCs were the largest recipients as well as providers of FDI, accounting for 58.6 percent of inward FDI stock in 1985. Whereas the U.S. share of outward FDI stock was declining, its share of inward FDI stock increased from 12 percent in 1980 to 19 percent in 1985. Japan was the only DC that maintained an extremely low share of inward FDI stock, at 0.5 percent in 1985, because of its governmental, societal, and cultural barriers to investment flows. Although the South had received over
<table>
<thead>
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<tbody>
<tr>
<td></td>
<td>Value</td>
<td>%</td>
<td>Value</td>
<td>%</td>
<td>Value</td>
<td>%</td>
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<td>%</td>
<td>Value</td>
<td>%</td>
<td>Value</td>
<td>%</td>
</tr>
<tr>
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<td>124.2</td>
<td>44.0</td>
<td>238.4</td>
<td>32.3</td>
<td>430.5</td>
<td>24.1</td>
<td>1316.2</td>
<td>21.7</td>
<td>3162.0</td>
<td>19.5</td>
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<tr>
<td>Japan</td>
<td>0.5</td>
<td>0.7</td>
<td>15.9</td>
<td>5.7</td>
<td>44.0</td>
<td>6.0</td>
<td>201.4</td>
<td>11.3</td>
<td>278.4</td>
<td>4.6</td>
<td>680.3</td>
<td>4.2</td>
</tr>
<tr>
<td>Germany</td>
<td>0.8</td>
<td>1.2</td>
<td>18.4</td>
<td>6.5</td>
<td>59.9</td>
<td>8.1</td>
<td>151.6</td>
<td>8.5</td>
<td>541.9</td>
<td>8.9</td>
<td>1450.9</td>
<td>9.0</td>
</tr>
<tr>
<td>Britain</td>
<td>12.4</td>
<td>18.3</td>
<td>37.0</td>
<td>13.1</td>
<td>100.3</td>
<td>13.6</td>
<td>229.3</td>
<td>12.8</td>
<td>897.8</td>
<td>14.8</td>
<td>1510.6</td>
<td>9.3</td>
</tr>
<tr>
<td>France</td>
<td>4.1</td>
<td>6.1</td>
<td>10.6</td>
<td>3.8</td>
<td>37.8</td>
<td>5.1</td>
<td>112.4</td>
<td>6.3</td>
<td>445.1</td>
<td>7.3</td>
<td>1397.0</td>
<td>8.6</td>
</tr>
<tr>
<td>Italy</td>
<td>1.1</td>
<td>1.6</td>
<td>2.0</td>
<td>3.3</td>
<td>16.6</td>
<td>2.2</td>
<td>60.2</td>
<td>3.4</td>
<td>180.3</td>
<td>3.0</td>
<td>517.1</td>
<td>3.2</td>
</tr>
<tr>
<td>Canada</td>
<td>2.5</td>
<td>3.7</td>
<td>3.5</td>
<td>10.4</td>
<td>43.1</td>
<td>5.8</td>
<td>84.8</td>
<td>4.7</td>
<td>237.6</td>
<td>3.9</td>
<td>520.4</td>
<td>3.2</td>
</tr>
<tr>
<td>Total G7</td>
<td>53.3</td>
<td>78.7</td>
<td>219.8</td>
<td>77.9</td>
<td>540.1</td>
<td>73.1</td>
<td>1270.2</td>
<td>71.1</td>
<td>3897.3</td>
<td>64.2</td>
<td>9238.3</td>
<td>57.0</td>
</tr>
<tr>
<td>Total DCs</td>
<td>67.0</td>
<td>99.0</td>
<td>275.4</td>
<td>97.7</td>
<td>664.9</td>
<td>90.0</td>
<td>1640.4</td>
<td>91.9</td>
<td>5186.2</td>
<td>85.4</td>
<td>13,623.6</td>
<td>84.1</td>
</tr>
<tr>
<td>World Total</td>
<td>67.7</td>
<td></td>
<td>282.0</td>
<td></td>
<td>738.8</td>
<td></td>
<td>1785.6</td>
<td></td>
<td>6069.9</td>
<td></td>
<td>16,205.7</td>
<td></td>
</tr>
</tbody>
</table>

*a The 1960 to 1985 data are for West Germany.
*b G7 = Group of Seven
*c DCs = developed countries

### TABLE 9.2
Inward FDI Stock (U.S. $ Billions)

<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Value</strong></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td><strong>DCs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>83.0</td>
<td>12.0</td>
<td>184.6</td>
<td>19.0</td>
<td>394.9</td>
</tr>
<tr>
<td>Japan</td>
<td>3.3</td>
<td>0.4</td>
<td>4.7</td>
<td>0.5</td>
<td>9.8</td>
</tr>
<tr>
<td>Germany</td>
<td>36.6</td>
<td>5.2</td>
<td>36.9</td>
<td>3.8</td>
<td>111.2</td>
</tr>
<tr>
<td>Britain</td>
<td>63.0</td>
<td>9.1</td>
<td>64.0</td>
<td>6.6</td>
<td>203.9</td>
</tr>
<tr>
<td>France</td>
<td>25.9</td>
<td>3.7</td>
<td>36.7</td>
<td>3.8</td>
<td>97.8</td>
</tr>
<tr>
<td>Italy</td>
<td>8.9</td>
<td>1.3</td>
<td>19.0</td>
<td>2.9</td>
<td>60.0</td>
</tr>
<tr>
<td>Canada</td>
<td>54.2</td>
<td>7.8</td>
<td>64.7</td>
<td>6.7</td>
<td>112.8</td>
</tr>
<tr>
<td><strong>LDCs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Africa</td>
<td>32.0</td>
<td>4.6</td>
<td>33.8</td>
<td>3.5</td>
<td>60.6</td>
</tr>
<tr>
<td>Asia and Oceania</td>
<td>218.3</td>
<td>31.5</td>
<td>287.3</td>
<td>30.0</td>
<td>358.4</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>50.4</td>
<td>7.3</td>
<td>80.1</td>
<td>8.2</td>
<td>110.5</td>
</tr>
<tr>
<td><strong>World Total</strong></td>
<td>692.7</td>
<td>972.2</td>
<td>1942.2</td>
<td>5757.4</td>
<td>14,909.3</td>
</tr>
</tbody>
</table>

*DCs = developed countries
*LDCs = less developed countries
1980 and 1985 data are for West Germany

60 percent of total FDI before World War II, this figure fell after the war because of LDC demands for more control over their natural resources in the 1970s, the LDC foreign debt crisis in the 1980s, a gradual shift in FDI from primary products to manufacturing, and an increase in technology-related investment in the North. Among the LDCs, the most prosperous and resource-rich states received the most FDI. Thus, Table 9.2 shows that the share of FDI stock directed to Africa, which has many of the LLDCs, declined from 4.6 percent in 1980 to only 3.5 percent in 1985. Asian and Latin American LDCs, by contrast, received 30 and 8.2 percent of total inward FDI stock in 1985. The five largest LDC recipients of inward FDI stock in 1985 were Hong Kong, Brazil, Indonesia, Saudi Arabia, and Mexico. The Central and Eastern European socialist states and the Soviet Union received almost no FDI from 1975 to 1985.21 Thus, DCs were directing most FDI in the mid-1980s to each other, and many LDCs were marginalized.

The 1980s to the Present

As discussed, FDI flows have declined in some years such as 1982–1983, 2001–2003, and 2008. However, FDI flows since the 1980s have on average increased faster than at any time since the nineteenth century. Table 9.3 shows that inward and outward FDI stock as a share of the GDPs of DCs increased from 4.9 and 6.2 percent in 1980 to 24.7 and 33 percent in 2008. A number of factors account for the rapid growth of FDI. First, the reemergence of orthodox liberalism with deregulation, privatization, and an end to restrictions on capital flows gave MNCs more freedom to expand their activities. Second, the breakup of the Soviet bloc opened up large new areas for FDI as the transition economies instituted market reforms, and China also became a major FDI recipient. A third factor was the problems with international trade. The protracted Uruguay and Doha Round negotiations, combined with the use of NTBs, caused many MNCs to extend their activities abroad to circumvent trade barriers. Finally, significant advances in information and transportation technologies enabled MNCs to extend their global network.22

An important feature of FDI is the degree to which it has been concentrated in the “Triad”—the United States, the EU, and Japan. From 1985 to 2002, the triad accounted for about 80 percent of the world’s outward FDI stock and for 50–60 percent of the inward FDI stock. U.S. firms have shown a strong preference for investing in Europe, intra-European investment has accelerated, and Japan and Western European countries have invested heavily in the United States. Clusters of non-Triad states also have strong FDI links with each Triad member. Table 9.4 shows that the nine largest host countries for FDI from 1985 to 1995 were also included among the largest home countries for FDI (those with the superscript a) and that all but one of these nine (China) is an advanced industrial state. The only important home country for FDI that is not also an important host country is Japan. Although Japan has eased some of its formal impediments to inward FDI, a number of informal
barriers remain. As Table 9.2 shows, Japan accounted for only 1.4 percent of inward FDI stock in 2008—well below the shares for other G7 countries.\textsuperscript{23}

Despite the continued predominance of the DCs, there have been some notable changes in outward FDI since the 1980s. First, the United States lost its dominant position as a source of FDI. As Table 9.1 shows, the U.S. share of outward FDI stock fell from 44 percent in 1975 to 19.5 percent in 2008. Second, there were erratic changes in Japan’s share of FDI outflows. As Table 9.1 also shows, Japan’s share of outward FDI rose dramatically from 6 percent in 1985 to 11.3 percent in 1990. A strong Japanese yen as a result of the 1985 Plaza accord, combined with trade barriers on Japanese goods such

| TABLE 9.3 |
| Share of Inward and Outward FDI Stock as a Percent of GDP\textsuperscript{a} |
|---|---|---|---|---|---|
| DCs\textsuperscript{b} |
| Inward | 4.9 | 6.2 | 8.2 | 8.9 | 16.1 | 24.7 |
| Outward | 6.2 | 7.3 | 9.6 | 11.3 | 21.1 | 33.0 |
| United States |
| Inward | 3.0 | 4.4 | 6.9 | 7.3 | 12.9 | 16.0 |
| Outward | 7.8 | 5.7 | 7.5 | 9.5 | 13.5 | 22.0 |
| Japan |
| Inward | 0.3 | 0.3 | 0.3 | 0.6 | 1.1 | 4.1 |
| Outward | 1.8 | 3.2 | 6.6 | 4.5 | 6.0 | 13.9 |
| Germany |
| Inward | 3.9 | 5.1 | 7.1 | 7.8 | 14.3 | 19.2 |
| Outward | 4.6 | 8.4 | 8.8 | 10.5 | 28.5 | 39.2 |
| Britain |
| Inward | 11.8 | 14.1 | 20.6 | 17.6 | 30.4 | 36.9 |
| Outward | 15.0 | 22.0 | 23.2 | 26.9 | 62.3 | 56.7 |
| France |
| Inward | 3.8 | 6.9 | 7.1 | 12.3 | 19.5 | 34.7 |
| Outward | 3.6 | 7.1 | 9.1 | 13.2 | 33.5 | 48.9 |
| Italy |
| Inward | 2.0 | 4.5 | 5.3 | 5.8 | 11.0 | 14.9 |
| Outward | 1.6 | 3.9 | 5.2 | 8.8 | 16.4 | 22.5 |
| Canada |
| Inward | 20.4 | 18.4 | 19.6 | 21.1 | 29.3 | 27.5 |
| Outward | 8.9 | 12.3 | 14.7 | 20.3 | 32.8 | 34.7 |

\textsuperscript{a}GDP = gross domestic product  
\textsuperscript{b}DCs = developed countries  

TABLE 9.4

Leading Host Economies for FDI (Cumulative Inflows, 1985–1995)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>FDI (U.S.$ Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>477.5</td>
</tr>
<tr>
<td>2</td>
<td>United Kingdom</td>
<td>199.6</td>
</tr>
<tr>
<td>3</td>
<td>France</td>
<td>138.0</td>
</tr>
<tr>
<td>4</td>
<td>China</td>
<td>130.2</td>
</tr>
<tr>
<td>5</td>
<td>Spain</td>
<td>90.9</td>
</tr>
<tr>
<td>6</td>
<td>Belgium–Luxembourg</td>
<td>72.4</td>
</tr>
<tr>
<td>7</td>
<td>Netherlands</td>
<td>68.1</td>
</tr>
<tr>
<td>8</td>
<td>Australia</td>
<td>62.6</td>
</tr>
<tr>
<td>9</td>
<td>Canada</td>
<td>60.9</td>
</tr>
<tr>
<td>10</td>
<td>Mexico</td>
<td>44.1</td>
</tr>
<tr>
<td>11</td>
<td>Singapore</td>
<td>40.8</td>
</tr>
<tr>
<td>12</td>
<td>Sweden</td>
<td>37.7</td>
</tr>
<tr>
<td>13</td>
<td>Italy</td>
<td>36.3</td>
</tr>
<tr>
<td>14</td>
<td>Malaysia</td>
<td>30.7</td>
</tr>
<tr>
<td>15</td>
<td>Germany</td>
<td>25.9</td>
</tr>
<tr>
<td>16</td>
<td>Switzerland</td>
<td>25.2</td>
</tr>
<tr>
<td>17</td>
<td>Argentina</td>
<td>23.5</td>
</tr>
<tr>
<td>18</td>
<td>Brazil</td>
<td>20.3</td>
</tr>
<tr>
<td>19</td>
<td>Hong Kong</td>
<td>17.9</td>
</tr>
<tr>
<td>20</td>
<td>Denmark</td>
<td>15.7</td>
</tr>
</tbody>
</table>

*Economies that are also among the 20 leading home economies for FDI.


as voluntary export restraints, forced Japanese firms to invest and produce more abroad.\(^{24}\) However, Table 9.1 also shows that Japan’s share of outward FDI fell back to 4.2 percent in 2008. Persistent economic recession and the financial problems of major Japanese banks (see Chapter 11) led to changes in the corporate strategies of many Japanese MNCs, which found it difficult to expand abroad.\(^{25}\) Table 9.3 shows that Japan’s outward FDI stock accounted for only 13.9 percent of its GDP in 2008, the lowest share of any G7 country. Third, as Table 9.1 shows, the DC share of outward FDI stock fell from 91.9 percent in 1990 to 84.1 percent in 2008. LDCs increased their share of outward FDI stock, and East Asian economies have been the most active investors. South Korea, Singapore, Taiwan, and China (including Hong Kong) accounted for more than two-thirds of FDI outflows from the LDCs in 2004.\(^{26}\)

There have also been some notable changes in inward FDI since 1980. First, Table 9.2 shows that the U.S. share of inward FDI stock steadily
increased from 12 percent in 1980 to 21.8 percent in 2000. However, the U.S. share declined to 15.3 percent in 2008; this is concerning because inward FDI has become important for the future of U.S. prosperity. Although the U.S. share of inward FDI has fluctuated since 2000, economists attribute the general downward trend to several factors: The U.S. dollar was overvalued, and this elevated the cost of producing in the United States; some other countries gave more incentives to MNCs to engage in offshore production; U.S. corporate taxes were higher than taxes in some other locations; and MNCs were concerned about U.S. economic prospects. Second, Canada was the only G7 country whose share of inward FDI stock fell in all of the years listed in Table 9.2; overall, the Canadian share fell from 7.8 percent in 1980 to 2.8 percent in 2008. The U.S. share of Canada’s inward FDI has declined from about 80 percent in 1980 to 60 percent today, and this decrease is linked to the creation of CUSFTA and NAFTA. Before free trade, U.S. MNCs often located inside Canada to avoid paying tariffs; but under NAFTA, a U.S. firm can produce in the United States (or Mexico) and freely export to Canada. Canada has not attracted more FDI from sources other than the United States for a variety of reasons related to productivity, labor costs, taxes, and the increase in value of the Canadian dollar. Third, the DC share of inward FDI stock has declined, and the LDC share has increased (to a limited extent) in recent years. Table 9.2 shows that the DC share of inward FDI fell from 72.7 percent in 1990 to 68.5 percent in 2008, whereas the LDC share rose from 27.3 percent to 28.7 percent during the same period. As Table 9.4 shows, a small group of rapidly growing LDCs, including China, Mexico, Singapore, Malaysia, Argentina, Brazil, and Hong Kong, were among the 20 leading host economies for FDI between 1985 and 1995. China and India are major candidates for inward FDI because they offer MNCs a huge supply of cheap labor, their workforces are becoming more educated and technologically skilled, and, in terms of numbers, they are the two largest consumer markets in the world. However, China attracts much more FDI than India. Whereas China has moved quickly to adopt economic initiatives and reforms, India has delayed in removing regulatory practices that MNCs consider burdensome. However, India is attracting more FDI in some areas such as outsourcing contracts that provide business services for MNCs. In 2008, China’s FDI inflows surged to a historic high of $108 billion, and it became the third-largest FDI recipient in the world after the United States and France. Although India ranked 10 places behind, it was narrowing the gap with China. In contrast to the more prosperous LDCs, most Sub-Saharan African LDCs have been marginalized. Table 9.2 shows that Africa accounted for only 3.4 percent of inward FDI stock in 2008, compared with 17.3 percent for Asia and 7.9 percent for Latin America. Fourth, FDI has become a significant part of the privatization process in transition economies in Eastern Europe and the FSU. The following sections examine the effects of MNCs on home and host states. Most of the discussion of host state–MNC relations is devoted to the LDCs, and much of the discussion of home state–MNC relations focuses on the advanced industrial states.
MNC–HOST COUNTRY RELATIONS: DETERMINANTS AND EFFECTS OF FDI

We earlier discussed the reasons firms decide to become MNCs, but it is also important to examine why firms direct FDI to one host state rather than another. For example, analysts disagree as to whether MNCs are more likely to invest in LDCs with democratic or authoritarian governments. Some authors assume that democratic LDCs attract more FDI, because democratic institutions impose constraints on governments that decrease political risks and preserve MNCs’ private property rights. Other authors assume that authoritarian LDCs attract more FDI, because autocratic leaders can repress labor unions, drive down wages, and shield MNCs from popular pressures for environmental controls. The results of empirical studies to determine which of these views is correct have been inconclusive. For example, one study found that “regime type . . . seems to have little impact on foreign investors”; a second study found that “empirically the results prove rather conclusive—democracies attract more FDI”; and a third study found that “in fifteen Latin American countries for the period of 1981 to 1996 . . . abuse of civil liberties and political rights . . . had a positive and statistically significant effect on inflows of U.S. FDI.”

A major problem is that authors use different measures of democracy; whereas some focus on the holding of elections, others emphasize the rights of workers and peasants, freedom of the press, or economic rights and privileges. Thus, more research is needed to determine which types of countries attract FDI. Scholars also have different views of the effects of FDI on host states. Orthodox liberals see MNCs as contributing to LDC development by providing external capital, new technologies, and modern ideas that replace traditional social values. They assert that states have different factor endowments and that foreign investment goes to areas where it is most needed or in shortest supply. Thus, inward FDI compensates for inadequate local savings, export earnings, and foreign aid; tax revenues from MNC profits supplement local taxes; and MNCs fill LDC needs for imported technology. Although liberals acknowledge that a strong MNC presence may initially result in more income inequality, they attribute this to the positive effect of MNCs on income growth in general. This inequality is a temporary price to be paid for economic success, and the market will bring about more convergence of incomes over the long term.

The first major challenge to orthodox liberal views came from two economists, Stephen Hymer (a Marxist) and Charles Kindleberger (a liberal). They argued that FDI cannot simply be equated with the movement of capital from home to host countries, because MNCs often get financing for FDI by borrowing funds in the host countries. Although FDI supporters see free markets as promoting open competition, Hymer and Kindleberger noted that MNCs are oligopolistic; they lack certain advantages that local firms possess, but gain competitiveness by creating an oligopoly. For example, an MNC can raise barriers to the entry of other firms through its use of new technologies, economies of scale, and privileged access to global finance. Thus, Hymer wrote that “the industries in which there is much foreign investment tend to be
concentrated industries, while the industries in which there is little or no foreign investment tend to be unconcentrated.” Drawing on Hymer’s ideas, dependency theorists argue that MNCs appropriate local capital rather than bringing in new capital, prevent local firms from participating in the most dynamic sectors of the economy, increase income inequalities in the host country, and use capital-intensive technologies that contribute to unemployment. They also see MNCs as undermining host countries by co-opting local elites, imposing political and economic pressure (often with the help of MNC home countries), and altering consumer tastes and habits. Although Latin American and East Asian NIEs are industrializing, MNCs prevent these states from achieving genuine autonomous development; for example, one study claims that MNCs in Brazil keep “the innovative side of their businesses as close to home as possible” and ensure that “the industrialization of the periphery will remain partial.”

A number of studies indicate that MNC effects on host states are neither as positive nor as negative as neoliberal and dependency theorists maintain, and that a host state’s options vary under different circumstances. For example, one factor affecting a host state’s options is the amount of competition among investors; a host state has greater leverage if it has more investors to choose from. Although states have become more dependent on investment, the diversity of investment sources has also increased because U.S. MNCs have become less dominant and there are more European, Japanese, and Southern MNCs. Raymond Vernon’s obsolescing bargain model (OBM) is another factor that can cause a host state’s relations with MNCs to change over time. A host state has a weak bargaining position before an MNC invests in it because the MNC can pursue other options and the host state must provide incentives to attract the initial investment. The MNC’s bargaining power stems from its sophisticated technology, brand-name identification, access to capital, product diversity, and ability to promote exports. After the investment is made, however, the host state has more bargaining leverage because the MNC commits itself to immobile resources. The host state can treat these resources as a “hostage,” and it gains bargaining, technological, and managerial skills through spin-offs from the foreign investment. Thus, the host state may be able to renegotiate the original bargain and gain more favorable terms from the MNC.

Three factors—fixed investments, new technologies, and brand identification—help determine whether an industry will be subject to the OBM. In regard to the first factor, the OBM is more likely to apply to projects that require large fixed investments. Although such projects initially give foreign investors considerable leverage, later the fixed investments can become hostage to the host state. MNCs with smaller fixed investments can more easily withdraw from the host state. A second factor is the type of technology used; MNCs using sophisticated technologies that are unavailable to the host state may be less vulnerable to aggressive host state policies at a later date. A third factor is the importance of product differentiation through advertising. When a firm’s sales depend on brand identification and consumer loyalty, it is in a stronger position vis-à-vis the host state. MNCs can employ various
strategies to offset the risks of the OBM. For example, they can decrease their vulnerability to host state pressures by vertical integration and by establishing alliances with the local private sector in joint ventures. When an MNC becomes more firmly established in a host state, it can gain political and economic support by creating linkages with local suppliers, distributors, and consumers. State-to-state interactions can also affect MNC–host state relations, and one analyst argues that first-tier bargaining between the host and home states can give MNCs more influence in second-tier bargaining with host states. For example, DC home states have induced LDC host states to liberalize their policies toward FDI through bilateral investment agreements (discussed later in this chapter) and conditions attached to IMF and World Bank structural adjustment loans.

Foreign investment in the oil industry provides a prime example of how the OBM is more applicable in some periods than in others. There was strong evidence for the OBM in the 1970s and early 1980s when international oil companies lost control of agreements they had with LDCs, and oil produced for the international market was gradually brought under state control. From the mid-1980s, however, the international oil companies began to regain their leverage over LDC oil producers as oil prices declined; the oil companies found alternative investment options; and British prime minister Thatcher and U.S. president Reagan called for economic liberalization, privatization, and deregulation. Expropriation and nationalization in the natural resource industries declined sharply in the 1980s and 1990s, and a number of scholars concluded that the OBM had “outlived its usefulness.” In the current decade, however, there has been a resurgence of resource nationalism as rising oil prices have given oil-exporting LDCs increased bargaining power, and the OBM has regained some of its importance in explaining MNC–host state relations. In sum, theoretical models such as the OBM can have more relevance in some periods than in others.

**HOST COUNTRY POLICIES TOWARD MNCs**

Host state policies toward MNCs vary widely, ranging from nationalizations to efforts to attract MNCs with concessions and incentives; and many states have an “attraction-aversion dilemma” vis-à-vis FDI. For example, governments may welcome FDI in some sectors while limiting or blocking it in others (e.g., in defense industries). States also may try to impose obligations such as performance requirements on MNCs to maximize the benefits of FDI. Some federal governments follow restrictive policies toward foreign investment, while their subnational governments (e.g., states or provinces) compete with one another to attract FDI. Although states seek the capital, technology, and organizational skills of MNCs, they may try to preserve large segments of the domestic market for local firms. The issue becomes even more complicated when a country’s positive statements about FDI differ from the experiences of foreign investors.

The following sections discuss host state policies in the South and the North.
The South

Before World War I the South imposed very few restrictions on MNCs. Colonial territories were open to investment from the imperial powers, and independent Latin American LDCs generally accepted the liberal view that foreign investment would further their economic development. Russia’s nationalization of its oil industry after the 1917 revolution had an impact on LDC attitudes, with some shifting to more nationalist policies during the interwar period. However, the South’s adoption of restrictive policies was more notable after World War II. In extreme cases, communist regimes in China, North Korea, North Vietnam, and Cuba nationalized Western assets. In other cases, many newly independent states sought limits on FDI to preserve their national sovereignty. FDI often bred hostility because it involved foreign control over LDCs’ natural resources and public utilities and was associated with the former colonial powers. However, LDCs had limited ability to pressure for a greater share of FDI benefits because they lacked experience in dealing with MNCs and had few sources of external finance. From 1946 to 1959, U.S. MNCs accounted for more than two-thirds of all new foreign-owned subsidiaries in the South.  

In the 1960s and 1970s, LDCs were more activist and had more leverage for several reasons. The growing number of non-U.S. MNCs gave the LDCs alternative sources of finance; FDI was often in natural resources, which were subject to the obsolescing bargain; OPEC’s success in raising oil prices encouraged LDC activism vis-à-vis MNCs in general; dependency theorists encouraged the South to exert more pressure on MNCs; and LDCs increased their managerial, administrative, and technical abilities to regulate MNC behavior. Thus, nationalization of foreign firms became widespread in the petroleum and mining industries. LDCs also posed a major challenge to liberal economic views of FDI in the United Nations. In the 1950s and 1960s, the liberal approach to FDI emphasized national treatment, compensation to MNCs for any infringement of their privileges, and the right of MNCs to seek support from their home countries. By the late 1960s, LDCs instead pressured for agreements to restrict the rights of MNCs, permit discrimination in favor of national firms, and give host state institutions authority to resolve investment disputes. OPEC’s success in raising oil prices in 1973 gave the LDCs more influence, and the UN General Assembly passed resolutions on FDI despite objections of the North such as the 1974 NIEO Declaration calling on host states to unilaterally apply rules to resident MNCs. However, these resolutions were largely symbolic, and the United Nations failed to reach an agreement on a comprehensive code of conduct for MNCs (discussed later in this chapter).  

By the late 1970s, the South shifted to a more conciliatory position for several reasons:

- The nationalization of large-scale petroleum and mining industries was largely completed.
- LDC experience with nationalizing natural resource industries was disappointing because of declining productivity, failure to introduce new technologies, and continued dependence on MNCs for marketing products.
LDC militancy caused MNCs to shift some of their investments from the South to DCs with natural resources such as Australia, Canada, and the United States. The 1980s foreign debt crisis and world recession led to cutbacks in bank loans to LDCs, and the South’s fear of exploitation by MNCs was replaced by concern that its inward FDI was declining.

Many LDCs therefore adopted more open policies toward MNCs during the 1980s; for example, Mexico liberalized its policies and supported the NAFTA provisions for freer foreign investment. The most significant change was in the policies of transition economies, especially China. Although China was largely closed to FDI from the 1950s to 1970s, it became more welcoming to FDI in the late 1970s and even granted foreign investors special treatment not available to domestic firms. Thus, China soon became the largest LDC host country for FDI. Although LDCs adopted more welcoming policies, some governments imposed local content and export requirements on MNCs and pressured them to enter into joint ventures with local firms. The East Asian NIEs, for example, welcomed investment but attached a number of conditions to inward FDI. However, most LDCs and transition economies as well as DCs are currently seeking to attract FDI. Of the 1,035 changes in FDI laws of countries from 1991 to 1999, 974 were more favorable and only 61 were less favorable to FDI. Most new measures by LDCs and transition economies reduce restrictions on foreign entry and offer incentives such as lower taxes to promote investment in priority industries. FDI is the largest source of external finance for LDCs, and during financial crises they have found FDI to be more stable than other capital flows. Whereas investment ratings and short-term financial considerations influence access to bank lending and portfolio investment, FDI responds more to underlying economic fundamentals. Despite the general LDC trend toward welcoming FDI, exceptions exist in certain sectors and geographic regions. For example, some Latin American countries nationalized strategic industries, especially extractive industries. In Venezuela, the national oil company Petróleos de Venezuela S.A. took over the operations of the gas company Exterran (the United States); in Bolivia, the government completed the nationalization of the oil and natural gas industry; and in Ecuador, increased taxes on windfall profits on oil have generated friction with some foreign companies.

It is important to note that the poorest LDCs find it difficult to attract FDI even when they liberalize their investment policies. For example, most Sub-Saharan African LDCs adopted policies to encourage FDI, partly under pressure from IMF and World Bank structural adjustment loans (see Chapter 11). However, low economic growth rates, civil conflicts, political crises, and high indebtedness levels have adversely affected their FDI inflows. As Table 9.2 shows, Africa’s share of inward FDI stock was only 3.4 percent in 2008, compared with much higher shares for Asia and Latin America.
MNC investments have on average focused more on natural resources and lower technology manufacturing in the South, and on higher technology production in the North. MNCs also loom larger in LDC than DC economies, and DCs are often major home as well as host countries for FDI; thus they are reluctant to restrict incoming FDI. Despite these differences, DC policies have also shifted over time.

The North

The United States, Western Europe, and Canada imposed very few controls on foreign firms during the nineteenth century, largely because of liberal attitudes fostered by British hegemony. Western Europe followed more open policies than the United States toward FDI after World War I, but their positions reversed after World War II when the United States emerged as the global hegemon. Indeed, the Europeans adopted more restrictive policies in the 1960s largely because of concerns about the dominance of American MNCs. In his book *The American Challenge*, the French writer Jean-Jacques Servan-Schreiber attributed the success of U.S. MNCs to the dynamism of American society, and he called on Europe to reform its educational, industrial, and social policies, and focus on establishing its own MNCs. In response, European governments promoted national champions in key industries by subsidizing research, encouraging mergers, and increasing procurement from national firms; and they demanded that foreign MNCs contribute to job creation and export promotion. France in particular screened inward FDI and rejected more FDI proposals than other European states. Canada also began a screening process in the 1970s because 50 percent of its manufacturing output and 70 percent of its oil production were foreign controlled. As Table 9.3 shows, inward FDI accounted for 20.4 percent of Canada’s GDP in 1980, compared with only 11.8 percent for Britain, 3.8 percent for France, 3 percent for the United States, and 0.3 percent for Japan. In 1974 Canada created a Foreign Investment Review Agency (FIRA) to determine whether foreign takeovers were of “significant benefit” to the country, and in 1980 it developed a National Energy Program (NEP) to increase Canadian ownership in the oil and gas industry. These policies produced major tensions with the United States.

However, Japan had the most interventionist DC policy. Table 9.2 shows that Japan’s inward FDI accounted for only 0.4 percent of total inward FDI stocks in 1980, compared with 12 percent for the United States and 9.1 percent for Britain. Japan’s low level of inward FDI resulted partly from the difficulty Western MNCs had in adapting to its cultural and linguistic differences, but Japan’s investment restrictions also played a critical role. Dating back to the sixteenth century, Japan’s international economic controls resulted from fear of foreign intervention and pride in its distinct economy and society. During the 1930s, Japan developed policies to extract benefits from foreign investment, such as access to capital and technology, while avoiding the drawbacks of foreign control; and after World War II Japan continued to restrict FDI inflows.

In contrast to the restrictions of the 1970s, most DCs began to seek FDI in the mid-1980s for several reasons. First, states viewed FDI restrictions as less
Host Country Policies Toward MNCs

legitimate because of the phasing out of global capital controls and the reemergence of orthodox liberalism. Second, states viewed FDI as a remedy for increased global competitiveness and unemployment. The average unemployment rate in OECD countries rose from 3.3 percent in 1973 to 8.6 percent in 1983, and governments placed considerable value on the jobs FDI could provide. DCs also began to view inward FDI as a means of enhancing their competitiveness, and they offered financial incentives and tax concessions to attract MNCs. A third factor in the policy shift was the change in the country composition of FDI. As other DCs joined the United States as important home countries for FDI, they favored fewer restrictions on MNCs. For example, the EC was ambivalent about a 1981 U.S. proposal that GATT should compile an inventory of host countries’ trade-related investment measures; but after European MNCs increased their outward FDI, they favored greater discipline over host countries and supported the U.S. position in the GATT Uruguay Round.\footnote{46} Japan also felt pressure to ease its inward FDI restrictions as its outward investment increased. Although Japan had removed most legal obstacles to inward FDI by the 1980s, intangible barriers continue to limit the role of foreign firms. Foreign M&As are less common in Japan because shareholders with ties to the firms’ management and members of keiretsus (groups with extensive cross-shareholdings) hold most of the stock of Japanese firms. For example, of the 584 M&As involving Japan in 1992, 165 were Japanese firms acquiring other Japanese firms, 165 were Japanese firms acquiring foreign firms, and only 32 were foreign firms acquiring Japanese firms. It is also difficult to develop new FDI projects because of the costs and complexities of doing business in Japan, exclusionary business practices of the keiretsus, and bureaucratic practices that discriminate against foreign firms. Japan is adopting policies to encourage more openness, and foreign takeovers of Japanese firms are increasing. However, Table 9.3 shows that inward FDI accounted for only 4.1 percent of Japan’s GDP in 2008; this was well below the 24.7 percent figure on average for all DCs.\footnote{47}

A fourth reason for more open investment policies was the pressure imposed by the United States. Canada and Mexico as U.S. neighbors felt this pressure most strongly. For example, the Canadian Liberal government loosened the controls on inward FDI it had instituted through FIRA and the NEP because of U.S. protests and a U.S. challenge in GATT. The Progressive Conservative government elected in 1984 then rescinded the NEP and replaced FIRA with Investment Canada, which did more to encourage than to review inward FDI. Subsequently, the CUSFTA and NAFTA led to further liberalization of Canadian (and Mexican) foreign investment regulations. Canada’s position on inward FDI was also changing because it was becoming a more important source of FDI. As Table 9.3 shows, in 2008 Canada’s outward FDI stock accounted for a higher percentage of its GDP (34.7 percent) than its inward FDI stock (27.5 percent).\footnote{48}

As the main advocate of open investment policies, it is ironic that the United States began to adopt some restrictive policies in the 1980s and 1990s. This policy shift resulted from the relative decline of its economic
hegemony and its increased role as a host country for FDI. Table 9.3 shows that inward FDI accounted for only 3 percent of U.S. GDP in 1980 and 4.4 percent in 1985. However, U.S. inward FDI rose to 6.9 percent of GDP in 1990 and to 16 percent by 2008. Some congressional leaders warned that foreign investors were acquiring U.S. high-technology firms and that the U.S. military was depending more on foreign-controlled suppliers. Thus, U.S. policies became more interventionist with a number of proposed and actual legislative changes. Most important was the Exon-Florio amendment to the 1988 Omnibus Trade and Competitiveness Act, which enables the president to block foreign mergers or acquisitions of U.S. firms that pose a possible danger to national security. The authority to implement Exon-Florio rests with an interagency Committee on Foreign Investment in the United States (CFIUS). The U.S. Congress did not pass some more extreme proposals, and the CFIUS and U.S. presidents have implemented the Exon-Florio amendment with considerable moderation. However, an administration could limit inward FDI if it chose to liberally interpret the national security clause in Exon-Florio. Despite the Exon-Florio amendment, the United States continues to support liberal foreign investment policies in international forums. For example, the United States was the main force behind the TRIMs negotiations in the GATT Uruguay Round and negotiations for a Multilateral Agreement on Investment in the OECD. The North in general supports liberalization, and most DC regulatory changes in recent years have been investment friendly.49

MNC–HOME COUNTRY RELATIONS

The number of major home countries for MNCs has always been small. Western Europe was the source of about 80 percent of FDI before World War I, and Britain accounted for the largest share. The United States, Britain, and the Netherlands accounted for 65–75 percent of outward FDI stock between World War I and 1980. Although the sources of FDI became more diverse after 1980, six DCs accounted for about 75 percent of the total in the early 1990s—the United States, Britain, Germany, France, Japan, and the Netherlands. Some LDCs and transition economies have become more important as sources of FDI, and the value of outward FDI stock from these countries reached $1.4 trillion in 2005.50 Despite the increase in FDI from LDCs and transition economies, Table 9.1 shows that DCs still accounted for 84.1 percent of outward FDI stock in 2008. This discussion of FDI–home country relations therefore focuses mainly on the North.

The effects of FDI on a home country depend on the characteristics of both the home country and its MNCs. Whether policy makers focus on the characteristics of the state or the MNC, questions about the costs as well as benefits of FDI to home countries have increased in recent years. This section begins with a discussion of home country policies toward MNCs. It then examines two contentious questions in regard to home country–MNC
relations: (1) What are the costs and benefits of FDI for labor groups in the home country? and (2) What is the relationship between the competitiveness of a home country and the competitiveness of its MNCs?

Home Country Policies Toward MNCs

Home countries normally view outward FDI as an indication of economic and political strength and as beneficial to their competitiveness. Thus, they usually give their MNCs favored treatment and try to protect them from hostile actions by foreigners, especially when the MNCs operate in strategic industries. However, governments sometimes associate outward FDI with a decrease in home country exports, a decline in the country’s industrial base, and losses in domestic employment. In such circumstances, home countries may try to stem the flow of outward FDI. Some governments also view their MNCs as tools of foreign policy and may attempt to monitor, control, or restrain their outward FDI in the interests of the home economy.

The Pre–World War II Period

During the nineteenth and early twentieth centuries, home countries supported their corporations and protected them vis-à-vis foreigners. For example, in the colonial period, European states sometimes intervened militarily to ensure that their companies developed and prospered. During the interwar years, European home countries provided subsidies and other assistance to support airlines, shipping firms, and oil companies that were closely tied to their strategic interests. In the 1930s, the Japanese army occupied Chinese plants and gave Japanese companies control over their management. The United States also was sometimes willing to support its companies’ interests in Latin America with military force. However, governments at times took actions to limit outward FDI; for example, the Nazi government in Germany had to approve all new FDI, and it only rarely gave its approval. Although the U.S. government was concerned that outward FDI could transfer technology and employment to foreign countries, it adopted no policies to restrict FDI outflows before World War II.51

Early Postwar Period

In the 1950s to 1970s, the United States as the hegemonic power both protected its MNCs and pressured them for political and economic reasons. For example, in 1962 the U.S. Congress passed the Hickenlooper Amendment, which threatened to withhold development assistance from LDCs that nationalized American MNC affiliates without providing adequate compensation. The United States also viewed its MNCs as tools of foreign policy. For example, the U.S. government used its Trading with the Enemy Act and Foreign Assets Control Legislation in the 1960s and 1970s to limit the trade of U.S. subsidiaries with China, Cuba, North Vietnam, and North Korea. Host governments for U.S. subsidiaries in Canada, Europe, and Latin America considered these policies an infringement of their sovereignty, and they often adopted laws to counter the U.S. legislation. The United States also tried to control corporate behavior in response to its growing
balance-of-payments deficits. In the 1960s, the government called on U.S. MNCs to limit capital outflows to their foreign affiliates; in the 1970s, the government created the Domestic International Sales Corporation (DISC) program, which provided tax incentives to encourage MNCs to export from the United States instead of from abroad.\textsuperscript{52}

Although European governments recovering from World War II were concerned that outward FDI would adversely affect their balance of payments, they did little to either encourage or limit outward FDI in the 1950s and 1960s. Japan was the only major economy that systematically restricted outward FDI for about two decades after World War II. In its efforts to keep scarce capital at home for postwar reconstruction, Japan scrutinized FDI projects and approved only those that would increase exports, provide access to raw materials, and pose no threat to Japanese producers. Thus, Table 9.1 shows that Japan accounted for only 0.7 percent of outward FDI stock in 1960. Japan did not begin to liberalize its controls on outward FDI until the late 1960s, when its balance-of-trade surpluses were rapidly increasing.

The 1980s to the Present Although the United States eased its limits on economic transactions with communist countries as the Cold War declined, it sometimes acted in response to international events. In the early 1980s, for example, Western Europe and the Soviet Union agreed to construct a natural gas pipeline; Western European firms were to provide equipment for the pipeline’s construction in return for future deliveries of Soviet natural gas. After Poland declared martial law in December 1981, the United States retaliated against the Soviet Union by imposing an embargo on materials produced by U.S. companies that were to be used in constructing the pipeline. The United States not only prohibited subsidiaries of U.S. MNCs from exporting equipment and technology to the Soviet Union but also ordered foreign companies not to export goods produced with technology acquired under licensing agreements with U.S. companies. The Reagan administration’s opposition to the pipeline stemmed from concerns that Western Europe would become dependent on Soviet gas exports, and that these exports would provide the Soviet Union with hard currency to strengthen its economy. However, planning for the pipeline was already at an advanced stage, and Britain, France, West Germany, and Italy ordered their resident firms to ignore the U.S. restrictions and provide the goods and technology to the Soviet Union. A number of firms, such as Dresser-France (a U.S. subsidiary) and licensees of General Electric in Britain, Italy, and West Germany, complied with the European orders. Although the United States imposed penalties on these firms, the Europeans did not back down; eventually the U.S. sanctions were removed and the European sales proceeded.\textsuperscript{53} Since the breakup of the Soviet Union, U.S. extraterritorial actions have been aimed mainly at Cuba. For example, the 1996 Helms–Burton Act penalizes foreign companies for doing business in Cuba if they use assets or property of U.S. MNCs (or individuals) that were nationalized after the 1959 Cuban Revolution; but foreign governments indicated that their companies would not abide by this legislation.\textsuperscript{54}
Other home countries have been less inclined than the United States to take such blatant political actions to control MNC behavior. However, Japan and Western Europe have established close linkages with their MNCs to achieve common economic objectives, while the United States has maintained more of an arm’s length relationship between business and government (the U.S. defense and oil industries are notable exceptions). Realists argue that the United States should counter the actions of Japan and Europe by developing an industrial policy to support U.S. MNCs, especially in high-technology areas; this would involve assessing competitive trends in high-technology industries and shifting federal R&D funds from military uses to dual-use and economic areas. The United States has pursued some limited industrial policy initiatives but not to the same extent as Japan and some European countries. In contrast to industrial policy measures, liberals support dependence on the market and on firms that are the lowest cost suppliers, regardless of their nationality.

The Effects of MNCs on Labor Groups in Home Countries

A major controversy regarding the impact of MNCs on home countries relates to whether or not foreign production causes a loss of exports and jobs at home. The debate began in the 1970s when the American Federation of Labor–Congress of Industrial Organizations (AFL-CIO) reversed its liberal trade policy position and called for limits on imports and on FDI by American firms. In the early 1990s, U.S. labor groups opposed NAFTA because of concerns that MNCs would shift their operations to Mexico. The assumption of the AFL-CIO and other U.S. labor groups is that workers in the home country are likely to lose their jobs when a U.S. firm switches from exporting to serving foreign markets through subsidiaries. Other DCs have also been concerned about FDI and the loss of jobs. For example, a 1993 report to the French Senate argued that outward FDI was a major cause of unemployment among factory workers, Japanese policy makers warned that unemployment resulted from the relocation of plants to other Asian countries, and Germany was concerned about the employment effects of industries relocating in Eastern Europe.

Liberals generally dismiss these concerns, arguing that U.S. FDI “tends in the aggregate to create rather than destroy U.S. job opportunities in high-wage, export-oriented industries.” Although outward FDI destroys some jobs in the home country, “it creates others, and the jobs thus gained tend to pay higher wages than the jobs lost.” Thus, liberals often present evidence that MNCs have a better record than domestic firms in job creation, worker salaries, export performance, and technological innovations in the home country. Liberals also reject the idea that home country workers suffer because MNCs transfer activities to LDC subsidiaries with lower wages and standards. For example, one liberal study argues that investment by U.S. firms in Mexico as a result of NAFTA “creates U.S. jobs, both in the short run, by boosting U.S. exports of capital goods, and in the long run, by establishing channels for the export of U.S. intermediate components, replacement parts, and associated goods and services.” Realists and historical
materialists by contrast emphasize the negative effects of outward FDI on employment stemming from export substitution and intrafirm imports. Export substitution occurs when production of a subsidiary in country B substitutes for exports from the parent firm in country A, or when exports from the subsidiary in B to a third country (C) substitute for goods and services that A formerly supplied to C. Intrafirm imports are goods and services that the home country imports from foreign affiliates of a parent firm. Realists argue that export substitution and intrafirm imports reduce production and employment in the home country, and historical materialists add that the mobility of capital and MNCs puts immobile workers at a disadvantage. The constant threat that MNCs will “outsource” jobs to subsidiaries in low-wage countries forces workers in the home country to accept lower salaries, health benefits, pensions, and job security. MNCs from this perspective benefit both by exploiting low-cost labor in LDC host countries and by reducing labor costs in DC home countries. Critical theorists reject the liberal view that workers in the home country will be compensated for the loss of manufacturing jobs with the growth of skilled service positions by arguing that MNCs are now even exporting more skilled positions to lower salary locations.60

Despite numerous studies on MNCs, it is difficult to find unequivocal evidence supporting one side or the other on this issue. A major problem confronting empirical researchers is that we cannot know whether a specific firm’s exports would have been maintained if it had not established foreign subsidiaries. Firms that establish foreign affiliates are often more competitive, and workers in a less competitive firm may lose jobs whether at home or abroad. Creation of foreign production facilities can also be both job displacing and job creating for workers in the home country, depending on whether an MNC is able to expand and diversify its production facilities. With all the variables involved, it may be easier to determine the impact of FDI on specific jobs in specific firms than to provide a broader view of the impact on aggregate employment and exports. Finally, most analysts would agree that FDI in LDCs is more likely to adversely affect less skilled than more skilled workers in DC home countries. The “fairness” of this situation depends not only on our economic views but also on our political and social views. Thus, the controversy over the effects of FDI on workers in home countries shows no signs of abating.61

Competitiveness and Home Country–MNC Relations

Another contentious issue is whether a state’s competitiveness is closely linked with the competitiveness of its MNCs, or whether MNCs have worldwide interests that differ from the interests of their home countries. Realists argue that a state’s MNCs have a major impact on its competitiveness because its “standard of living in the long term depends on its ability to attain a high and rising level of productivity in the industries in which its firms compete.”62 For example, Canada has a good standard of living despite the high degree of foreign ownership in its manufacturing industry; but it can never have the highest standard because the best jobs and R&D are located in the home country.63 Liberals by contrast often argue that MNCs seek profitable
opportunities around the world and “are becoming disconnected from their home nations.” They see U.S. competitiveness as depending more on U.S. workers’ education and skills than on U.S. corporate ownership; if Americans have the requisite training, foreign MNCs will employ U.S. workers. Thus, U.S. senator Lamar Alexander asserted that the American auto industry was earlier defined as “the Big Three companies in Detroit. Now the definition is any company that makes a substantial number of cars and trucks in the U.S. and has a big payroll here, pays big taxes here and buys supplies here.” Some liberals go even further and assert that we are entering a “borderless world” in which a corporation’s nationality no longer makes a difference. An analyst’s position on competitiveness affects their policy prescriptions. Whereas realists argue that governments should pursue industrial policies to promote their own MNCs in high-technology areas, interventionist liberals believe that governments should focus more on upgrading their workers’ skills so that MNCs of any nationality will want to do business, invest, and pay taxes there.

Interventionist liberals can point to China as a prime example of a country that has reaped enormous benefits from foreign MNCs because of its large population; its booming market; its low production costs; and its reasonably skilled, hard-working, and low-wage workers. China’s surging exports have been “one of the great economic success stories in the modern era,” and foreign MNCs have had a major role in this export success. Whereas wholly and partially owned foreign subsidiaries accounted for less than 6 percent of China’s exports in 1986, this figure climbed to about 55 percent in 2004. Foreign subsidiaries also accounted for 81 percent of China’s exports of technology-intensive goods in 2000 and for more than 90 percent of China’s exports of electronic circuits and mobile phones. Foreign MNCs have used China as an export platform, from which they can send goods to other parts of Asia and around the world.

As liberals note, there is also some evidence that large MNCs are becoming more global in their operations and outlook and less closely tied to their home countries. For example, the sales of foreign affiliates of U.S. firms were four times greater than U.S. merchandise exports between 1988 and 1990; U.S. foreign affiliates accounted for 43 percent of their parent companies’ total profits in 1990; and U.S. firms increased their foreign R&D spending by 33 percent, compared with an increase of only 6 percent in the United States from 1986 to 1988. National boundaries are also becoming blurred as some MNCs spread their head office functions and list their shares in stock exchanges in several countries. For example, Shell and Unilever have headquarters in Britain and the Netherlands, and Astra-Zeneca has its headquarters in one state and conducts most of its R&D in another state. Another example is Asea Brown Boveri, which was formed from a merger of Sweden’s ASEA and Switzerland’s Brown Boveri; moved its headquarters from Stockholm to Zurich; has Swiss, German, and Swedish managers; and does its business in English. The increase of cross-border M&As and cross-holding of shares are additional complications in defining an MNC’s nationality, and integrated production systems make it difficult to determine a product’s
origins. MNCs can insulate themselves from national policies and conditions by sourcing inputs, information, and personnel from around the world. For example, an automobile manufactured by Ford may be assembled in Britain with inputs from all over Europe, from designs produced in the United States, and from stages of processing in various locations. In this age of globalization, liberals argue that the highest priority should be “to provide competitive conditions for businesses in general in the country rather than only for the country’s firms in particular.”

Despite the blurring of nationalities, realists note that most MNCs are home country oriented and that a state’s competitiveness is linked with the competitiveness of its MNCs. R&D is a major factor promoting competitiveness, and MNCs tend to keep much of their R&D activity at home. In 1984, for example, the ratio of R&D to sales for industrial machinery and equipment firms in Canada was only 40 percent of the U.S. ratio, and much of this difference resulted from the high degree of foreign ownership in Canadian industry. Although U.S. MNCs are more willing than Japanese MNCs to invest in R&D abroad, even U.S. companies spent only 8.6 percent of their R&D funding in foreign countries in 1988. One factor in a country’s competitiveness is its ability to maintain a positive trade balance, and U.S. affiliates of Japanese firms are more likely than U.S. firms to import goods and services into the United States. R&D funding is also essential for developing new technologies, and the control of high-technology industries can affect a country’s national security. Despite China’s success as an export platform for foreign MNCs, “its reliance on stitching and welding together products that are imagined, invented and designed by others” means that it sometimes has to pay large amounts in licensing fees and patent royalties to foreigners. Much of Apple’s iPhone is made in China, but only a small share of the profits from the sale of iPhones stays in China.

Although a state’s competitiveness is tied to the competitiveness of its firms, there are important national differences. For example, U.S. MNCs tend to favor their home country less than MNCs of Japan and Germany. Studies show that U.S. MNCs are more interested in the financial returns on investments, whereas Japanese MNCs emphasize market share; U.S. MNCs are more willing to invest in overseas R&D than Japanese MNCs; and German and Japanese MNCs put more emphasis than U.S. MNCs on exporting from the home country. Thus, Robert Reich’s question as to whether “our MNCs” look after “our national interests” may be more relevant for U.S. MNCs than for Japanese and German MNCs.

A REGIME FOR FDI: WHAT IS TO BE REGULATED?

Despite the global influence of MNCs, the principles, norms, and rules for foreign investment are more rudimentary than those for trade and monetary relations; and no IO has a role in a foreign investment regime comparable to the WTO’s role in the global trade regime. Most government policies on MNCs are
formulated at the national level, but the transnational nature of MNCs makes these policies inadequate. The main obstacle to forming a foreign investment regime is the lack of consensus on what should be regulated—the MNC, the host state, or the home state. The prominent role of private actors (MNCs and multinational banks) as sources of investment capital also makes international regulation a difficult and contentious issue. According to orthodox liberals, investment agreements should regulate host state behavior and provide maximum protection against nationalization, performance requirements, and other impediments to MNC operations in the global marketplace. Home countries should also be able to intervene on behalf of their MNCs to counter host country actions that inhibit investment flows. Realists and historical materialists, by contrast, view host country restrictions on foreign investment as perfectly legitimate. Realists argue that state intervention is necessary to ensure that FDI does not conflict with the national interest and national security, and historical materialists believe that investment agreements should regulate MNCs rather than host states.

The United States as the global hegemon provided much of the foreign investment regulation in the 1950s and 1960s. U.S. policy sought to protect FDI flows against host country actions such as nationalization and to ensure that MNC behavior did not conflict with the West’s Cold War objectives. European states concluded bilateral investment treaties (BITs) in the 1960s to help protect their investments in LDCs (BITs are discussed later in this chapter). In the 1970s, attention shifted to developing international regulations for FDI, and some economists called for the creation of “a General Agreement for the International Corporation” like the GATT for trade. Several events in the 1970s contributed to the view that this agreement should regulate the behavior of MNCs; for example, currency speculation by MNCs posed a threat to the Bretton Woods pegged exchange rates, and some DCs such as France and Canada began to screen foreign investment to limit the influence of U.S. MNCs. In a widely quoted study, Raymond Vernon argued that “global corporations must be regulated to restore sovereignty to government” because the MNC is “not accountable to any public authority that matches it in geographical reach.” The South took the main initiative in the 1970s, pressuring for UN regulation of MNCs rather than host states. As a result, the United Nations set up a Commission on Transnational Corporations in 1974 with a mandate to develop a binding Code of Conduct for MNCs. To counter the UN emphasis on regulating only MNCs, the OECD’s 1976 Declaration and Decisions on International Investment and Multinational Enterprises included guidelines for the behavior of both MNCs and host states.

By the late 1970s, it was evident that the North would not agree to the South’s demands for a UN Code of Conduct for MNCs, and several factors contributed to a shift back to emphasis on controlling the behavior of host states. For example, the South’s share of inward FDI was declining because of the 1980s foreign debt crisis, concerns about LDC political and economic stability, and the emphasis on high-technology investment in the North.
Thus, LDCs followed less interventionist policies toward MNCs as their needs for capital increased, and the North was able to begin forging a consensus that host state (not MNC) behavior should be regulated. Before examining the multilateral efforts to regulate foreign investment, the next section provides some background on BITs.

**BILATERAL INVESTMENT TREATIES**

Bilateral treaties to protect and promote foreign investment have a long history. In the eighteenth century, the United States, Japan, and some Western European states concluded bilateral treaties that dealt with investment as well as trade, maritime, and consular relations. When the GATT-based multilateral trade regime was formed, countries began to conclude separate BITs. The first BIT was ratified in 1959, and most of the earlier treaties were between DCs and LDCs. With the breakup of the Soviet bloc, many Eastern European countries signed BITs with DCs and LDCs, and the number of BITs between LDCs increased as more LDCs became home countries for FDI. BITs are the most widely used international agreement for protecting FDI and MNCs. Most BITs call on host states to provide national treatment to MNC subsidiaries, which ensures that they are treated at least as favorably as domestic firms. Other provisions include the right of MNCs to repatriate profits, and the right to “fair” compensation in cases of expropriation. The treaties also prohibit host country performance requirements committing MNCs to export goods produced in the host country or to purchase goods and services locally, and they have dispute resolution procedures that MNCs can use to seek compensation in cases of hostile host country actions. Although some more recent BITs refer to the host country’s right to regulate FDI, BITs continue to give priority to the rights of MNCs.\(^7\)

The South tends to view BITs with the North as one-sided because they impose obligations on the host state to protect foreign investment without any corresponding obligations on the home country or the MNC. However, many LDCs have agreed to sign BITs because they assume this is necessary to attract foreign investment. Even in the 1970s, when LDCs called for a New International Economic Order, they participated in BITs for pragmatic reasons to attract FDI. The 1980s foreign debt crisis resulted in a sharp reduction in commercial bank loans, and LDC debtors became more dependent on foreign investment for development finance (see Chapter 11). Thus, the total number of BITs increased from 167 in the late 1970s to 385 in 1989. As DC foreign aid declined during the 1990s, the number increased even more rapidly to 2,676 BITs in 2008.\(^8\) However, several studies find “little evidence that BITs have stimulated additional investment” to signatory LDC states.\(^9\) LDCs with weak domestic institutions are not likely to gain from signing BITs, because BITs act as a complement rather than as a substitute for domestic laws protecting private property. Thus, many countries in Sub-Saharan Africa have difficulties in attracting FDI even when they sign BITs.
From the North’s perspective, BITs provide a “second best solution in the absence of a universal investment agreement.” Other than some regional agreements such as NAFTA, BITs continue to be the best means to regulate the treatment of foreign investors by LDC host countries. It is important to note that the South’s approach to BITs has become less uniform as the number of BITs between LDCs has continued to grow. About 26 percent of all BITs today are South–South treaties. The rapid increase in the number of BITs of all types presents a major problem because it is resulting in “a wide range of non-uniform and inconsistent arrangements that could become increasingly inefficient, complex, and non-transparent.” The following sections focus on efforts to establish more uniform regulations in the United Nations, the EU, NAFTA, the GATT/ WTO, and the OECD.

**UNITED NATIONS**

As discussed, concerns were raised about MNC effects on the national sovereignty of host states in the 1960s and 1970s. A high-profile case involving the International Telephone and Telegraph Corporation (ITT) and Chile brought the issue of regulating MNCs to UN attention. ITT was concerned that Salvador Allende, the Marxist candidate in Chile’s 1970 presidential election, would nationalize its Chilean affiliate without compensation. As a result, ITT tried to prevent Allende’s election and have him removed from power after he was elected, and also tried to involve the U.S. Central Intelligence Agency and U.S. Information Agency in its activities. When ITT’s actions became public in 1972 through published documents of a syndicated columnist, a U.S. Senate subcommittee investigated the case and released a report on *The International Telephone and Telegraph Company and Chile*, and the UN secretary general appointed a Group of Eminent Persons to examine the impact of MNCs. In 1974 the UN group’s report condemned “subversive political intervention” by MNCs such as ITT in Chile, and called for the development of a code of conduct for governments and MNCs. The United Nations then established a *Commission on Transnational Corporations* to develop a comprehensive information system on MNC activities and a code of conduct, and a *UN Center on Transnational Corporations (UNCTC)* to serve as its secretariat. An intergovernmental working group began preparing a draft code of conduct and submitted its report to the commission in 1982, but a long period of negotiations followed because of fundamental disagreements among UN members. For example, there was no consensus on whether the code should be a set of voluntary guidelines or have the force of law. Most LDCs and socialist states supported the draft code because it sought to prevent MNC tax evasion, restrictive business practices, and transfer pricing. The DCs as leading home states for MNCs, by contrast, argued that the draft code did not deal with host state treatment of MNCs. After years of sporadic negotiations, the United Nations abandoned its efforts to form a consensus on a code of conduct for MNCs in 1992; the UNCTC was dissolved in 1993 and replaced by a less proactive Division on Transnational Corporations and Investment under UNCTAD auspices.
UNCTAD has developed expertise on foreign investment issues, and its annual World Investment Reports and Trade and Development Reports are highly regarded. However, UN efforts since 1993 have been limited to promoting voluntary standards of behavior for MNCs. At the 1999 World Economic Forum in Davos, UN secretary-general Kofi Annan invited MNCs to join a UN-led partnership mission called the Global Compact. The compact comprises 10 principles on human rights, labor standards, the environment, and anticorruption that are designed to promote responsible global capitalism. The compact has continued to gain support, and hundreds of companies and organizations ranging from business, labor, and civil society groups to cities and even stock exchanges have signed on to it. Unlike a regulatory code of conduct, the compact is voluntary and depends on a self-reporting system. Critics argue that MNCs may endorse the compact to gain publicity, but that they are often slow in implementing the 10 principles. The UN’s Global Compact Office has responded by generating a “grey list” with names of companies that signed on but did not report on what they were doing to comply with the compact’s terms. However, the efficacy of this “moral suasion” approach is uncertain, and only “time will tell whether these changes will influence corporate conduct in the long term.”

REGIONAL APPROACHES: THE EU AND NAFTA
Regional agreements often include investment as well as trade provisions, partly because of the failure of multilateral institutions to develop a strong foreign investment regime; this section focuses on two important examples: the EU and NAFTA. As a common market, the EU provides for the free movement of capital and protection of FDI among the member states. Thus, the European Commission has legal authority to monitor and regulate MNC activities to ensure that there is a “level playing field.” The EU has also been concerned that European MNCs are not large enough to compete with American and Japanese MNCs, and its policy toward MNCs is therefore “two-edged, encouraging multinational activity in a transnational European market, while seeking to remedy the concerns caused by this activity by specific binding measures of containment.” In view of the high level of EU integration, NAFTA’s method of dealing with FDI is more likely than the EU’s to serve as a model for future efforts to develop a multilateral foreign investment regime.

The investment provisions in NAFTA Chapter 11 have created considerable controversy regarding the regulation of FDI. In one respect, the Chapter 11 investment provisions were unique because they marked the first time that a regional FTA “provided a full set of legal rights and protections to foreign direct investors (from other member countries).” In another respect, the Chapter 11 provisions were not really new, because they “carry forward on a trilateral basis all of the key provisions of U.S. bilateral investment treaties.” For example, NAFTA commits its three members to provide MFN and national treatment to foreign investors; to ban all new export performance, local content, and
technology transfer requirements; and to phase out most existing performance requirements within 10 years. NAFTA also commits governments to compensate investors in cases of expropriation, which it defines in very broad terms. Most liberal economists believe that “open investment policies should be the norm,” with limited exceptions for issues such as national security.\textsuperscript{90} Liberals applaud NAFTA for its significant advances in freeing investment flows but criticize the sectoral exceptions that prevent NAFTA from completely liberalizing North American investment.\textsuperscript{91} For example, the United States excludes its maritime industry, Canada exempts its cultural industries, and Mexico excludes its energy and rail sectors. Realists and critical theorists, by contrast, view the NAFTA investment provisions as threatening national sovereignty and the ability of environmental and labor groups to protect their interests. In the view of critical theorists, the NAFTA rules increase capital mobility and give the capitalist class greater leverage vis-à-vis labor. MNCs can transfer their operations from the United States and Canada to Mexico to benefit from lower labor costs and environmental standards, contributing to a competitive “race to the bottom.”\textsuperscript{92} Realists argue that NAFTA’s limits on the use of performance requirements prevent host countries from gaining positive spinoffs from foreign investment. By preventing these measures, NAFTA makes it difficult for host countries to channel foreign investment to further their national objectives.\textsuperscript{93}

The most controversial aspect of NAFTA Chapter 11 is its investment dispute resolution provisions, which permit private investors to obtain relief directly from governments for alleged NAFTA violations. Chapter 11 stipulates that a private investor from a NAFTA state can compel one of the other two NAFTA governments to participate in binding arbitration to determine whether the investor has incurred financial losses because of the government’s alleged breach of its obligations. Whereas BITs have included this type of investor–state arbitration for many years, in the WTO only governments have “standing” in dispute settlement cases, and investors must be represented by governments in settling their claims. Liberals have praised these procedures for “distancing investment disputes from the political arena. An investor who feels that it has suffered damage... by a NAFTA country can pursue its claim without having to involve its government.” Realists by contrast see the procedures as providing “a vehicle for investors to harass governments whose policies they dislike.”\textsuperscript{94} By giving MNCs legal standing in investment disputes with governments, the NAFTA provisions pose a direct threat to national sovereignty. Environmentalists strongly criticize the fact that many Chapter 11 investor complaints have challenged governments’ antipollution and public health policies. Many early supporters of Chapter 11 assumed that it would prevent the Mexican government from over-regulating the activities of U.S. and Canadian business. However, U.S. and Canadian government actions are being challenged in a growing number of investment disputes, which are sometimes highly controversial. Thus, all three NAFTA governments have expressed concerns about Chapter 11, and they want to ensure that the protection of investors’ rights “does not threaten the ability of governments to regulate in the public interest.”\textsuperscript{95}
THE GATT/WTO TO THE OECD AND BACK TO THE WTO

The WTO is a natural institution to deal with FDI because of the close relationship between foreign investment and trade. However, FDI is the “neglected twin” of trade because it has been less subject to multilateral regulation. The proposed ITO of the 1940s contained some controversial FDI-related topics, and this was a major factor in the U.S. rejection of the Havana Charter. As a result, GATT did not deal with investment until the TRIMs was negotiated in the Uruguay Round and incorporated into the WTO (see Chapter 7). Although the TRIMs is an important beginning in recognizing the relationship between trade and investment, it is largely symbolic because many LDCs are reluctant to accept limits on their investment policies. TRIMs does not impose major new restraints on government actions vis-à-vis FDI; it only bans certain investment-related measures that are inconsistent with GATT/WTO provisions. The GATS and the TRIPs also contain some investment provisions, but the WTO does not provide a comprehensive body of rules for FDI; they are not designed specifically with investment in mind and are scattered throughout the agreement.

Instead of conducting investment negotiations in the WTO, the DCs began negotiations in the OECD in 1995. The OECD seemed to be a natural venue for developing a Multilateral Agreement on Investment (MAI) because OECD countries account for such a large share of FDI inflows and outflows. The OECD also had long-term experience with investment issues: In 1961 it adopted two codes to liberalize capital flows, in 1976 it issued a Declaration on International Investment and Multinational Enterprises, and its definitions and ideas had a major influence on the BITs. The United States wanted a comprehensive and binding MAI, and it was frustrated that LDCs had opposed even the limited TRIMs agreement in the GATT negotiations. Most OECD members are capital exporters, and the United States therefore wanted the OECD to be the venue for the MAI negotiations. However, the EU Commission preferred the WTO as a venue because it wanted the agreement to bind non-OECD countries, which were a growing destination for FDI. Canada also favored the WTO as a venue because NAFTA already dealt with its most important investment relationship (the United States), and it wanted an MAI to benefit Canadian MNCs in the South. Despite these differences, the MAI negotiations began in the OECD for several reasons: Many LDCs in the WTO opposed negotiations on investment issues; and some EU members wanted to negotiate for themselves in the OECD rather than having the EU Commission negotiate for them in the WTO. (The EU Commission represents the EU members in the WTO, but EU members represent themselves in the OECD.) To allay concerns about the exclusivity of the MAI negotiations, the OECD indicated that nonmember states would be consulted.

The OECD negotiations addressed three major issues: protection for foreign investors, liberalization of investment, and dispute settlement procedures. The investment protection talks focused on compensation for expropriation of property, freedom of investors to transfer profits and dividends out of host countries, and fair and equitable treatment for foreign
investors. The investment liberalization talks focused on host country obligations to limit performance requirements and provide MFN and national treatment to foreign investors. The dispute settlement talks focused on procedures investors as well as states could take to submit complaints for binding international arbitration. Although BITs and NAFTA already dealt with many of these issues, the MAI would be multilateral and more comprehensive than previous agreements. Despite early progress in the talks, the negotiating group requested a one-year extension of its mandate in May 1997 because of significant national differences. For example, France and Canada wanted to exempt culture from the agreement to protect their arts and media sectors; the EU and Canada resented the U.S. Helms–Burton law that could be used to sanction foreign companies for investing in Cuba, Iran, and Libya; and OECD members disagreed as to whether environmental and labor measures should be included. These differences gave outside critics such as civil society groups and LDCs the opportunity to organize opposition to an agreement. Although LDCs had become more open to foreign investment after the 1982 foreign debt crisis, they resented being excluded from the OECD negotiations and feared that an MAI would limit host government policies. Indeed, most OECD members seemed “to agree that an MAI should not impose any obligations on firms but that it should be binding on governments.” This position resulted from the North’s opposition to the South’s efforts to develop a UN code of conduct for MNCs and from growing neoliberal support for free foreign investment and capital flows. In the South’s view, by contrast, the 1990s Asian financial crisis demonstrated the need for regulation of foreign investment and capital flows (see Chapter 11).

A coalition of NGOs launched the most effective opposition to an MAI, arguing that it would threaten human rights, labor and environmental standards, and LDC development. They predicted that an MAI would result in a race to the bottom among countries willing to lower their labor and environmental standards to attract foreign investment. A crucial turning point occurred when Ralph Nader and his consumer advocacy group acquired a draft copy of the MAI and put it on the Internet. Using a variety of websites, NGOs mobilized a strong opposition composed of human rights, consumer advocacy, and labor and environmental groups. Gramscian theorists would argue that the NGOs organized a counterhegemony, which used the Internet “with incredible effectiveness to derail a planned . . . pact designed to increase globalization.” Problems also mounted within the OECD when France forced a suspension of the OECD negotiations in 1998 because of its concerns about culture and the threat to national sovereignty. The failure of the MAI negotiations shows that the OECD is better suited to providing advice and analysis and concluding nonbinding accords than it is to negotiating binding agreements on sensitive issues.

Even before the MAI talks collapsed, the EU and Japan tried to revive the investment issue at the WTO’s first Ministerial meeting in 1996 when they pressured for negotiation of the so-called Singapore issues: trade facilitation, competition policy, government procurement, and investment. However, the
South was adamantly opposed to negotiating these issues, and the impasse was eventually resolved by the decision that only one of the Singapore issues (trade facilitation) would be negotiated in the Doha Round. Any current work the WTO does on investment will therefore be separate from the multilateral trade negotiations. A major obstacle to WTO negotiations is the wide North–South divergence of views on whether an MAI should regulate the behavior of MNCs, host states, or home states. With the failure of the WTO to regulate foreign investment, the OECD has again moved in to fill the gap. The OECD has, of course, avoided trying to revive the contentious MAI talks and has instead focused on its traditional activities of identifying investment barriers so that peer pressure can be exerted on states. In 2006, the OECD released a comprehensive *Policy Framework for Investment*, identifying policies that states can adopt to attract foreign investment. Despite the OECD’s continuing efforts to liberalize investment, governments have not established a multilateral foreign investment regime with effective regulations and procedures. As a result, private actors are having a greater role in regard to FDI issues.

**PRIVATE ACTORS**

In view of the lack of multilateral mechanisms to regulate MNCs, private actors have become involved with promoting corporate social responsibility (CSR). NGOs representing consumer, environmental, religious, and other groups have pressured MNCs to engage in socially responsible behavior, and MNCs have engaged in a degree of voluntary self-regulation. This section discusses the role of NGOs and civil society groups, and the “considering IPE theory and practice” section that follows examines the CSR concept from different theoretical perspectives.

As discussed in Chapter 2, NGOs and civil society groups may be conformist, reformist, or rejectionist. Conformists largely endorse MNC behavior and do not favor restrictions on their activities, reformists believe that MNCs can and should be reformed with some regulation, and rejectionists believe that MNCs are not reformable. NGO reformists want to promote responsible MNC behavior without engaging in ideological confrontation. For example, reformist environmental strategies include ecoconsumerism or NGO campaigns to purchase products from ecologically minded firms, partnerships between NGOs and business firms to make production methods more environmentally responsible, and codes of conduct that call on MNCs to voluntarily engage in socially conscious behavior. Rejectionist NGOs seek to expose and punish irresponsible corporate behavior and are less willing to engage in dialogue. Their strategies include consumer boycotts to publicly expose and punish environmental abuses, monitors to track and disseminate information about MNCs’ destructive activities, and counterinformation to refute MNC claims. Some rejectionists aim to develop a counterhegemony to “confront the hegemonic formation of globalization,” which includes MNCs. Some NGOs employ reformist and
rejectionist strategies simultaneously. For example, Greenpeace worked with companies to develop ozone-friendly refrigerators at the same time as it was encouraging consumers to boycott Shell Oil Company over its alleged involvement with state suppression in Nigeria. In efforts to avoid negative NGO campaigns and government regulations, many MNCs have been developing their own regulatory frameworks and collaborating with reformist NGOs. Instead of binding commitments at the international level, business firms and associations have supported voluntary agreements as an alternative. Thus, the International Chamber of Commerce endorsed 16 principles on the environment known as the *Business Charter on Sustainable Development* before the 1992 UN Conference on Environment and Development in Rio de Janeiro, Brazil.

The question arises as to how effective NGOs have been in altering MNC behavior. MNCs have different levels of vulnerability to NGO strategies. For example, oil companies are less vulnerable to NGO pressure because governments depend on MNCs’ access to oil technology, expertise, and distribution networks. NGOs also have limited monitoring capabilities; although they direct their campaigns and protests at certain high-profile companies, they permit other companies to be free riders. Overall, MNCs have not changed significantly as a result of NGO activities, and NGO pressure does not substitute for adequate multilateral regulation.

### Considering IPE Theory and Practice

As discussed, liberals, realists, and historical materialists have widely divergent views regarding MNCs. Liberals view MNCs as positive agents of change that contribute to efficiency and stimulate innovation, economic growth, and employment. Realists believe that host states should be able to impose performance requirements and other regulations on MNCs to promote industrial development and protect the national interest. Historical materialists argue that MNCs overcharge for their goods and services, create dependency relationships with LDC host states, and pose a threat to labor groups and the environment in home as well as host states.

In this section, we discuss competing theoretical views of corporate social responsibility, a concept to which many MNCs are now directing some attention. CSR evokes a wide divergence of views, both within and between the IPE theoretical perspectives. Three common definitions of CSR are

- the responsibility of a corporation to “operate ethically and in accordance with its legal obligations and to strive to minimize any adverse effects of its operations and activities on the environment, society and human health”
- “actions that appear to further some social good, beyond the interests of the firm and that which is required by law”
- “the contribution that a company makes in society through its core business activities, its social investment and philanthropy programs, and its engagement in public policy.”

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The first definition describes CSR as operating ethically but also in accordance with the law, the second emphasizes the fact that CSR goes beyond obeying the law, and the third does not even mention the law. CSR can mean different things to researchers and practitioners, and to companies, NGOs, consumers, and governments; it may include such activities as corporate governance, philanthropy, environmental management, labor rights, community development, and animal rights. Some orthodox liberals have rejected CSR as irrelevant to MNCs and their basic objectives. For example, Milton Friedman has asserted that there is “one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it . . . engages in open and free competition, without deception or fraud.” However, orthodox liberals today find it more difficult to dismiss CSR than Friedman did in 1962 when he wrote this passage, because many private and public groups now support CSR. Thus, many neoliberals (including MNC and industry representatives) now give credence to CSR, but they believe it should be voluntary rather than regulated; regulation would stifle innovation and national competitiveness. Regulation is also unnecessary because MNCs are aware that there are financial benefits in being socially responsible. Peer pressure alone will cause MNCs to develop CSR policies and collectively increase standards.

At the other extreme from neoliberals are critical theorists who view CSR as a contradiction in terms, because the MNC “remains . . . a legally designated ‘person’ designed to valorize self-interest and invalidate moral concern.” The corporate ideal from this perspective “compels executives to prioritize the interests of their companies and shareholders above all others and forbids them from being socially responsible—at least genuinely so.” These critical theorists basically agree with neoliberals such as Friedman that CSR has little or no relevance for MNCs, but unlike the neoliberals they view this in highly negative terms. Whereas some critical theorists reject the idea that MNCs can be socially responsible, others argue that CSR can only have meaning if it is subject to mandatory regulation; a voluntary approach would not lead to responsible corporate behavior. For example, one NGO has argued that “the image of multinational companies working hard to make the world a better place is often just that—an image. . . . What’s needed are new laws to make businesses responsible for protecting human rights and the environment.”

In between the more extreme orthodox liberal and critical views are a wide range of interventionist liberals who see CSR as a viable concept that can depend on a combination of government regulation and voluntary involvement. For example, Jagdish Bhagwati argues that “in the main, voluntary codes must characterize what corporations should do . . . and mandatory codes must address what they should not do.” MNC self-regulation can supplement but not substitute for government regulation. However, government regulation cannot resolve all CSR issues because the law has many gray areas. MNCs should therefore be expected to follow the spirit as well as the letter of the law. When legal standards are unclear or difficult to enforce, corporate culture or pressure from consumer groups and NGOs may also be
important. According to interventionist liberals, MNCs will have the motivation to engage in CSR for various reasons. For example, companies often view CSR as part of good financial management, because unethical firms tend to be unsustainable in the long term; and CSR can both contribute to society and increase the profitability of participating firms. Some interventionist liberals use the term “strategic CSR” to refer to “good works that are also good for business.”

In sum, there is a wide divergence of theoretical views on CSR as there are on other aspects of MNCs. It is difficult to build a good body of empirical research in this area because of the private nature of MNCs, and because many researchers have strongly held views. As one analyst states, “one of the very few generalizations that accurately characterize FDI and MNCs is that their benefits have been exaggerated by advocates and their harm has been exaggerated by critics.”

The next chapter addresses another subject on which there is a diversity of strongly held views: international development.

QUESTIONS

1. How and why do liberals, realists, and historical materialists differ in their views of what should be regulated in a foreign investment regime?
2. Do liberals, realists, and historical materialists believe that the nationality of an MNC makes a difference? Do you think that the competitiveness of a country is closely tied with the competitiveness of its MNCs?
3. Why does a business firm choose to become horizontally integrated? Why does a firm choose to become vertically integrated?
4. In what ways have the major host and home countries for FDI changed over time? Have there been changes in the position of the South vis-à-vis the North in FDI? Is it possible to generalize about “the South”?
5. What are some of the major effects of MNCs on home and host states? Do you think that the effects have on the average been more positive or negative?
6. What is the role of BITs, NAFTA, the United Nations, the WTO, and the OECD in regulating FDI? Why was the decision made to negotiate an MAI in the OECD, and was this a wise decision?
7. What is the obsolescing bargaining model? Does the OBM have more validity in some areas and periods of time than in others?
8. Have NGOs had an impact on the behavior of MNCs? What is CSR, and what are the competing theoretical views regarding the value of the concept?

KEY TERMS

bilateral investment treaties 275
corporate social responsibility 283
foreign direct investment 249
Global Compact 278
greenfield investment 250
horizontal integration 252
multinational corporations 249
obsolescing bargain model 262
portfolio investment 249
transfer prices 252
vertical integration 252
FURTHER READING


NOTES


58. Graham, Fighting the Wrong Enemy, p. 83.


68. Cohen, Multinational Corporations and Foreign Direct Investment, p. 207.

69. Ibid.


91. Alan M. Rugman and Michael Gestrin, “A Conceptual Framework for a Multi-


International Development

The Bretton Woods institutions have been credited with contributing “to almost unprecedented global economic growth.”¹ However, a large percentage of people living in the South have received little benefit from this growth. According to the 2007–2008 Human Development Report, about 1 billion people live on less than $1(U.S.) a day and 2.6 billion people—that is, 40 percent of the world’s population—live on less than $2 a day. About 10 million children die each year before the age of 5 mostly because of poverty and malnutrition. There are also striking gaps between the richest and the poorest. Whereas the 40 percent of the world’s population living on less than $2 a day account for 5 percent of global income, the richest 20 percent account for 75 percent of global income. Income inequality within countries is also a major problem, and more than 80 percent of the world’s population live in countries where income differentials are widening.²

Despite the South’s socioeconomic problems, there are major differences in economic development among LDCs. As Table 10.1 shows, East Asian and Latin American NIEs, and OPEC states tend to be middle- to high-income economies. For example, in 2007 Singapore and Hong Kong, China, had per capita GNIs (at purchasing power parity rates) of $47,950 and $43,940, respectively; OPEC members Kuwait and Saudi Arabia had per capita GNIs of $52,810 and $22,910, respectively; and the per capita GNIs for Mexico and Argentina were $13,910 and $12,970, respectively. In stark contrast, Table 10.1 shows that poorer African and Asian states such as Burundi, Niger, Nepal, and Bangladesh had GNIs per capita of $330, $630, $1,060, and $1,330, respectively. Sub-Saharan Africa is the poorest LDC region; estimates indicate that it will account for almost one-third of global poverty in 2015, up from one-fifth in 1990. In addition to their higher incomes, Table 2.3 in Chapter 2 shows that East Asia and Latin America rank higher than other LDC regions on human development indicators. For example, life expectancy in 2007 was 73.4
and 72.2 years for Latin America and the Caribbean, and East Asia and the
Pacific, respectively; life expectancy in South Asia and Sub-Saharan Africa, by
contrast, was 64.1 and 51.5 years, respectively.

The various LDC regions also have different rates of development. As
discussed in Chapter 11, an international debt crisis that erupted in the 1980s
had a serious effect on development in many LDCs. Thus, Sub-Saharan Africa
and Latin America and the Caribbean had negative economic growth rates (of
−1.2 and −0.4 percent) from 1980 to 1989. However, East Asia had a positive
economic growth rate of 6.2 percent during this period. More recently, rapid
economic growth in China and, to a lesser extent, India is evident from overall
poverty figures. For example, from 1981 to 2001 the number of people living
on less than $1 U.S. per day fell from 634 million to 212 million in China and
from 382 million to 359 million in India. However the number living on less
than $1 U.S. per day increased by almost 90 million in Sub-Saharan Africa
from 1990 to 2001, and by more than 14 million in Europe and Central Asia
from 1981 to 2001. In Sub-Saharan Africa a major factor was the high
incidence of HIV/AIDS; in Europe and Central Asia there was economic
disruption after the breakup of the Soviet bloc and Soviet Union.3

Despite these regional differences, the South in general lacks wealth and
power vis-à-vis the North. Although LDCs look to the North for trade, foreign
investment, development assistance, and technology transfers, they fear that
these linkages prevent them from becoming more independent in policy
making. The KIEOs (the IMF, World Bank, and WTO) have helped the South
gain access to external finance and export markets, but LDCs believe that
some KIEO policies inhibit their development efforts, and they resent the
North’s dominance in these organizations. This chapter assesses the strategies

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**TABLE 10.1**

GNI<sup>a</sup> Per Capita (PPP<sup>b</sup> U.S.$)—Southern Economies—2007

<table>
<thead>
<tr>
<th>East Asian NIEs</th>
<th>Higher and Middle-Income OPEC Members</th>
<th>Latin American NIEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>$47,950</td>
<td>Kuwait</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>43,940</td>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>South Korea</td>
<td>24,840</td>
<td>Iran</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Mexico</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Argentina</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Brazil</td>
</tr>
</tbody>
</table>

**Low-Income**

<table>
<thead>
<tr>
<th>Africa</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethiopia</td>
<td>$780</td>
</tr>
<tr>
<td>Malawi</td>
<td>760</td>
</tr>
<tr>
<td>Niger</td>
<td>630</td>
</tr>
<tr>
<td>Burundi</td>
<td>330</td>
</tr>
<tr>
<td>Cambodia</td>
<td>$1,720</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>1,710</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>1,330</td>
</tr>
<tr>
<td>Nepal</td>
<td>1,060</td>
</tr>
</tbody>
</table>

<sup>a</sup>GNI = gross national income  
<sup>b</sup>PPP = purchasing power parity  

*Source:* World Bank, *World Development Indicators 2009* (Washington, D.C.: World Bank, 2009), Table 1.1
LDCs have pursued to promote their economic development, such as import substitution, socialism, and export-led growth. With the revival of orthodox liberalism, LDCs have shifted to more open economic policies. However, current development policies fall short in meeting the needs of the poorest and most disadvantaged (e.g., LDC women and children) and in looking after the needs of the future as well as the present (e.g., in preserving the environment). As background for examining the LDC economic development strategies, this chapter first discusses the IPE theoretical perspectives; the role of official development assistance (ODA); and the functions of the World Bank, which has “a unique position as a generator of ideas about economic development.”

IPE PERSPECTIVES AND NORTH–SOUTH RELATIONS

This section briefly summarizes the main tenets of the IPE perspectives as they relate to North–South relations. (For a more detailed discussion, see Chapters 3–5.) Realists in the North, preoccupied with the issues of power and influence, tend to ignore the economic interests of poorer countries in the South. In the realist view, “Third World states want power and control as much as wealth,” and it is only when LDCs pose a challenge to the North’s predominance that most realists take notice.

In the 1970s realist scholars looked at OPEC’s increased leverage in raising oil prices and at LDC efforts to gain more power and wealth through an NIEO; in the 1980s and 1990s, realists focused on the challenge the East Asian developmental state model posed to the North; and in more recent years realists have been interested in emerging powers such as China, India, and Brazil. Despite the lack of realist attention to poverty in the South, realist ideas have had considerable influence on LDC policies. For example, Alexander Hamilton and Friedrich List argued that late industrializers (the United States and Germany at the time) required more government involvement if they were to “catch up” with Britain—the leading state. Drawing on these ideas, LDC development strategies such as import substitution and export-led growth call for a larger role for the state in promoting development.

LDC economic problems in the liberal view stem more from inefficient domestic policies than from their dependent position in the global economy. Indeed, liberals often see North–South interdependent linkages as providing even more benefits for the South than for the North. LDCs that follow open economic policies and increase linkages with the North are therefore more likely to achieve successful development. Although all liberals encourage LDCs to follow open, market-oriented policies, interventionist liberals (also called reformist liberals) recognize that North–South inequalities can put LDCs at a disadvantage. Whereas orthodox liberals emphasize equal treatment and reciprocity, interventionist liberals call on the North to consider the special needs of the South. However, interventionist liberals believe that the necessary changes can occur within the existing capitalist order, and they share the faith of other liberals in private enterprise and the market.
As historical materialists, dependency theorists reject the liberal view that LDC economic problems result from inefficient domestic policies. Instead, they see capitalist states in the core of the global economy as either “underdeveloping” LDCs in the periphery or preventing them from attaining genuine, autonomous development. Class linkages also play a role, with elites in the South (the “comprador” class) collaborating with capitalists in the North to reinforce the pattern of LDC dependency. World-systems theorists modified the dependency argument by introducing a third category of countries, the semiperiphery, because some LDCs such as East Asian and Latin American NIEs were successfully industrializing. Countries may move upward from the periphery to the semiperiphery or even the core, but this only rarely occurs. Whereas some historical materialists call for a redistribution of resources from the core to the periphery or even the core, but this only rarely occurs. Whereas some historical materialists call for a redistribution of resources from the core to the periphery or even the core, but this only rarely occurs. Where others believe that the core will never willingly transfer resources; thus, they call for a social revolution in the South and/or a severing of contacts with the North. The solution for disadvantaged groups, according to Gramscian theorists, is the development of a counterhegemony.

OFFICIAL DEVELOPMENT ASSISTANCE

Development assistance or foreign aid refers to grants, loans, or technical assistance that donors provide to recipients on concessional rather than commercial terms. Concessional loans (or soft loans) have lower interest rates, longer grace periods, and longer repayment periods than commercial loans (or hard loans). Private actors such as NGOs and foundations (such as the Bill and Melinda Gates Foundation) provide some valuable foreign aid, but by far the largest share of aid is official development assistance (ODA) provided by governments. To qualify as ODA, a loan must have a grant element of at least 25 percent. The grant element refers to the loan’s financial terms, or the interest rate, maturity period, and grace period (the interval before the first repayment of capital); it ranges from 0 for a loan at 10 percent interest to 100 percent for a grant that requires no repayment. Scholars have widely divergent views regarding the motivations for aid-giving. Most liberals acknowledge that donors provide ODA partly to gain commercial benefits, but they see this aid as a positive-sum game that can also help promote socioeconomic and political development of recipients. Realists often see aid as a policy tool that donors developed to influence recipients in the bipolar Cold War, and that they now use to support the war on terrorism. Critical theorists view aid in highly negative terms as perpetuating dependency relations, promoting the integration of the South in an unequal global market, and failing to deal with serious problems such as environmental degradation. In reality, all of these theoretical views have some merit. Donors sometimes provide aid for humanitarian and development reasons, but they also seek to promote their own political and economic interests.

Regardless of the motivation for foreign aid-giving, it is important to ask whether it is necessary and whether it is effective in decreasing poverty and promoting economic development. Critics point out that LDCs acquire much more
revenue from private capital flows and merchandise exports than from aid. From 1990 to 1996 private international finance to LDCs increased to more than six times ODA flows, and in 2002 two Oxfam staff members wrote that “if developing countries increased their share of world exports by just five percent, this would generate $350 billion—seven times as much as they receive in aid.” Remittances, the money that millions of migrants earn abroad and send back to their home countries, also surpass ODA flows to middle-income LDCs. The World Bank estimated that remittance flows in 2005 amounted to $250 billion (U.S.). However, private capital, trade, and remittances are adequate substitutes for aid for only some LDCs. Most private capital to LDCs goes to China and about 10 other East Asian and Latin American countries, and very little goes to the least developed countries (LLDCs). Furthermore, the poorest LDCs are least likely to benefit from international trade. Thus, aid continues to be important for poorer LDCs and for sectors such as health and education.

Jeffrey Sachs, a strong advocate of foreign aid for the poorest LDCs, argues that “the extreme poor are caught in a poverty trap” because of “disease, physical isolation, climate stress, environmental degradation, and . . . extreme poverty itself.” Their governments “lack the financial means” to extricate themselves from this trap. In 2000 the United Nations established eight Millennium Development Goals (MDGs) to be achieved by 2015, and Sachs sees ODA as a critical factor in reaching those goals. In efforts to halve the proportion of people suffering from extreme poverty and hunger between 1999 and 2015 (the first MDG), Sachs has recommended a doubling of aid in 2006 and almost another doubling by 2015. The increased ODA would help “to jump-start the process of capital accumulation, economic growth, and rising household incomes.” However, critics such as William Easterly and Dambisa Moyo strongly question the effectiveness of aid-giving. Easterly argues that many LDCs have developed economically without large amounts of foreign aid, and that aid does not necessarily promote development. Although “the typical African country received more than 15 percent of its income from foreign donors in the 1990s,” this “surge of aid was not successful in reversing or halting the slide in growth of income per capita.” Easterly believes that aid can sometimes be useful as part of a piecemeal, bottom–up approach to development; but he criticizes the top–down planning approach of most large development agencies, and he attributes LDC problems more to corruption and bad government than to a lack of foreign aid. Dambisa Moyo, a young economist from Zambia, is even more strongly opposed to Sachs’s pro-aid position. In Moyo’s view “millions in Africa are poorer today because of aid; misery and poverty have not ended but have increased.” She argues that aid should be cut off because it promotes corruption and detracts from development. In her view, Africa has better alternatives to aid, including going to the financial markets, emphasizing trade, and encouraging investment from China.

The Sachs–Easterly–Moyo debate shows that some of the major IPE debates are within the same theoretical perspective—in this case they are all liberal economists. As with many IPE debates, the reality is somewhere in between. Both Sachs’s external constraints (lack of capital), and Easterly’s and
Moyo’s internal constraints (bad governance and corruption) can interfere with development. Although Moyo and Easterly are correct that the results of aid have often been disappointing, the poorest LDCs may have few alternatives. Unlike middle-income LDCs, LLDCs often lack competitiveness in trade, and creditworthiness for borrowing on financial markets. Moyo’s book was written shortly before the outbreak of the 2008 global financial crisis, and by the time it was published the financial markets were virtually closed to borrowing by most LLDCs. Regardless of the overall merits of foreign aid, ultimately the amount provided depends on the aid donors. After briefly discussing the trends, determinants, and effects of aid-giving, this chapter focuses mainly on the development strategies of the LDCs.

In the 1950s and 1960s, the North provided ODA to promote economic growth in the South, and in 1970 the United Nations resolved that the net ODA of DCs should amount to at least 0.7 percent of their GNPs (most countries did not meet this objective). However, this aid was often provided for security and commercial reasons, and the main security issue after World War II was the Cold War. The members of the OECD’s Development Assistance Committee (DAC) provided almost 90 percent of aid during the Cold War, while the Soviet Union and its Warsaw Pact allies provided about 10 percent. The DAC continues to supply most of the aid today, but China has also become an important aid giver, especially in Sub-Saharan Africa. Table 10.2 shows the net ODA of DAC members as a percent of their GNIs. As the bottom line in Table 10.2 shows, after an initial decline from 1960 to 1970, ODA stayed in the 30 percent range from 1970 to 1990, but by 2000 the ODA level had fallen to 0.22 percent of GNI. Most notable was the decline of U.S. aid from 0.21 percent of its GNI in 1990 to 0.10 percent of its GNI in 2000. The United States had been the largest aid donor (despite the low percent of its aid relative to its GNI), but Japan took over first place for much of the 1990s. Cold War security concerns were a major motivation for U.S. aid in the 1945–1990 period, and the collapse of the Soviet Union was the most important factor accounting for its decline. Geostrategic security issues, especially the terrorist attack on New York’s World Trade Center on September 11, 2001, help to explain a degree of revival of foreign aid since 2001. As Table 10.2 shows, total ODA as a percent of GNI increased from 0.22 in 2000 to 0.28 in 2007, and U.S. aid increased from 0.10 to 0.16 percent of its GNI. Increased ODA has been part of an effort to combat terrorism, on the theory that poverty can contribute to extremism and violence.

Commercial factors have also influenced the level and destination of aid-giving, and they became more important with the return of orthodox liberalism. As ODA declined in the 1980s and 1990s, the increase of foreign investment fueled “the belief that the financing needs of developing countries could be met by a reliance on the markets.” However, private investment cannot substitute for ODA to the least developed countries because it is speculative and volatile, rarely deals with the environment and other social concerns, and is directed to LDCs with higher incomes or with mineral and oil resources. DAC members give most of their ODA as bilateral aid directly to recipient countries; in 2006, they gave
### TABLE 10.2

| Net Official Development Assistance of DAC Members as a Percent of GNI |
|---------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Australia                | 0.38      | 0.59      | 0.48      | 0.34      | 0.27      | 0.32      |
| Austria                  | —         | 0.13      | 0.23      | 0.25      | 0.23      | 0.50      |
| Belgium                  | 0.88      | 0.48      | 0.50      | 0.46      | 0.36      | 0.43      |
| Canada                   | 0.19      | 0.43      | 0.43      | 0.44      | 0.25      | 0.29      |
| Denmark                  | 0.09      | 0.38      | 0.74      | 0.94      | 1.06      | 0.81      |
| Finland                  | 0         | 0         | 0.22      | 0.63      | 0.31      | 0.39      |
| France                   | 1.38      | 0.65      | 0.63      | 0.60      | 0.30      | 0.38      |
| Germany                  | 0.31      | 0.32      | 0.44      | 0.42      | 0.27      | 0.37      |
| Greece                   | —         | —         | —         | —         | 0.20      | 0.16      |
| Ireland                  | 0         | 0         | 0.16      | 0.16      | 0.29      | 0.55      |
| Italy                    | 0.22      | 0.16      | 0.17      | 0.31      | 0.13      | 0.19      |
| Japan                    | 0.24      | 0.23      | 0.32      | 0.31      | 0.28      | 0.17      |
| Luxembourg               | 0         | 0         | 0         | 0.21      | 0.71      | 0.91      |
| Netherlands              | 0.31      | 0.63      | 0.97      | 0.92      | 0.84      | 0.81      |
| New Zealand              | 0         | 0         | 0.33      | 0.23      | 0.25      | 0.27      |
| Norway                   | 0.11      | 0.33      | 0.87      | 1.17      | 0.76      | 0.95      |
| Portugal                 | 1.45      | 0.45      | 0         | 0.25      | 0.26      | 0.22      |
| Spain                    | 0         | 0         | 0         | 0.20      | 0.22      | 0.37      |
| Sweden                   | 0.05      | 0.37      | 0.78      | 0.91      | 0.80      | 0.93      |
| Switzerland              | 0.04      | 0.14      | 0.24      | 0.32      | 0.34      | 0.37      |
| United Kingdom           | 0.56      | 0.37      | 0.35      | 0.27      | 0.32      | 0.36      |
| United States            | 0.53      | 0.31      | 0.27      | 0.21      | 0.10      | 0.16      |
| Total                    | 0.52      | 0.34      | 0.37      | 0.33      | 0.22      | 0.28      |

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DAC = Development Assistance Committee of the OECD  
GNI = gross national income  

Source: OECD, Development Co-operation (Paris: OECD, various years).

Despite the strategic and commercial motives for aid, ODA also plays an important role in addressing the needs of poorer LDCs for development finance. As discussed, in 2000 the United Nations established eight MDGs...
that are to be achieved by 2015, and the increase in ODA from 0.22 percent of GNI in 2000 to 0.28 percent in 2007 (Table 10.2) is partly a result of the MDGs. However, the emphasis donors place on commercial and political-security objectives tends to make ODA a volatile and unpredictable source of funding for long-term development needs. Although aid has revived somewhat, it is not meeting the UN development goals. The *Monterrey Consensus* on Financing for Development urged DCs to make concrete efforts to reach the ODA target of 0.7 percent of GNI set by the United Nations in 1970. (The *Monterrey Consensus* was an outcome of the UN Conference on Financing for Development held in 2002.) As Table 10.2 shows, in 2007 only five relatively small donors had met the 0.7 percent goal: Denmark, Luxembourg, the Netherlands, Norway, and Sweden. The two largest economies in the OECD, the United States and Japan, ranked among the lowest in 2007 in terms of aid as a percent of GNI (0.16 percent for the United States and 0.17 percent for Japan). Some argue that aid has in fact not revived since 2000, because 28 percent of ODA went for debt relief in 2005. It is questionable whether this represents a real addition to ODA, because much of the debt would not have been repaid (see Chapter 11). As discussed, some analysts also question whether aid contributes to economic development. Donors often provide aid for commercial and security reasons, and recipients often engage in corruption and redirect aid for other purposes. LDCs would therefore be well advised to devote considerable attention to alternative strategies to promote development. Thus, most of this chapter focuses on the development strategies of LDCs. The next section focuses on the World Bank, which is not only a major source of multilateral development finance but also has considerable influence over LDC development strategies.

**THE WORLD BANK GROUP**

The *World Bank* (“the Bank”) has a major effect on LDC development strategies because of its dominant role “as a non-private lender, as a research and idea-generating unit, and as a provider of advice to the Third World.” The World Bank is the largest lender of multilateral funds for international development, but it also has influence as a rating agency for others; its lending decisions, data collection, and analyses have a strong influence on bilateral donors, regional development banks, and private investors. The Bank’s influence has an important coordinating function because aid-giving is so fragmented today. In 2006 there were about 225 bilateral donor agencies and 242 multilateral agencies. The Bank also contributes to the evolution of ideas, and development debates are often based on support for, or opposition to, World Bank positions. Thus, the Bank forms the core of an *epistemic community* or “a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area.” Recognized expertise is a source of power in today’s knowledge-based world
economy, and several factors account for the Bank’s influence in generating ideas: The Bank affects the terms on which LDCs gain access to development finance and international capital markets, it has the largest group of development economists and research budget of any development organization, and the global media direct attention to Bank reports. The following discussion examines the Bank as an IO and the views of its proponents and critics.

Located in Washington, DC, the Bank is actually a World Bank group composed of five institutions (see Figure 2.1 in Chapter 2). The first institution, the International Bank for Reconstruction and Development (IBRD), was planned at the 1944 Bretton Woods conference. The DCs established the IMF to deal with monetary and balance of payments issues, and their decision to form the IBRD was “something of an afterthought.” The DCs expected the IBRD to give priority to European reconstruction over Southern development, and Harry Dexter White of the U.S. Treasury Department even suggested that the new institution be called the Bank for Reconstruction. Although the negotiators responded to LDC protests by pledging that the IBRD would give “equitable” consideration to reconstruction and development, the first IBRD loans in 1947 went to France, the Netherlands, and Denmark. It was not until the United States established the European Recovery Program or Marshall Plan for Western Europe in 1948 that the IBRD shifted its focus to development.

The Bank, like the IMF, is a weighted voting institution. Each member has a capital subscription (or quota) based on its economic strength, which determines its financial contribution to the Bank and its number of votes. DCs as a group have the largest subscriptions and number of votes; in March 2010 the G5 had 37.38 percent of the votes in the IBRD policy-making bodies. The United States led with 16.40 percent, followed by Japan, Germany, Britain, and France, with 7.87, 4.49, 4.31, and 4.31 percent, respectively. However, there are pressures for change, and in April 2010 the World Bank won the first general increase in its capital since 1988 in return for a transfer of some votes from smaller European countries to emerging economies such as China, India, and Brazil. Members pay only 10 percent of their subscriptions to the IBRD and hold the remaining 90 percent as callable capital if needed to meet the IBRD’s financial obligations. The IBRD receives most of its funds for development loans from borrowing on world capital markets. A capital market consists of institutions in a country (e.g., the stock exchange, banks, and insurance companies) that match supply with demand for long-term capital. The principal U.S. bond-rating services give IBRD bonds a triple-A credit rating, because LDCs have a good record in repaying its loans and its members provide financial backing if necessary with their callable capital. To make its bonds attractive to purchasers, the IBRD must pay market interest rates on the funds it borrows, and it therefore charges near-conventional interest rates on loans to LDCs. Since IBRD loans are not concessional, the OECD introduced the concept of official development finance (ODF) for official development loans that have too low a grant element to qualify as official development assistance (ODA). The IBRD’s quasi-commercial loans are considered to be ODF because it extends them for development purposes, it accompanies the
loans with economic and technical advice, and LDCs receive the loans on better terms than they could obtain from borrowing directly on capital markets (LDCs deemed uncreditworthy cannot even borrow on capital markets).

To be a Bank member, a state must also join the IMF and provide it with detailed information about its economy. This requirement deterred most Communist states from joining the Bank for many years, even though they would have liked to receive Bank loans (see Table 11.3 in Chapter 11). The Board of Governors is the main policy-making body in the Bank (and the IMF). Every Bank member has one governor, but the governors have different numbers of votes based on the weighted voting system. The governors meet only once a year to review the Bank’s operations and policies, admit new members, and amend the Articles of Agreement, and they delegate most of their functions to a 24-member Board of Executive Directors (or Executive Board). The Executive Board, which also has weighted voting, is responsible for approving all Bank loan proposals and developing the Bank’s general policies. Whereas the G5 countries have enough votes to appoint their own executive directors, coalitions of members elect the other executive directors every two years. (China, Saudi Arabia, and Russia also have appointed their own executive directors, but they have fewer votes than the G5 countries.) Elected executive directors must cast the votes of their entire coalition group as a unit.

Early in the Bank’s history, the DCs were willing to give the president and staff considerable discretion in daily operations because of the lack of Communist members, the Bank’s weighted voting system, and the North’s dominant position on the professional staff. The staff also has a degree of autonomy from governments because the IBRD receives most of its funds from financial markets (dependence on financial markets has other costs). Several factors also give the Bank staff more autonomy from the Executive Board: The executive directors lack analytical support to monitor the staff’s management of complex issues; the frequent rotation of executive directors puts them at a disadvantage in relation to staff members who are career civil servants; and although the executive board can reject a staff loan proposal, only the Bank president can decide whether to propose a loan. Despite the staff’s prerogatives, its autonomy has limits, and the United States and some other DCs have scrutinized Bank actions more closely in recent years (see discussion later in this chapter).

The International Finance Corporation (IFC) became the second Bank group institution in 1956 (see Figure 2.1 in Chapter 2). Reflecting the Bank group’s liberal economic orientation, the IFC encourages private business and investment in LDCs, and it is the largest multilateral source of loans and equity financing for private-sector projects in the South. Whereas the IBRD provides loans only to governments or with a government guarantee, the IFC gives loans to private ventures in LDCs without a government guarantee. The IFC is also more sensitive to business risk than the IBRD, because it is expected to make a profit in normal commercial terms. The IFC invests in equity shares of corporations, brings foreign and domestic partners together in joint ventures, and persuades commercial banks to lend to LDCs through joint financing deals with banks as co-lenders. Like the IBRD, the IFC charges near-commercial rates on its loans.
In view of the IFC’s profits and the high interest rate on its loans, critics question
whether the IFC is a money-making or philanthropic institution. However, the
IFC argues that it provides technical, financial, and environmental advice for
private-oriented development projects.\textsuperscript{27}

The \textit{International Development Association} (IDA), which became the
third Bank group institution in 1960, was formed in response to the South’s
complaints that poorer LDCs could not pay the high interest rates on IBRD
loans. The South also opposed the Bank’s weighted voting system, and
throughout the 1950s it demanded a soft-loan agency in which it would
have greater control. The North finally agreed to create the IDA in 1960,
but it insisted that IDA be under World Bank auspices with its weighted
voting system. Although the IDA and IBRD are legally and financially
distinct, they share the same staff and their projects must meet the same
criteria. The IDA provides soft loans or “credits” to LDC governments with
no interest, 10-year grace periods, and 35- to 40-year maturities. (The IDA
also provides a small share of its funds as grants to low-income countries in
“debt distress.”\textsuperscript{28}) Unlike IBRD and IFC loans, IDA credits meet the criteria
for Official Development Assistance (ODA). LDCs and transition economies
are categorized in three groups in terms of eligibility for loans: States with
stronger economies such as Argentina, Brazil, Mexico, Malaysia, Thailand,
Iran, Egypt, Poland, Russia, and China are only eligible for IBRD loans;
states with somewhat weaker economies such as India, Pakistan, Bolivia,
and Azerbaijan are eligible for a blend of IBRD and IDA funds; and states
with the weakest economies such as Bangladesh, Vietnam, Honduras,
Tanzania, Kenya, Ethiopia, and Nigeria are eligible for only IDA credits.\textsuperscript{29}
The interest-free terms of IDA credits give it no basis for borrowing on
capital markets, and it therefore depends on replenishments by DC
governments every three years. Other donors often wait for the United
States to pledge funds before making their own pledges, and the U.S.
Congress sometimes delays approval of IDA contributions. Orthodox liberal
views that LDCs should rely on private capital rather than IDA “handouts”
pose a constant threat to its finances.

The other two Bank group institutions—the \textit{International Center for
Settlement of Investment Disputes} (ICSID) and the \textit{Multilateral Investment
Guarantee Agency} (MIGA)—encourage the flow of private foreign investment
to LDCs and transition economies. The ICSID was formed in 1966 to provide
facilities for conciliation and arbitration of investment disputes. The need for a
neutral international forum arose because foreign investors view host country
courts as biased, and host countries see home country courts as threatening
their sovereignty. The MIGA was formed in 1988 to provide guarantees to
foreign investors for noncommercial risks, such as currency inconvertibility,
expropriation, war, and civil disturbances, and to help LDCs and transition
economies inform others of investment opportunities.\textsuperscript{30}

The Bank has considerable influence over bilateral as well as multilateral
aid. Donor governments consider Bank reports a key source of data and analy-
sis on development issues, and the Bank chairs a number of aid consortia and
consultative groups which enable DC donors to avoid duplication and coordinate their bilateral aid-giving. However, consultative groups also permit donors to exert collective pressures on a recipient government because only one recipient and its major donors attend each meeting. As the most important multilateral development institution, the Bank also provides a model for regional banks such as the Inter-American, African, and Asian Development Banks and the European Bank for Reconstruction and Development (EBRD). Like the World Bank, these regional banks usually raise funds on international capital markets and lend at near-commercial interest rates; they also have IDA-type soft-loan affiliates that raise funds from government subscriptions. Whereas the World Bank focuses on larger projects and programs, the regional banks support smaller development projects at the regional level.

The United States is the most important Bank member, and there are several indications of its influence. First, it has more votes than any other member. Second, English is the Bank’s only working language, reflecting its location in Washington, DC. The U.S. view that a single working language contributes to efficiency contrasts with the view of many other states that cultural and ethnic diversity dictates the need for more than one working language in IOs. Third, the Bank president has always been American, and the executive directors accept the U.S. government’s nominee for the position. Whereas the U.S. Treasury Department handles most matters related to U.S. involvement in the Bank, the White House nominates Bank presidents and “invariably chooses candidates with connections to the U.S. political establishment.” However, U.S. influence has declined in some respects. For example, the share of the Bank’s outstanding securities held in the United States has steadily decreased and U.S. voting power in the Bank has fallen from about 40 percent of the total to less than 17 percent. There is increasing pressure from the emerging economies to end the tacit agreement that the Bank president would always be an American and the IMF managing director would always be a European and the 2008 global financial crisis is giving the emerging economies more influence. For example, many DCs are reducing their IDA contributions because of budgetary shortfalls. Emerging economies such as Brazil and China by contrast have become IDA donors, and the Bank is looking to them for increased contributions.

Despite the decline in U.S. influence, it continues to be the most important Bank member for several reasons:

- The United States is the only country with sufficient voting power (over 15 percent) to veto amendments to the Bank Articles of Agreement and decisions to increase the Bank’s capital.
- Other DCs have been willing to let the United States take “the lead—and the heat—for doing what they wanted anyway,” and they do not want to jeopardize relations with the United States on this issue. Japan and Europe have been more interested in controlling regional institutions such as the EBRD in Europe.
- The United States has considerable structural or soft power in the Bank, enabling it to induce “other countries to want what it wants.” This soft
power depends on U.S.-based civil society actors such as academics, think tanks, and NGOs with ready access to the Bank in Washington, DC.

- The creation of IDA in 1960 gave the United States more influence than it had over the IBRD. The U.S. threat to withhold IDA replenishments is sometimes explicitly linked with U.S. objections to specific Bank policies.  

Despite the influence of the United States and other DCs, the Bank sometimes asserts its autonomy on issues and uses its expertise to influence foreign aid officials in the DCs. Thus, the United States and the Bank have “a complex, evolving relationship that is part symbiosis, part two-way influence, and part struggle over the Bank’s autonomy of action.”

This chapter briefly outlines some salient issues raised by critics and supporters of the Bank. The strongest critics are historical materialists on the left and orthodox liberals on the right. Historical materialists accuse the Bank of enriching the North at the expense of the South, and of bolstering “an international capitalist system that is detrimental to mankind and the environment.” Some orthodox liberals, by contrast, see the Bank as interested “in ever-increasing multinational aid” and advise it to “impose a greater check on the staff’s tendency to be ‘state enthusiasts.’ ”

Defenders of the Bank consider it inevitable that it “should be subjected to severe criticism from the ideologues of both left and right.” However, scholars who are not rightist or leftist ideologues also criticize the Bank’s policies. For example, one recent study criticizes the Bank for “hypocrisy”; that is, for espousing a number of development policies and goals that it does not put into practice. As this chapter discusses, the Bank has in fact often disregarded challenges to its liberal free market approach to development, and it has been more willing to criticize government failure than market failure. During the 1980s and 1990s, the Bank used its structural adjustment loans (SALs) to pressure LDCs to adopt orthodox liberal policies. Only recently has the Bank adopted some policies to cushion vulnerable groups and states from unrestrained market pressures. Other criticisms of the Bank range from its patronizing attitude toward the United Nations Development Program (UNDP) and the regional development banks; its highly centralized structure in Washington, DC, with too little staff time spent in the field; and the priority it gives to large project commitments with fast-disbursing loans over project supervision, implementation, and evaluation. In fairness to the Bank, as the largest multilateral development institution it is a target of criticism regardless of its policies. For example, some critics charge that the Bank is too slow to change its policies in response to civil society pressures and LDC requirements. However, when the Bank alters its policies, others charge that it is embracing “the latest fads in development thinking regardless of their substantive merits.” The Bank, like other IOs, is also largely a creature of its member states; for example, the Bank’s ability to increase loans to the poorest LDCs depends on the North’s willingness to provide IDA replenishments. We now turn to a discussion of LDC development strategies.
LDC DEVELOPMENT STRATEGIES

Most development economists in the early postwar period were “surprisingly sceptical about the benefits of free trade and capital movements.” The decline in the North’s demand for imports during the 1930s Depression had caused world prices for Latin American commodity exports to collapse, and John Maynard Keynes’ interventionist liberalism had more appeal to development economists than orthodox liberalism. Interventionist liberals accepted the idea that LDCs required more government intervention in their economies than DCs. The apparent success of Soviet central planning in the 1930s also contributed to support for “statism,” or a greater role for the state in the economy. This skepticism of free trade and emphasis on statism provided the setting for the ISI strategy after World War II. As we will discuss, ISI was ultimately unsuccessful and has been replaced by other development strategies. The remainder of this chapter focuses on the succession of LDC development strategies since World War II.

IMPORT SUBSTITUTION INDUSTRIALIZATION

The ideas of several major economists influenced Southern development strategies during the early postwar period. As discussed, development strategies drew on Keynesian interventionist liberalism. Although Keynes focused on government involvement in the North, his ideas contributed to the view that LDC governments should do more to promote economic development. Development strategies also drew on the ideas of Raúl Prebisch and Hans Singer, who rejected the classical liberal view that LDCs should focus on primary product exports to exploit their comparative advantage. In 1950, Prebisch and Singer separately published studies arguing that the North-South income gap was growing because of a long-term decline in the prices of primary products (raw materials and agricultural goods). Whereas the demand for industrial goods such as automobiles and televisions rises as income increases, the same does not apply to primary products. Indeed, the North’s demand for raw materials may even decline as technological advances lead to the discovery of substitutes (such as synthetic rubber for natural rubber). Thus, LDCs that depend on primary product exports suffer from declining terms of trade. When LDCs increase the production of primary products to gain more revenue, the surplus stocks in fact result in lower prices and more poverty. To close the gap, LDCs should therefore decrease their emphasis on primary products and focus on industrialization. Prebisch argued that import substitution industrialization (ISI) would permit LDCs to produce manufactured goods they had previously imported. In the 1950s Prebisch began to use the terms center and periphery, and his writings formed the core of Latin American structuralism. Although Prebisch’s structuralism was a precursor to dependency theory, he was more optimistic than dependency theorists that the South could catch up with the North through protectionism and state-promoted industrialization.
Realists such as Hamilton and List had supported policies similar to ISI for late industrializers, and some LDCs had developed ISI as a short-term response to the Great Depression. However, it was only after World War II that the South adopted ISI as a long-term development strategy. Central to ISI was the argument that LDCs should promote industrial growth through protectionist barriers and subsidies for their infant industries. In the 1950s and 1960s LDCs in Latin America, Asia, and Africa followed ISI policies, and import substitution “emerged as the new gospel for Third World industrialization.”

The World Bank generally supported ISI during the 1950s even though it was a realist development strategy with strong nationalist overtones, because the Bank was affected by postwar interventionist liberal views that the state should have an important role in development. The Bank’s approach to development placed considerable emphasis on industrialization, which meant ISI in the 1950s, and it provided funding for major infrastructure projects such as transportation and communications facilities and power projects that LDCs needed to industrialize.

Initially, ISI provided some major gains for the South. For example, Latin America had healthy industrial growth rates in the 1940s and 1950s, India’s steel production increased by six times from 1951 to 1966, and some African states such as Ghana also registered industrial gains. International conditions were favorable to ISI, because LDCs benefited from prosperity and growth in North America and Western Europe. The “green revolution” also led to the development of high-yielding grains in the 1950s that increased agricultural output in Asian LDCs and masked the fact that ISI was promoting industrialization at the expense of agriculture. However, serious problems developed with ISI during the 1960s and 1970s. For example, a global food crisis in the 1970s exposed ISI weaknesses, as inclement weather and Soviet crop shortfalls increased demand for food imports, and global food stocks fell to their lowest levels in 20 years. The food crisis had its severest effects on the South because many LDCs could not purchase foodstuffs on global markets at inflated prices.

When OPEC drastically raised oil prices in 1973, a number of LDC oil importers such as India were doubly hit by the food and energy crises. These external stresses exposed a number of weaknesses in ISI as a development strategy. First, the global food crisis pointed to the pitfalls in emphasizing industrialization at the expense of agriculture. The neglect of agriculture contributed to poverty in the countryside, the need for food grain imports, and the stagnation of agricultural exports. The LDC share of world agricultural exports fell from 44 percent in 1955 to 32 percent in 1970, and the decline in revenue exacerbated LDC balance-of-payments deficits. Second, despite its emphasis on promoting self-sufficiency, ISI increased the South’s dependence on the North. In view of their shortages of capital and foreign exchange, LDCs encouraged inward FDI as part of their ISI policies to promote industrialization. Thus, MNCs established subsidiaries behind the LDC trade barriers, and the U.S. government supported ISI as part of “its vigorous efforts to secure favorable conditions for U.S. foreign direct investment.”

The most serious weakness of ISI was its inability to promote industrial competitiveness. Although industrialization proceeded well under an “easy”
first stage of ISI, the second stage was more difficult. In the first stage, LDCs replaced nondurable consumer imports such as shoes, household products, and clothing with domestic production. LDCs have a sizable domestic market for these labor-intensive goods, and they do not require large amounts of capital investment, advanced technology, or a network of component suppliers. However, LDCs had to move to a second stage to maintain high industrial growth rates, replacing imports of intermediate goods (e.g., petrochemicals and steel) and producer and consumer durables (e.g., refrigerators and automobiles) with domestic production. These second-stage products were more difficult to produce because they are capital intensive and depend on economies of scale and higher levels of technology. LDCs had to import technology and inputs to produce these goods, and the cost of the imports outweighed any savings from locally producing the final goods. ISI also exacerbated income inequalities and unemployment in LDCs, because the emphasis on capital-intensive production concentrated development gains in a small segment of the population in industrial enclaves.\textsuperscript{51} LDCs pursuing second-stage ISI experienced a slower growth of primary product exports, greater dependence on imports, and a failure to increase manufactured exports. In response to their balance-of-payments problems, LDCs sought external loans, aid, and investment and turned increasingly to trade protectionism. Liberal economists began to argue that “an import substitution policy tends to be less and less successful the longer it continues,”\textsuperscript{52} and the World Bank also changed its views. By the late 1960s, World Bank and IFC “financing of profitable import-substituting industry” was giving way “to a more discriminating policy of industrial financing.”\textsuperscript{53} Even Prebisch warned that “the proliferation of industries of every kind in a closed market has deprived the Latin American countries of the advantages of specialization and economies of scale.”\textsuperscript{54} Prebisch hoped that regional trade agreements would provide economies of scale so that Latin American LDCs could continue to industrialize under ISI. However, Latin American regionalism during the 1970s was unsuccessful (see Chapter 8).

Many Latin American and South Asian states continued with second-stage ISI during the 1960s and 1970s, because protectionist domestic groups limited their ability to institute policy change. However, some LDCs turned to socialist central planning based on the Soviet Union model, and others changed from ISI to export-led growth strategies. The following discussion will show that export-led growth was much more successful than ISI and socialist development strategies.

**SOCIALIST DEVELOPMENT STRATEGIES**

During the 1960s, scholars challenged ISI from both the right and the left, and many left-leaning scholars turned to dependency theory (see Chapter 5). Dependency theorists saw ISI as too moderate an approach, and argued that the South could promote autonomous development only by turning to socialism and severing linkages with the North. A small number of LDCs including
China, North Korea, Cuba, Ethiopia, Mozambique, Tanzania, Vietnam, Laos, Cambodia, and Burma adopted socialist development strategies. In some cases these strategies were patterned after the Soviet model, with state central planning largely replacing market signals in allocating resources and setting production targets, wages, and prices. LDCs taking the socialist route often reduced socioeconomic inequities by providing better access to health care and education, improving the status of women, and opening more facilities to the public. However, LDCs (other than China to some extent) generally lacked the communications and transportation infrastructure for central planning and a well-trained bureaucracy to design and monitor the plans. LDCs also encountered the same problems that plagued the Soviet Union and Eastern Europe; that is, central planners were more successful in setting production targets and increasing output than in ensuring the quality of output and the efficient use of resources.

Tanzania’s experience with socialism is particularly instructive because it began with such high ideals under an internationally respected leader Julius Nyerere. Nyerere issued the Arusha Declaration—a statement of party principles—in early 1967 that called for national self-reliance, state control of the major means of production and exchange, and a development approach that focused first on the lowest rural level. To implement this program, Nyerere produced plans for widespread nationalization ranging from private banks and insurance companies to food processors and export-trading companies. In addition, he proposed to promote rural development by creating self-sufficient socialist villages throughout the country. Nyerere hoped that bringing the rural population together in large communal villages (ujamaas) would provide peasant farmers with access to modern methods, equipment, and basic services; reduce inequality among classes; and increase agricultural productivity.

However, Nyerere’s plans proved to be unrealistic. For example, the government tried to convince the rural population to move to larger villages. When the people did not comply, the government eventually resorted to coercion and brutality, and about 11 million people were moved to new villages between 1973 and 1977. This mass disruption caused a rapid decline in food production, and despite Nyerere’s emphasis on self-reliance Tanzania had to seek IMF and World Bank loans and large amounts of food aid. Nyerere’s plans for nationalizations and state control also proved to be unsuccessful. Many state corporations were formed that were poorly managed, inefficient, overstaffed, and debt-ridden. The OPEC oil price increases in 1973–74 added further to Tanzania’s problems, and by the late 1970s it had a soaring trade deficit and foreign debt. As a socialist state, Tanzania registered major improvements in primary school enrollment, adult literacy rates, sanitation, and life expectancy. However, this progress was financed mainly by foreign aid. Tanzania received about $3 billion in foreign aid during the 1970s, primarily from the West.

Despite the aid to Tanzania, high oil prices, poor weather, low export revenues, and increasing debt service were plaguing the country by 1981. When orthodox liberalism returned with Thatcherism and Reaganism, Tanzania was
still very poor and far from self-reliant. Thus, privatization began to take hold, and Nyerere left the presidency frustrated and saddened. Several other LDCs with socialist policies had similar experiences, and the LDCs that had looked to the Soviet bloc for economic and military support lost that option when the Soviet bloc collapsed in the 1980s and 1990s. Thus, very few LDCs currently follow socialist strategies, and even the holdouts such as Cuba are seeking closer ties with the capitalist world.\textsuperscript{55}

**EXPORT-LED GROWTH**

The East Asian NIEs—South Korea, Taiwan, Singapore, and Hong Kong—adopted export-led growth strategies that were far more successful than the socialist and ISI strategies in the 1970s and 1980s. South Korea and Taiwan provided the best examples of export-led growth, because Singapore and Hong Kong are so small geographically, and Hong Kong was a British crown colony before it was incorporated into mainland China. In the 1950s Taiwan and South Korea adopted ISI policies, which resulted in balance-of-payments deficits and did not decrease their dependence on primary commodity exports. Thus, Taiwan and South Korea followed Japan’s example in the 1960s and shifted from ISI to a policy of encouraging the growth of manufactured exports. While maintaining moderate protection of domestic producers, they promoted exports with tax incentives, export credits, export targets, and duty-free imports of inputs required by exporters. Taiwan and South Korea also abandoned minimum wage legislation to encourage increased employment in export-oriented industries. During the early 1980s, Southeast Asian economies such as Malaysia, Indonesia, and Thailand followed a similar path and switched to export-led growth strategies. Thus, Hong Kong, Singapore, South Korea, and Taiwan were “first-tier” Asian NIEs; and Malaysia, Indonesia, and Thailand were “second-tier” NIEs. The change to export-led growth had a dramatic effect on economic performance. For example, South Korea’s GDP grew at an average annual rate of more than 8 percent during the 1960s, and its exports rose from about $31 million in 1960 to $882 million in 1970. In the 1960s most South Korean and Taiwanese industrial exports required relatively little capital and large amounts of unskilled labor, but industrial wages gradually increased and there was a structural transformation as the two economies began producing sophisticated industrial goods with highly skilled labor. By the late 1980s, Taiwan and South Korea were the tenth and thirteenth largest world exporters of manufactures, respectively.\textsuperscript{56}

The East Asian successes of the 1960s to 1980s were often compared with the experiences of the Latin American NIEs—Argentina, Brazil, Chile, and Mexico.\textsuperscript{57} Although the Latin Americans began to provide some incentives for exports in the 1960s, their policies continued to be based mainly on ISI. Thus, the first two columns of Table 10.3 show that East Asian NIEs had much higher GDP per capita growth rates than Latin American NIEs. Whereas South Korea’s GDP per capita of $747 was well below the per capita GDPs of
### TABLE 10.3

<table>
<thead>
<tr>
<th>GDP Per Capita and Export/GDP Ratios</th>
<th>GDP Per Capita</th>
<th>Export/GDP Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>East Asian NIEs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>$2,247</td>
<td>$11,952</td>
</tr>
<tr>
<td>South Korea</td>
<td>747</td>
<td>4,094</td>
</tr>
<tr>
<td>Singapore</td>
<td>1,777</td>
<td>11,693</td>
</tr>
<tr>
<td>Taiwan</td>
<td>980</td>
<td>4,607</td>
</tr>
<tr>
<td><strong>Latin American NIEs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>$2,949</td>
<td>$3,474</td>
</tr>
<tr>
<td>Brazil</td>
<td>1,400</td>
<td>3,424</td>
</tr>
<tr>
<td>Chile</td>
<td>3,231</td>
<td>3,933</td>
</tr>
<tr>
<td>Mexico</td>
<td>2,312</td>
<td>3,649</td>
</tr>
</tbody>
</table>

*a* GDP = gross domestic product  
*b* NIEs = newly industrializing economies  


All four Latin American NIEs in 1963, by 1988 South Korea’s per capita GDP of $4,094 was above the figures for the Latin Americans. The change was even more dramatic for Hong Kong and Singapore, with their per capita GDPs soaring above $11,000 by 1988. The last two columns of Table 11.3 show that export-led growth strategies led to much higher export-to-GDP ratios. Whereas South Korea’s export-to-GDP ratio of 2.3 was well below the Latin American figures in 1963, its export-led growth policies resulted in a ratio of 35.4 in 1988, exceeding the ratios of the Latin American NIEs. The 1988 export-to-GDP ratios for Singapore (164.2), Taiwan (51.8), and Hong Kong (51.1) were much higher than the Latin American ratios. There were also striking differences in the composition of exports, with Taiwan, South Korea, and Hong Kong each producing more manufactured exports than all of Latin America by the late 1980s.  

The East Asian NIEs had a few years of reduced growth during the 1980s foreign debt crisis (see Chapter 11), but they did not have to seek debt rescheduling and soon adjusted their economies and resumed rapid growth rates. Although the East Asians had about the same debt-to-GDP ratios as other oil importers, their debt-to-export ratios were much lower. Their healthy export positions, combined with large infusions of foreign investment (especially from Japan), provided sufficient revenue so they could continue their debt payments without depending on IMF and World Bank loans. The Latin Americans following ISI, by contrast, were more severely affected by the debt crisis and had to seek substantial IMF and World Bank funding. As we will discuss, the East and Southeast Asian economies encountered economic problems that became starkly evident in the late 1990s. However,
just as ISI had been the “gospel” for LDC industrialization in the 1950s, export-led growth emerged as the new gospel for many development specialists from the 1970s to the early 1990s. Although there was a general consensus that export-led growth was more successful than ISI, scholars disagreed on the reasons for the East Asians’ success.

IPE Perspectives and the East Asian Experience

Liberals, realists, and historical materialists had different explanations for the success of East Asian export-led growth in the 1960s to 1980s. Liberal economists argued that East Asia’s export-led growth strategy was “outward-oriented” as opposed to Latin America’s “inward-oriented” ISI strategy. The East Asians were open to freer trade and competition because they did not have “the mistrust of markets and private entrepreneurship that motivates large-scale doctoring in other Asian countries and in African and South American countries.”

Thus, liberals attributed the East Asians’ success to their adoption of the open market policies of Western DCs. Realists by contrast attributed East Asia’s performance to the role of a strong developmental state “in engineering economic growth, development and success in these countries.” Although Hamilton and List had argued that late industrializers required state intervention to catch up with more advanced states (see Chapter 3), it was not until the early 1980s that Chalmers Johnson coined the phrase “developmental state” in regard to Japan and the East Asian NIEs. Realists attributed several characteristics to the East Asian developmental state:

- It provided extensive guidance to the market, controlling investment flows, promoting the development of technology, and protecting selected infant industries.
- It identified development as its main objective, encouraging citizens to increase investment rather than consumption and using repression if necessary to enforce its priorities.
- It invested heavily in education to give people the skills to be globally competitive.
- It depended on a highly skilled, technocratic bureaucracy that was committed to instituting economic reforms.

ISI and export-led growth both depended on government intervention, but realists argued that these policies differed in two respects: (1) The East Asian developmental state focused mainly on export industries, whereas ISI focused on industrialization mainly to meet domestic demand. (2) ISI protected all local industries, whereas the developmental state supported a small number of key industries most likely to succeed.

Unlike liberals and realists, world-systems theorists believed that the NIEs were not in fact achieving genuine economic development. Although the NIEs were in the semiperiphery, they were simply “more advanced exemplars of dependent development,” still dependent on states in the core.
Thus, André Gunder Frank argued that NIEs producing end products such as shirts, radios, or automobiles were “increasing their dependent integration into a worldwide division of labor . . . in which they are allocated the least remunerative and technologically obsolete contribution.”  

A fourth group of theorists explained the East Asian success in terms of political culture, or widely shared social values that affect a state’s political economy. They argued that the realist focus on the state was insufficient because “the nature of . . . society is important in determining whether or not state policies are effective.” The political cultures of Japan, China, and the East Asian NIEs are influenced by Confucian philosophy, which is supportive of an economic development model based on collective values, respect for authority, hard work and enterprise, strong kinship ties in entrepreneurship, and a benevolent state staffed by highly educated individuals. Thus, Confucianism was a key factor explaining the success of Japan and East Asia in promoting economic development.

Most analysts opted for the realist model of the strong developmental state as the best explanation for East Asia’s rapid economic growth. However, the Asian financial crisis of the late 1990s raised serious questions about all of these models and demonstrated “how rapidly an informed consensus can change.” A financial crisis can be defined as an escalation of financial disturbances such as sharp decrease in asset prices, the failure of large financial intermediaries, and disruption in foreign exchange markets. The crisis often results in decreased employment, purchasing power, and production, and the possibility that many people, firms, and governments are unable to meet their financial obligations.

The Asian Financial Crisis

In 1993 the World Bank issued a report on The East Asian Miracle which examined the region’s “remarkable record of high and sustained economic growth” from 1965 to 1990, and a number of analysts began to refer to the East Asian “miracle economies.” As discussed, economists could not agree on a satisfactory explanation for the East Asian success, and the term miracle implied that “the phenomenon was beyond purely scientific explanation.”

Although East Asia’s rapid growth continued into the 1990s, by 1996 there were signs of lower earnings, slower export growth, and surplus industrial capacity. For example, problems emerged in Thailand’s real estate and financial sector, several large South Korean enterprises or chaebol failed, and the Japanese economy continued to stagnate. In 1997 there was a massive run on Thailand’s baht currency, causing a sharp downturn in the baht’s value, and in the country’s growth and assets. Thailand’s problems also spread to neighboring countries such as Indonesia, Malaysia, South Korea, the Philippines, and Singapore. Foreign investors lost confidence in their currencies, and the most severely affected economies had to seek IMF and World Bank loans. By 1999 the worst part of the financial crisis was over, and the region began to recover as U.S. and European demand for East Asian exports increased. Although there was growing
Confidence in the future of East Asian economic growth, the economies were slow to institute some needed economic reforms, and they continued to be vulnerable to changing economic conditions.\textsuperscript{71} The following discussion examines the reasons for the East Asian shift from “miracle” to “meltdown” status and the effects of the financial crisis on international development strategies. (Chapter 11 discusses the effects of the financial crisis on the IMF’s role and the need for a new international financial architecture.)

The East Asian financial crisis caused some analysts to question whether the “miracle” was over or whether it had even occurred, and economists that had tried to explain the rapid East Asian growth “now struggled to explain the ‘meltdown.’ ”\textsuperscript{72} Historical materialists had questioned whether the East Asian economies were achieving genuine, autonomous development, and they believed that the financial crisis added weight to their arguments. Although the strong developmental state contributed to rapid East Asian economic growth in the 1970s and 1980s, this growth was highly dependent on U.S. and Japanese policies. Taiwan and South Korea had special linkages with the United States because of their strategic location vis-à-vis the Soviet Union and China; thus, the United States provided them with military and economic aid and opened its market to their exports while permitting them to follow protectionist policies. East Asian economic growth also stemmed from special linkages with Japan. Japanese colonialism had created the social foundations for industrialization in East Asia, but also the basis for dependency relations. When the Japanese yen increased in value as a result of the 1985 Plaza Agreement (see Chapter 6), Japanese companies invested in East Asian subsidiaries to take advantage of cheaper costs of production. These Japanese investments helped East Asia avoid the worst effects of the debt crisis that ravaged Latin America and Africa during the 1980s (see Chapter 11).

In the late 1980s, however, East Asia’s dependence on the United States and Japan began to have some major drawbacks. For example, the United States responded to its growing balance-of-payments deficits by becoming more protectionist, and South Korea and Taiwan offered concessions because of fears that the United States would retaliate against what they considered to be “unfair” trade practices. With the breakup of the Soviet bloc and the decline of the Cold War, the United States was also less willing to supply large amounts of aid to South Korea and Taiwan. In sum, changes in the United States’ economic and strategic position made it less willing to provide the East Asian NIEs with support. East Asian development was also fragile because of the region’s dependence on Japan. Although East Asian industrial exports to the West were increasing, the goods were often produced by Japanese subsidiaries, designed in Japan, composed of imported Japanese components, and dependent on Japanese technology. For example, South Korea’s automobile industry depended on Japanese auto parts and advanced technology. When Samsung, a large Korean industrial conglomerate, received government approval to enter the auto industry in 1994, it planned to import the advanced technology it needed from Nissan in Japan.\textsuperscript{73} Although the East Asians had trade surpluses with the West, they had growing trade deficits with Japan.
The depreciation of the Japanese yen relative to the U.S. dollar in the 1990s put downward pressure on East Asian currencies, many of which were pegged (at least partly) to the U.S. dollar. As Japanese exports became more competitive and Japan’s imports from East Asia declined, problems of indebtedness and lack of competitiveness in the region increased. The financial crisis began when Thailand had to float its baht currency in 1997 (the baht had been pegged to a basket of currencies, with the U.S. dollar the most important).74

Realists and liberals viewed the historical materialist contention that East Asians had not achieved genuine, autonomous development as unduly negative. As discussed, East Asia had largely recovered from the financial crisis by 2000, and there was renewed confidence in economic growth in the region. Even if the East Asian NIEs had not been miracle economies, they had developed rapidly for several decades, and their economic development has resumed. It is therefore important to discuss the liberal and realist perspectives. In 1968, Samuel Huntington argued that authoritarian governments provided stability and order in developing societies and that democracy was a luxury to be introduced at a later time.75 Although authoritarian East Asian developmental states limited individual freedom, realists point out that these governments oversaw some marked improvements in economic growth and prosperity. Liberals by contrast attributed the East Asian financial crisis to this pervasive role of governments and government–business linkages in the region. In their view, the 1990s financial crisis revealed that authoritarian developmental states were not as efficient and immune to political pressure as realist writers maintained. For example, authoritarian states and close government–business linkages contributed to widespread nepotism, and the operation of banks and access to credit depended more on political connections than on market forces. Thus, lenders and foreign investors expanded credit without sufficient safeguards to risky borrowers, and huge sums were spent for questionable building and real estate projects without clear sources of financing. These inefficiencies challenged the realist contention that East Asian authoritarian states promoted development.

Whereas liberals questioned the benefits of developmental states, realists questioned liberal claims that the East Asians benefited from economic interdependence. Indeed, realists argued that “deeper financial integration” was a “necessary condition” for the East Asian financial crisis.76 Most East Asian economies had opened their capital accounts, and the region received a dramatic increase of international capital inflows during the early 1990s. The financial crisis resulted from the vulnerability of these economies to the massive reversal of these capital flows. Deeper financial integration also contributed to a contagion effect in which creditors engaged in speculative attacks on currencies not because of economic fundamentals but because of the actions of other creditors.77 Realists, historical materialists, and some liberals also charged that the liberal economic emphasis on composite statistics such as the growth in GDP and per capita GDP led to an overestimation of East Asian development. In their view, the rapid East Asian economic growth in the 1980s and early 1990s resulted from increased labor and capital inputs
rather than increased efficiency. Thus, Paul Krugman has argued in reference to the East Asian economies that

sustained growth in a nation’s per capita income can only occur if there is a rise in output *per unit of input*. Mere increases in inputs, without an increase in the efficiency with which those inputs are used—investing in more machinery and infrastructure—must run into diminishing returns; input-driven growth is inevitably limited.  

Environmentalists have also argued that rapid East and Southeast Asian economic growth is not sustainable in the long term. In Indonesia, logging practices are contributing to a deforestation rate of 2.4 million hectares per year; in the Malaysian state of Sarawak, loggers have removed 30 percent of the forest area in 23 years; and in Vietnam, resources are being exported with little concern for social and environmental consequences. As discussed in Chapter 5, *sustainable development* is a policy that “meets the needs of the present without compromising the ability of future generations to meet their own needs.”

LDCs often argue that they cannot afford to divert resources from their immediate development to pay the costs for environmentally friendly policies; they also point out that DCs did little to protect the environment when they were developing and that the North produces more pollution than the South. However, countries that disregard the effects of environmental degradation will not be able to sustain their economic growth rates in the long term.

The export-led growth model has a number of strengths, and the East Asian developmental state outperformed other LDCs according to most economic indicators in the 1970s and 1980s. However, the East Asian financial crisis demonstrated that the export-led growth strategy also has weaknesses. The IMF, World Bank, and most industrial states strongly supported another development strategy in response to the 1980s foreign debt crisis and the 1990s Asian financial crisis: the orthodox liberal model. (We discuss the 1980s foreign debt crisis in Chapter 11.)

**THE REVIVAL OF ORTHODOX LIBERALISM**

Two characteristics are critical for the effective functioning of the developmental state: a highly skilled technocratic bureaucracy and close cooperation among major economic groups such as agriculture, business, and labor. However, most LDCs “lack the highly professional merit-based bureaucracies and the tradition of cooperation between key economic actors that would permit them to replicate the East Asian model.” Developmental states also have been rather authoritarian in guiding the economy and controlling labor, business, and other private groups; but today globalization pressures are causing democracy (in a political sense) to spread throughout the world. The most important constraint on replicating the developmental state model was the revival of orthodox liberalism. In line with the new orthodoxy, critics charge that the IMF and World Bank viewed “the market rational/market
ideological approach” as “the only correct course for development.” The shift to the right by British prime minister Margaret Thatcher and U.S. president Ronald Reagan in the late 1970s and 1980s resulted in a strong attack on realist or statist development strategies in the South. Thus, the Reagan administration, the U.S. Treasury, the Federal Reserve, and the international financial institutions responded to the 1980s foreign debt crisis by becoming powerful advocates of what later became known as the Washington consensus. The Washington consensus refers to the belief that “the combination of democratic government, free markets, a dominant private sector and openness to trade is the recipe for prosperity and growth.” (This is not what John Williamson meant by the term when he coined it in 1989.) In applying the Washington consensus to the 1980s foreign debt crisis, the IMF and the Bank provided structural adjustment loans (SALs) on the condition that recipients control inflation, decrease government spending, balance their budgets, privatize state-owned enterprises, deregulate financial and labor markets, and liberalize their trade and investment policies.

Structural Adjustment and the Theoretical Perspectives
A number of LDC debtors implemented World Bank and IMF–financed structural adjustment programs (SAPs) during the 1980s, and the South became “a laboratory for a huge experiment” in promoting economic development through orthodox liberalism. Studies of the effects of SAPs in Sub-Saharan Africa demonstrate the wide range of views regarding the effects of structural adjustment. For example, one study concluded that “the performance of poor compliers deteriorates over time and is significantly worse than the performance of countries that comply” with the SAP conditions; a second study found that LDCs that followed World Bank structural adjustment policy conditions most closely “failed to grow as quickly as several less compliant African economies during the same period”; and a third study argued that SAPs “over the past decade are leading to the destruction of the [African] continent . . . with the failure of the state being an immediate outcome and environmental deterioration being devastating in the long run.” In view of these conflicting perceptions, this section briefly discusses SAPs and the theoretical perspectives.

Historical materialists believe that SAPs are not “simply an innocuous remedial package for sustained growth and development,” but “an almost deliberate scheme for the perpetuation of export dependency . . . and reproduction of existing conditions of global inequality.” The SAPs will not alleviate the South’s problems because the IMF and World Bank caused the LDC debt problems in the first place. Whereas historical materialists are the harshest critics of structural adjustment, orthodox liberals are the strongest supporters. They believe that SAPs provide the necessary prescriptions and discipline based on the Washington consensus to deal with LDC debt problems. Interventionist liberals agree with orthodox liberals that SAPs are often necessary to combat domestic inefficiencies and corruption in LDCs; but they are more receptive to state interventionism and believe that the World
Bank and IMF should be more sensitive to the effect of SAPs on the poorest groups and states.\textsuperscript{88} Realists view the World Bank and IMF’s emphasis on downsizing government through privatization, deregulation, and trade liberalization as misguided because late industrializers require government intervention to catch up with the leading powers. Despite these differing perceptions, many analysts would agree that SAPs had serious problems in the 1980s and 1990s. After referring to some strengths of the SAPs, a discussion of their problems follows.

Structural Adjustment and Questions About Orthodox Liberalism

The World Bank’s SAPs were most effective in middle-income LDCs that export manufactures, such as Brazil, Morocco, the Philippines, South Korea, Thailand, and Uruguay. These states had more developed institutions for implementing policy reforms and better resilience in dealing with the disruptions resulting from structural adjustment policies. Thus, liberal studies indicate that SAPs in middle-income LDCs sometimes contributed to lower government budget deficits, increased export earnings, more financing for private investment, and greater economic growth and efficiency. However, the effects of SAPs on the poorest LDCs and the poorest groups within LDCs were a more contentious issue. The Bank endorsed liberal economic views that benefits from the efficient allocation of resources under free markets would “trickle down” to the poor. However, critics rejected this trickle-down theory and argued that the poorest groups had to bear the largest share of the adjustment burden. The persistence or exacerbation of poverty in low-income LDCs and the poorest within LDCs gave credence to these criticisms and eventually forced the Bank to alter its approach.\textsuperscript{89} Critics also charged that the emphasis of SAPs on privatization and deregulation did not address the need for effective LDC governments and that the Bank’s “top-down” approach to structural adjustment did not address the need for local participation in “owning” policies and implementing reforms. The following sections examine these criticisms by focusing on an LDC region (Sub-Saharan Africa) and a group within LDCs (women). We then discuss the World Bank’s attempts to address the problems by altering its policies.

Structural Adjustment and Sub-Saharan Africa

Some of the strongest criticisms of structural adjustment relate to its effects on Sub-Saharan Africa (“Africa” in this section). More than two-thirds of African states received SALs in the 1980s, but by the end of the decade structural adjustment had produced little improvement. During the 1980s per capita growth in Africa contracted at an annual rate of 2.2 percent, external debt tripled, and debt service accounted for 25 percent of goods and services exports. Per capita income at the end of the 1980s was lower than it had been in 1960, and government deficits rose from 2 percent in 1980 to more than 6 percent at the end of the decade. It is not surprising that the 1980s have been described as a lost decade for Africa.\textsuperscript{90}
Liberal economists argue that SAPs are often blamed for problems caused by general economic deterioration. Thus, the World Bank and IMF were simply reacting to the foreign debt crisis, which resulted from inefficient LDC economic policies and global economic changes such as the 1970s oil crisis. Furthermore, African problems such as political instability, civil wars, and famine are difficult to resolve, and African economic conditions would be even worse without IMF and World Bank SAPs. The Bank and IMF market-led prescriptions are the best strategies for eliciting adjustment and growth, because state-led strategies such as ISI were unsuccessful. However, critics argue that SAPs in Africa put too much emphasis on market-oriented policies and impose the largest costs on the poorest groups and states. IMF and World Bank demands that LDC debtors privatize, deregulate, and downgrade the role of the government ignore the fact that the public sector provides a critical source of employment for African LDCs. As government capacity declines, infrastructure such as transportation and communications, and services such as health care and education also suffer.

Furthermore, the emphasis on privatization does not address the fact that private firms are unwilling or unable to supply public goods required for development. LDCs rely on government to provide resources for education and other aspects of human capital necessary for industrialization and competitiveness. Critics also oppose the emphasis SAPs put on trade liberalization. Although Latin American and East Asian LDCs reap some benefits from freer trade, there are few benefits for lower income African and Asian LDCs. Domestic industries in Latin America and East Asia can often compete with growing imports because these states have sheltered their industrial producers for lengthy periods. African LDCs, by contrast, are only beginning to industrialize and require protection for their infant industries. World Bank and IMF market-based prescriptions harm Africa because most African LDCs are at an early stage of development and require a substantial role for the government.

Structural adjustment funds for privatization also had unintended consequences in contributing to corruption in many African states. Some African leaders sold “government assets to political cronies and select businessmen at minimum prices on highly favorable terms, including low-interest loans and lengthy pay-off periods.”

Structural Adjustment and LDC Women

Another criticism of IMF and World Bank SAPs is that they have disregarded gender issues. Gender inequality and the exploitation of women are evident in almost all societies, and therefore it is not possible for SAPs to be gender neutral. By disregarding the subsidiary role of women, SAPs reinforce male bias and exacerbate the problems confronting LDC women. The positions of LDC women vary widely as a result of diverse cultural values, historical factors, levels of economic development, and types of government. Women in the same society may also occupy vastly different positions depending on their social class and ethnicity. Nevertheless, it is possible to generalize about the challenges facing most LDC women:
In the household, women spend more time than men on unpaid subsistence work such as child care, food production and preparation, health care, and education.

Outside the home, more women than men work in the informal sector of the economy, which has little government regulation. Most informal-sector workers are service providers such as food stall operators, market traders, messengers, and shoe shiners, whose earnings are well below those in the formal sector.

In the formal sector, women are more concentrated in lower skilled, lower wage occupations, and they often receive lower salaries than men for doing the same work.

Women are more important in agricultural labor and less important in industry than men. In Africa, women produce about 90 percent of the food but are less important in the production of export crops.

In view of women’s lower wages in the formal sector and their overrepresentation in agriculture, the informal sector, and household work, women tend to have lower incomes than men. Households where women are the sole breadwinners are among the poorest groups in LDCs.93

World Bank policy prescriptions are based on macroeconomic concepts relevant for the economy as a whole rather than individual firms or households. The Bank gives little attention to the effect of its structural adjustment policies on women’s work because much of women’s time is spent doing unpaid subsistence work in the household, which does not appear in production statistics. For example, SAPs usually call for cutbacks in government spending, leading to decreased public funding for health, education, and water and sanitation facilities. Much of the burden of health care and education therefore shifts to the community and household, where women have most of the responsibilities. The World Bank and IMF also often pressure LDCs to lower government deficits by phasing out food subsidies. The higher food costs force women to use cheaper foods that take longer to prepare, such as coarse grain and root crops, and to bake at home rather than purchasing bread. Furthermore, hospitals may cut their costs by shifting care to the unpaid economy of the household. Whereas the Bank views cutbacks in government spending as a sign of increased efficiency, the costs are simply shifted to the unpaid economy where women do most of the work.94

Even if women worked only in the household, the off-loading of government services and subsidies would place unreasonable burdens on them. The need for income, however, “has forced women into the labor force to protect their families’ survival.”95 Thus, the share of women in the labor force rose in Asia from 29 percent in 1950 to 33.8 percent in 1985, and in Latin America from 18 to 24.2 percent. Women have often fared poorly in the labor force under SAPs. In Africa, for example, farmers are paid higher prices to encourage them to produce more crops for the export market; but men tend to produce the cash crops, and women produce the subsistence food crops. Men also market most of the crops produced, and women do not benefit from the increased prices
because men often keep most of the revenue for themselves. In sum, critics argue that SAPs affect women adversely in their multiple roles as mothers, household managers, community leaders, and wage earners. To confront the problems that SAPs pose for LDC women, it is necessary to dispel the myth that such programs are gender neutral.

**ANOTHER SHIFT IN DEVELOPMENT STRATEGY?**

In the late 1980s and 1990s, the World Bank became more responsive to criticisms of its structural adjustment policies and reassessed its orthodox liberal approach to development. To determine whether there has been another shift in the Bank’s development strategy, it is necessary to discuss the Bank’s reassessment of its approach to the role of the state in development, the poorest groups and LDCs, and the “top-down” imposition of conditionality based on the Washington consensus. The Bank’s reassessment can be divided into two periods: from the late 1980s to 1994 and from 1995 to the present.

**The Late 1980s to 1994**

In the late 1980s to 1994, the Bank began to reassess its approach to the role of the state in development and to the poorest LDCs and most vulnerable groups. The Bank did not want to veer too far from its market-oriented views, but it began to recognize that the state would have to play a major role in dealing with problems in the least developed countries. In 1989 the Bank “explicitly acknowledged for the first time” that Africa’s problems “had political as well as economic roots,” and that Africa needed “not just less government but better government.” In its 1991 *World Development Report*, the Bank also acknowledged that “governments need to do more in those areas where markets cannot be relied upon” such as health, education, family planning, and poverty alleviation. However, the 1991 report added that state intervention had to be market conforming to have a positive developmental impact, and that “governments need to do less in those areas where markets work, or can be made to work.”

Japan, as an important aid donor and foreign investor, viewed the changes in the 1991 report as inadequate, and it insisted that the Bank give more recognition to the East Asian developmental state model. After all, Japan could not “be expected to fund a set of policies, and an underlying ideology” that denied “its own experience of having been heavily interventionist.” As a result, the Bank published a 1993 policy research report on *The East Asian Miracle: Economic Growth and Public Policy* (henceforth, “the report”) examining the reasons East Asia had such “a remarkable record of high and sustained economic growth.” The report recognized the value of government intervention in some circumstances, noting that Japanese, Korean, and Taiwanese government policies of allocating credit to high-priority activities “may have been beneficial.” (Some observers saw this as a necessary concession to Japan’s Ministry of Finance, which financed the report.) However, most of the report
questioned the value of government-directed industrial policy, indicated that the East Asian model might not be successful elsewhere, and cautioned that East Asia’s successes should not “be taken as an excuse to postpone needed market-oriented reform.” The report also claimed that Malaysia, Thailand, and Indonesia (unlike the Northeast Asian economies) achieved rapid economic growth without an industrial policy and that other LDCs should emulate Southeast Asia. In sum, the Bank’s approach to the state’s role in development did not change significantly during the early 1990s. Although the report gave more recognition to government involvement in East Asian development, it attributed the East Asian success mainly to a liberal market-friendly approach.

The Bank also began to focus more on the poorest LDCs and most vulnerable groups. The Bank (and the foreign aid community) has gone through four phases of thought on poverty reduction. In the first phase from 1945 to the late 1960s, the Bank financed large infrastructure projects to provide LDCs with transportation and communication facilities, port development, and power projects. Bank officials believed that large transfers of capital and technology would contribute to industrial development, employment, and a reduction of poverty. This is the *trickle-down approach* to development aid, which assumes that prosperity will “eventually trickle down from the top, alleviating the problem of poverty at the bottom.” Although LDCs achieved rapid economic growth in the 1960s, the large capital-intensive projects bypassed the neediest and increased income disparities within LDCs. Bank president Robert McNamara responded by ushering in the second phase in the 1970s with a commitment to reducing poverty through a *basic needs* approach. Accordingly, the Bank developed a limited number of projects that provided health, educational, and family planning services to the poor; gave special attention to women and the poorest LDCs; and increased lending for agricultural and rural development, low-cost urban housing, and primary and nonformal education. However, the Bank’s (partial) shift to basic needs by targeting the poor was more difficult than anticipated, and orthodox liberals argued that the basic needs approach distracted attention from the need to promote economic growth.

Disillusionment with the basic needs approach along with significant global changes in the 1980s—the foreign debt crisis and the return of orthodox liberalism—ushered in the third phase of the Bank’s approach to poverty. The third phase in the 1980s was similar to the first phase in the 1950s and 1960s when the Bank relied on trickle-down theories of poverty reduction. However, the third phase put much more emphasis on orthodox liberal reforms. SAPs during the 1980s were conditioned on the implementation of neoliberal policies such as privatization, deregulation, and trade liberalization, and the basic needs of vulnerable groups were largely forgotten. Throughout the 1980s, there was growing pressure on the Bank to consider the distributional effects of structural adjustment. For example, a 1987–1988 United Nations Children’s Fund (UNICEF) study entitled *Adjustment with a Human Face* argued that it was necessary to include a “poverty alleviation dimension” in adjustment programs. This pressure eventually resulted in a fourth phase of Bank thinking on poverty, which began in the late 1980s.
The fourth phase is similar to the second phase in which the Bank devoted more attention to basic human needs and poverty reduction. For example, in 1989 the Bank acknowledged that “Sub-Saharan Africa has now witnessed almost a decade of falling per capita incomes and accelerating ecological degradation” and that there was a need for “special measures . . . to alleviate poverty and protect the vulnerable.”\textsuperscript{108} The Bank also devoted its 1990 \textit{World Development Report} to poverty and began to redesign its SAPs to decrease adverse effects on the poor.\textsuperscript{109} One indication of the Bank’s renewed interest in poverty reduction was its increased attention to \textbf{microfinance}. Microfinance refers to the provision of low-cost, short-term financial services, mainly savings and credit, to poor households that do not have access to traditional financial institutions. In the late 1970s, there was growing recognition that the lack of access to financial services prevented the working poor from improving their lives. A number of microfinance institutions (MFIs) were established at this time to lend money to the poor; the most well-known was the \textit{Grameen Bank}, which Professor Muhammad Yunus established in Bangladesh in 1976. In the 1990s, the donor agencies began to view microfinance as a key strategy in poverty reduction; and in 1993, the World Bank provided an initial grant of $2 million to support international replication of the Grameen Bank model. Many critical as well as liberal theorists supported microfinance. Whereas critical theorists liked “the ‘bottom-up’ aspects, attention to community, focus on women, and . . . the aim to help the underserved,” liberals liked “the prospect of alleviating poverty while providing incentives to work, the nongovernmental leadership, the use of mechanisms disciplined by market forces, and the general suspicion of ongoing subsidization.”\textsuperscript{110}

However, the Bank has never been fully committed to a poverty focus. In view of its sources of finance, tension continued to exist in the Bank between pressures for neoliberal reforms on one hand and concerns with the state and poverty on the other. In December 1994, the Bank had to directly confront the shortcomings of its development approach when Mexico encountered a serious financial crisis. Mexico had implemented an economic strategy based largely on the Bank’s neoliberal model and had signed the NAFTA with the United States and Canada. Critics also charged the Bank with being more interested in loan approval than development effectiveness and accountability, with lending to corrupt governments such as the Suharto regime in Indonesia, and with devoting too little attention to the social and environmental effects of its projects.\textsuperscript{111} On the fiftieth anniversary of the Bretton Woods agreements in 1994, NGOs launched a “Fifty Years Is Enough” campaign, which strongly criticized the Bank for failing to alleviate poverty and promote environmentally sustainable development. At the same time, the Bank faced new challenges to its financial influence. Whereas private capital flows to LDCs increased from $40.9 billion in 1990 to $256 billion in 1997, multilateral and bilateral development assistance declined from 57 to only 15 percent of all net financial flows to LDCs. Thus, the Bank had to alter its approach to development if it was to continue to be an effective development institution.\textsuperscript{112}
Another Shift in Development Strategy?

1995 to the Present

When James Wolfensohn was appointed the new Bank president in June 1995, he “promised to revolutionize the Bank and finish the . . . business of internal reform long overdue.” In efforts to prepare the Bank for a role in the twenty-first century, Wolfensohn first addressed the issues of corruption, HIV/AIDS, the role of women, and the information revolution. Corruption had been a taboo subject because the Bank was not supposed to delve into politics, but Wolfensohn argued that corruption interfered with development and therefore had to be a Bank concern. Despite resistance from many Bank member states as well as Bank staff, Wolfensohn also increased the Bank’s involvement in HIV/AIDS programs. Furthermore, Wolfensohn focused on upgrading the role of women in the Bank’s professional staff and in LDCs, and he pressed the Bank staff to take more leadership as a source of information on development ideas.

Second, Wolfensohn’s appointment of Joseph Stiglitz as senior vice-president and senior economist of the Bank also signaled a change in the Bank’s approach to poverty reduction, the state’s role in development, and the top–down imposition of conditionality. Stiglitz, who was formerly chair of the U.S. Council of Economic Advisors, had called for limits to privatization and a stronger state role in development.

In regard to the state, the Bank’s 1997 World Development Report argued that state minimalism “is at odds with the evidence of the world’s development success stories,” and described development as requiring “an effective state, one that plays a catalytic, facilitating role, encouraging and complementing the activities of private businesses and individuals.” The 1997 report also indicated that Africa had to “rebuild state effectiveness . . . through an overhaul of public institutions, reassertion of the rule of law, and credible checks on abuse of state power.” However, the report warned against state-dominated development and called for “a contraction of the role of the state” in South Asia, because overregulation was “both a cause and effect of bloated public employment and the surest route to corruption.” Regarding poverty, in 1995 the Bank helped create a Consultative Group to Assist the Poorest (CGAP), a multi-donor effort to increase the resources for microfinance. The Bank also consulted about 60,000 poor people in more than 50 states for a Voices of the Poor study, and the theme of the Bank’s 2000–2001 World Development Report was “Attacking Poverty.”

A third change was Wolfensohn’s introduction of a Comprehensive Development Framework (CDF). The CDF took a more holistic approach than structural adjustment, emphasizing the linkages among the economic, social, and institutional aspects of development. Unlike the top–down coercive conditionality of structural adjustment, the CDF was a consultative framework for development finance that emphasized partnership among the Bank, recipient governments, and civil society. Structural adjustment lending was eventually replaced with the Poverty Reduction Strategy Papers (PRSPs) approach, which relies on the consultative methods of the CDF. PRSPs are documents required by the IMF and World Bank before a country can be considered for debt relief.
In line with the CDF approach, the PRSPs are prepared by member countries through a participatory process involving domestic stakeholders as well as the IMF and World Bank. The PRSPs describe the economic and social policies a country will pursue over several years to promote growth and reduce poverty, along with the country’s external financing needs.\textsuperscript{119}

Despite the Bank’s expressed intentions to move away from the Washington consensus, there are reasons to question the degree to which it is actually shifting policy. First, to satisfy critics, the Bank has broadened its objectives to include poverty reduction, governance, democratic development and human rights, women in development, the environment, corruption, and microfinance; these are all positive objectives, but they have overloaded the Bank’s agenda.\textsuperscript{120} Second, global events sometimes constrain the Bank’s ability to alter its strategies. For example, the 1997\textit{World Development Report} on the need for an effective state was released shortly before the East Asian financial crisis. Orthodox liberals argued that the crisis demonstrated the weakness of East Asia’s developmental state model, and Japan’s economic problems added weight to their arguments. Third, the Bank remains subject to major constraints by its financial supporters. Stiglitz asked a development economics professor—Ravi Kanbur—to oversee the writing of the 2000–2001\textit{World Development Report} on attacking poverty, but the United States, the Bank, and the IMF charged that the draft report de-emphasized economic growth. Some Bank members also viewed the Bank’s CDF as “a capitulation to NGOs,” and critics argue that the Bank and IMF have used the PRSPs (which supplanted the CDF) simply to “co-opt the activist community and civil society into supporting the same traditional policies.”\textsuperscript{121} Stiglitz and Kanbur eventually left the Bank in response to the complaints of major donors, and critics see this as further evidence of the Bank’s “persistent failure . . . as a collective entity, to act in accordance with its ideals.”\textsuperscript{122}

At the end of Wolfensohn’s term, Paul Wolfowitz replaced him as the next Bank president. Wolfowitz was Bank president for only two years (2005–2007) in a period marked by controversy. He came to the Bank amid strong protests over his role as a key architect of U.S. military operations in Iraq and Afghanistan. During his tenure, Wolfowitz alienated many Bank staff members by attempting to run the Bank through personal aides and by remaining too closely tied to U.S. policies. He tried to continue Wolfensohn’s campaign against corruption in LDCs, but his actions were taken “without sufficient consultation and engagement of the World Bank staff or . . . its Board and shareholders.”\textsuperscript{123} Thus, there was little sympathy for him when he was accused of offering special favors to a Bank employee with whom he had a special relationship, and he was forced to resign. Despite wide calls for an open selection process, the United States wanted to continue appointing the Bank president, and Europeans supported this because of their wish to continue appointing the IMF Managing Director. In July 2007, Robert Zoellick, former U.S. trade representative and deputy secretary of state, became the next Bank president.
Although Zoellick has done much to smooth tensions in the Bank related to his predecessor, he will have to continue redefining the Bank’s role if it is to continue to influence development policy. A number of LDCs—especially in Latin America—are dissatisfied with the Washington consensus and are reassessing their own development strategies. In the 1980s, there was great hope that Latin America’s acceptance of market economics and democracy, combined with the United States’ decreasing emphasis on security matters, would result in more cooperative linkages. For example, there were predictions that a Free Trade Area of the Americas (FTAA) would produce much closer ties in the Western Hemisphere. However, the FTAA talks collapsed and there was a backlash in some Latin American countries “against the predominant trends of the last 15 years: free-market reforms, agreement with the United States on a number of issues, and the consolidation of representative democracy.”

A major reason for this change was that political and economic reform in Latin America did not achieve the desired results. China, India, and Malaysia had economic growth rates well above those of Latin America, which continued to be the world’s most unequal region in the distribution of wealth.

Defenders of the Washington consensus attribute Latin America’s economic problems to poor policy decisions and the inadequate implementation of liberal reforms. However, critics of the Washington consensus point to the pitfalls of an unrestrained free market, the dislocations associated with privatization and trade liberalization, and the environmental costs of orthodox liberal reform. Whereas historical materialists want to expand the state’s role in development, interventionist liberals argue that the state and the market complement each other. Thus, they call for a post-Washington consensus, in which the state would help overcome market failure, and open markets and democratic governance would help prevent state failure. Two left-wing currents have emerged in Latin America. The more extreme current in Venezuela and Bolivia is populist, nationalist, and stridently anti-American. The more moderate current in Chile, Uruguay, and Brazil emphasizes social policy within a market framework and rarely takes disagreements with the United States “to the brink.” Interventionist liberals argue that willingness to accept a post-Washington consensus based on state-market complementarity may encourage the moderate current in Latin America.

**Considering IPE Theory and Practice**

The postwar period has generally been marked by prosperity and economic growth for DCs of the North, but this has not been the case for the poorer LDCs and peoples in the South. The “South” is also increasingly diverse, with emerging economies such as China, India, Brazil, and South Korea at one end of the spectrum, and LLDCs in Africa and Asia at the other end. This chapter examines the strategies LDCs have used to promote their economic development and discusses the important role the
World Bank has played as the largest multilateral development organization in framing debates on these strategies. The discussion of ISI, socialist, export-led growth, and orthodox liberal models provides some basis for drawing conclusions about the most appropriate development strategies.

First, all the development strategies have shortcomings, and one is unlikely to find the “perfect” strategy. Development is a more difficult and complex process than Walt Rostow had indicated in *The Stages of Economic Growth*. Rostow’s claim that an LDC’s growth would become self-sustaining when it reached the “takeoff stage” raised false hopes that economic development was a readily achievable and irreversible process. As new development strategies emerge, there is always the danger of raising unrealistic expectations. For example, some analysts argue that “too much is claimed for microfinance, and that expectations are grossly exaggerated.” Despite the advantages of microfinance in reaching the poor, it is criticized for encouraging poor households to accept loans they may not be able to service, and for focusing on credit and loans when people have more need for savings and insurance. Microfinance also has limitations in reaching the poor. Although the 1997 Microcredit Summit in Washington, DC, launched a nine-year goal of reaching 100 million of the world’s poorest families, microfinance levels have fallen far short of this goal.

Export-led growth resulted in rapid growth rates in the East Asian NIEs in the 1960s to 1980s, and China has used this strategy to good effect in promoting its exports and building up the largest monetary reserves of any state. However, Japan’s export-led growth strategy left it too dependent on export markets for promoting its growth, and China has also done too little to build up a large domestic market so it can become less dependent on exports. China’s manipulation of its currency to support its export-led growth has also been a major factor contributing to the huge trade imbalances in the global economy that pose a serious threat to global economic stability today. In today’s interdependent world, it is important to consider the external as well as international effects of the development strategies adopted by large LDCs such as China. In sum, no development strategy may be adequate by itself, and LDCs may need to employ a combination of strategies.

Second, whereas liberals emphasize the need for domestic changes to achieve economic growth, historical materialists focus on the need to alter international relations (e.g., relations of dependency). In reality, economic development is a complex process that requires both domestic and international changes. Only a small number of LDCs such as the East Asian NIEs and more recently China and India have been able to meet both the domestic and international requirements for rapid economic development; the 1990s East Asian financial crisis shows that such rapid growth may be subject to setbacks (see Chapter 11). Third, the same development strategy is neither feasible nor desirable for all LDCs. Although East and Southeast Asian LDCs achieved impressive economic growth rates as developmental states, it is unlikely that many other LDCs could emulate their experience. The East Asian NIEs’ success resulted from a confluence of favorable external and domestic circumstances, such as U.S. and Japanese support and the presence of highly skilled,
Another Shift in Development Strategy?

technocratic government bureaucracies. These characteristics are often lacking in poorer African and Asian LDCs. The return to liberal orthodoxy in the 1980s also prevented many LDCs from following state-led growth policies. Instead, IMF and World Bank SAPs have pressured LDC debtors to engage in deregulation, privatization, and other measures to downsize the role of the state.

Fourth, negative experiences with IMF and World Bank SAPs have pointed to the pitfalls of focusing on the economic aspects of development without looking at the social and human aspects. The UNDP began publishing a *Human Development Report* in 1990 to emphasize that there is “no automatic link between growth and human development.” The human development approach assesses development not only in terms of a country’s per capita GDP growth but also in terms of life expectancy; health and sanitation; education; employment; and the income, gender, and rural–urban gaps. The IMF and World Bank also at first overlooked the environmental implications of SAPs. They simply assumed that by stimulating market-oriented reforms SAPs would lead to improved environmental management. However, critics argued that IMF and World Bank prescriptions such as currency devaluation and the removal of trade and investment restrictions would increase unsustainable exports of natural resources and pollution-intensive foreign investment in LDCs. The Bank responded to these criticisms by devoting more attention to the linkages between economic development on one hand and human development and the environment on the other.

Fifth, an economic development strategy should strike a balance between the state and the market. Whereas ISI policies emphasize state intervention and give too little consideration to market signals, orthodox liberalism disregards the fact that late industrializers require an active role for the state. East Asian governments were adept at using state–market interactions to their advantage, and this enabled them to register some striking economic gains. However, the East Asians also sometimes substituted “political whim . . . for proper risk assessment for commercial activities,” and their failure to provide adequate banking regulations helped precipitate the 1990s financial crisis. The 2008 global financial crisis, by contrast, shows the dangers of depending on the self-regulating market, and the need for a degree of government intervention and involvement (see Chapter 11). We need to determine the amount and type of government regulation that will ensure economic stability and the proper functioning of market signals.

Sixth, an economic development strategy should take account of North–South differences in wealth and power. Between 1980 and 2001, per capita income in all regions of the South except South Asia and East Asia and the Pacific declined relative to per capita income in the North, and the debt and financial crises were a reminder of the degree to which the South is still dependent on the North. The North should be willing to support development strategies that provide the South with special and differential treatment and give it some room for independent action (within the limits of global interdependence). One possible route to greater self-sufficiency is through establishing more South–South economic linkages.

Finally, the Washington consensus has not become the only broadly accepted approach to economic development today. As discussed, negative experiences with IMF
and World Bank SAPs raised awareness that the unrestrained market is not the answer to LDC problems. The East Asians also did not totally abandon their developmental state export-led growth model after the 1990s financial crisis, and as discussed China has used the export-led growth model to good advantage. It is important to note that “contrary to expectations” the East Asian NIEs “rapidly returned to levels of growth comparable to those prior to the crisis,” and that they have “become more involved in the global financial and trading systems without fully converging to the Washington consensus norms.”  

Thus, we are in a post–Washington consensus period in which most scholars believe that market discipline must be mediated by some state involvement. In sum, the realist, liberal, and critical perspectives all have something important to say regarding development strategies. Furthermore, there is no single best development strategy for all LDCs because of major differences among these states and their positions in the world. A variety of development strategies will be pursued in the future, as they have been in the past.

**QUESTIONS**

1. Why do the DCs give official development assistance (ODA), and why have ODA levels as a percent of countries’ GNIs generally declined over the years? What are the debates regarding the effectiveness of aid-giving?
2. Why has the World Bank group been so important in a development context, and how influential has the United States been in the Bank group?
3. What are the five main institutions of the World Bank group, and what functions do they perform?
4. How would you compare the effectiveness of import substitution, socialism, and export-led growth strategies? Do you think that other LDCs could pursue export-led growth strategies as effectively as the East Asian NIEs?
5. What are structural adjustment loans, and how have they affected LDCs, women, and the poorest groups in LDCs?
6. What is the Washington consensus, and what form do you think a post-Washington consensus should take?
7. How has the World Bank tried to change its approach to development, and how successful has it been? What are Poverty Reduction Strategy Papers?
8. What do you think is the best approach to development, and why?

**KEY TERMS**

- basic needs 323
- bilateral aid 299
- capital market 302
- concessional loans 297
- consultative groups 305
- developmental state 313
- epistemic community 301
- export-led growth 311
- financial crisis 314
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- Washington consensus 318
- World Bank 301
- World Bank group 302
FURTHER READING


NOTES


32. Roy Culpeper, Titans or Behemoths? The Multilateral Development Banks (Boulder, CO: Lynne Rienner, 1997).


58. Wade, Governing the Market, p. 34.


90. Meredith, *The Fate of Africa*, p. 375.


95. Stewart, “Can Adjustment Programmes Incorporate the Interests of Women?,” p. 27.


An international debt crisis erupted in the early 1980s that was “one of the most traumatic international financial disturbances” of the twentieth century. Although debt crises had occurred in earlier years, the world was unprepared for the 1980s crisis, which threatened many LDCs and the international banking system. The first and longest part of this chapter focuses on the origins and effects of the 1980s debt crisis and the strategies used to deal with it. Debt crises continue to pose a threat today; in 2009 the IMF analyzed the debt situation of 71 low-income countries and placed 28 of them in a “high risk” category. The latter part of this chapter discusses two major financial crises. First, we examine the East and Southeast Asian (henceforth “Asian”) financial crisis of the late 1990s, which resulted in the collapse of some currencies and a sharp decrease in capital formation and economic output. Second, we discuss the U.S. subprime mortgage crisis which unfolded into “the most severe financial crisis since the Great Depression and the only one since World War II that has been global in scope.” These crises all demonstrate the degree to which globalization and interdependence have increased in the global political economy.

**WHAT IS A DEBT CRISIS?**

As discussed in Chapter 6, a country that finances rather than adjusts to its current account deficits must borrow from external credit sources and/or decrease its foreign exchange reserves. If the country continues to borrow, it may be burdened with growing foreign debts. The severity of a country’s debt problem depends not only on the size of the debt but also on whether it has the ability and commitment to service its debt repayments. A **debt crisis** occurs when some major debtor states lack sufficient foreign exchange to make the
interest and/or principal payments on their debt obligations. Debt crises vary in severity and in the measures required to resolve them. If a state’s debt problem is temporary, it has a *liquidity* problem: It may defer some payments or obtain a new loan to meet its repayment commitments and then repay later on terms acceptable to the creditors. If a state is unable to service its debts indefinitely, it has a *solvency* problem. In this case, the debtor can regain its creditworthiness only if its creditors reduce the interest or principal payments on its debt. Debt crises may begin as liquidity problems and become solvency problems. Definitions of a debt crisis have subjective as well as objective elements. For example, the North defined the 1980s debt crisis as a threat to “the stability of the international financial system” resulting from “widespread difficulties in servicing the mountain of developing country debt.” The South, by contrast, defined the debt crisis as “a crisis of development” which began “for some developing countries after the first oil shock.”

Some scholars have compared the debt crises of the 1930s and the 1980s. One difference relates to the lending mechanisms. Most lending to Latin America in the 1920s occurred through the bond markets, and when LDCs defaulted on their debts in the 1930s, the losses were fragmented among many individual bondholders. In contrast, most lending to middle-income LDCs in the 1970s was private bank lending, and when the debtor countries threatened to default on their loans in the 1980s, the losses were more concentrated in the largest commercial banks. In 1982 the loans outstanding of the nine largest U.S. banks to 17 highly indebted states amounted to 194 percent of the banks’ capital and reserves, and a major debt default would have affected the core of the banking system. DCs and international institutions also had a greater role in the 1980s debt crisis for several reasons. First, creditor governments felt more pressure to intervene in the 1980s crisis because of the threat posed to the international banking system. Second, international institutions that deal with debt problems were almost nonexistent in earlier periods. During the 1980s, by contrast, the IMF pressured private banks to continue lending to LDC debtors, and debtor countries to alter their economic policies. Third, there was no hegemon to deal with the 1930s debt crisis, but the United States filled this position in the 1980s. The United States and IMF led the response in the 1980s, and the World Bank, the Paris and London Clubs, and the Bank for International Settlements (BIS) had supporting roles.

It is important to be familiar with the terminology used in regard to foreign debt. *Debt restructuring* agreements alter the terms between the creditor and debtor for servicing a debt, and can take two different forms. First, *debt rescheduling agreements* defer debt service payments and apply longer maturities to the deferred amount. Debt rescheduling is more effective if a debtor has a liquidity problem. Second, *debt reduction agreements* (also called *debt relief* or *debt forgiveness*) decrease the overall debt burden; that is, they include some debt forgiveness. They are more likely to be concluded when a debtor state has a solvency problem. As the following discussion shows, debt rescheduling was predominant in the earlier years of the debt crisis, but there was a shift to debt reduction for highly indebted low-income LDCs in later years.
THE ORIGINS OF THE 1980s DEBT CRISIS

The debt crisis began in August 1982, when Mexico announced that it could no longer service its public sector debt obligations. This produced shock waves because Mexico had an external debt of about $78 billion, $32 billion of which was owed to commercial banks. However, earlier warning signs of a possible debt crisis had been largely ignored. A number of LDCs, including Zaïre, Argentina, Peru, Sierra Leone, Sudan, and Togo, were involved in debt rescheduling negotiations from 1976 to 1980, and the South’s external debt had increased sixfold to $500 billion between 1972 and 1981. Foreign debt was also a growing problem in Eastern Europe, and Poland’s debt had reached serious proportions by 1981. After Mexico’s 1982 announcement, the debt crisis spread rapidly as private creditor banks moved to decrease their loan exposure to other LDC borrowers. Thus, 25 LDCs requested a restructuring of their commercial bank debt by late 1982, and in 1983 the World Bank reported that “almost as many developing countries have had to reschedule loans in the last two years as in the previous twenty-five years.” An analyst’s theoretical perspective may determine whether she attributes the 1980s debt crisis to unexpected changes in the global economy, irresponsible behavior of lenders, irresponsible behavior of borrowers, or the South’s dependence on the North.

Unexpected Changes in the Global Economy

Some observers attribute the debt crisis to unexpected changes such as the sharp increase in international grain and oil prices. Major surpluses of wheat and grain had accumulated during the 1960s, leading to production cutback programs in grain-exporting countries such as the United States and Canada. As a result of the cutbacks, the world’s grain supply was highly vulnerable to inclement weather and unexpected crop shortfalls in the Soviet Union in the early 1970s. In 1972 and 1973 global food stocks fell to their lowest level in 20 years, food grain prices sharply increased, and food aid was drastically reduced. Oil prices also increased sharply when the Arab OPEC countries limited supplies after the October 1973 Middle East war. Whereas LDC oil and food importers were doubly hit by the food and oil crises, the OPEC states accumulated huge “petrodollar” reserves, which they deposited in commercial banks; and the banks recycled the petrodollars through loans to middle-income LDCs. From 1974 to 1979 non-OPEC LDCs received about 60 percent of their external finance from commercial bank credits.

Another doubling of OPEC oil prices in 1979 (the “second oil shock”) led to a new wave of bank loans to oil-importing LDCs. The second oil shock contributed to a severe economic contraction in the North and a sharp decline in its demand for the South’s commodity exports, which made it difficult for LDCs to earn foreign exchange to service their debts. The South’s problems were compounded when the U.S. Reagan administration raised interest rates to limit inflation resulting from the 1979 oil price increases and
to facilitate U.S. borrowing abroad to cover its huge federal budget deficits. The banks were providing short-term loans to LDCs at variable interest rates, and the impact of the higher interest rates on LDC debt levels was rapid and severe.\(^{12}\) It may seem odd that the debt crisis began with Mexico—an oil exporter. However, oil-exporting LDCs had also borrowed private funds to launch ambitious development projects without anticipating that oil prices would fall sharply after 1979. Thus, unexpected changes in the global economy contributed to external debt problems for LDC oil exporters as well as importers.

Both commercial banks and debtor states often favor this external shocks explanation for the 1980s debt crisis because it awards “primary responsibility to economic policy shifts beyond their control.”\(^{13}\) However, external shocks do not explain why East Asian debtors fared so much better than Latin American debtors (see the following discussion). Thus, the policies of lenders and borrowers must also be considered as explanations for the crisis.

**Irresponsible Behavior of Lenders**

Historical materialists and some interventionist liberals consider irresponsible behavior of creditor banks to be a major cause of the debt crisis. Because banks in New York, London, and elsewhere had a surfeit of OPEC petrodollars, they aggressively increased loans to LDCs without giving due attention to their creditworthiness or the activities they were financing. The banks charged low interest rates on these loans because of inflationary conditions and the competition among lenders, which did not give LDCs adequate signals as to when to stop borrowing. After LDC debtors had become overly dependent on commercial bank loans, interest rates rose sharply in the early 1980s, and this heightened the severity of the debt crisis. Thus, “loan pushing” by commercial banks encouraged “debtor countries to increase their liabilities.”\(^{14}\) Critics also argue that DC governments and the IMF shared responsibility for the bank overlending. After the first oil shock in 1973, the DCs adopted policies that encouraged the flow of private bank funds to the South; for example, central banks in the G10 states provided assurances that they would assist banks recycling petrodollars if they encountered financial problems. The IMF also introduced new lending programs for LDC oil importers such as the 1974 oil facility, which encouraged private banks to upgrade their lending activities. Furthermore, the gradual lifting of capital controls (discussed in Chapter 6) eased the process by which U.S. and Western European banks could recycle petrodollars to the South. From this perspective, creditor banks, DCs, and the IMF shared responsibility for overlending, which was a major cause of the debt crisis.\(^{15}\)

**Irresponsible Behavior of Borrowers**

Many liberal theorists, especially orthodox liberals, attribute primary responsibility for the debt crisis to the behavior of the borrowing states. LDCs borrowed from private banks in the 1970s to avoid the conditionality
requirements of IMF loans, because private banks were not inclined (and did not have legal authority) to impose policy conditions on their loans to sovereign governments. Basic IMF principles—that indebted governments should not have unlimited access to balance-of-payments financing and should undergo adjustment measures—were jeopardized because private funds were so accessible. Thus, the IMF warned that

Access to private sources of balance of payments finance may...permit countries to postpone the adoption of adequate domestic stabilization measures. This can exacerbate the problem of correcting payments imbalances, and can lead to adjustments that are politically and socially disruptive when the introduction of stabilization measures becomes unavoidable.16

Liberals point out that LDC governments sometimes secretly seek IMF conditionality to help them push through unpopular economic reforms. As Robert Putnam notes, international negotiations are a two-level game that may enable “government leaders to do what they privately wish to do, but are powerless to do domestically”; for example, in Italy’s negotiations with the IMF, “domestic conservative forces exploited IMF pressure to facilitate policy moves that were otherwise infeasible internally.”17 Uruguay also made use of an IMF agreement to impose painful, unpopular economic austerity measures; the agreement raised the cost to domestic interests of opposing economic reform “because a rejection was no longer a mere rejection of...[Uruguay’s] president, but also of the IMF.”18 In most cases, however, LDC governments were inclined to follow the path of least resistance and seek private bank loans without instituting necessary reforms.

In addition to imprudent borrowing, liberals also attribute the debt crisis to the domestic policies of borrowing states. Although some LDCs used commercial bank loans to finance productive investments and economic growth, a number used the funds to make poor investments, increase public expenditures, import luxury goods, and pay off corrupt officials. Some LDCs reacted to the debt crisis in a timely manner with readjustment policies, but many others were unwilling or unable to change. Liberal economists often contrast the strong economic performance of Asian debtors following export-led growth policies with the weak performance of Latin American debtors following import substitution policies (see Chapter 10). The East Asians adopted outward-oriented export-led growth policies that put them in a stronger position because exports provided foreign exchange for servicing their debts.19 Thus, Table 11.1 shows that the three largest debtors were Latin American when the debt crisis erupted in 1982; the debts of Brazil, Mexico, and Argentina exceeded $92, $86, and $43 billion, respectively. Table 11.1 shows that South Korea, Indonesia, and the Philippines also had substantial debts in 1982, exceeding $37, $24, and $24 billion, respectively; but the stronger export position of the Asians (except the Philippines) enabled them to service their debts better than the Latin Americans. To assess a country’s ability to service its debt, economists use the debt service ratio which measures the ratio of a country’s interest and principal
TABLE 11.1
Total Debt, and Debt Indicators, 1982 (Millions of Dollars)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Debt</th>
<th>Debt/Exports (%)</th>
<th>Debt Service Ratio a (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>43,634</td>
<td>447.3</td>
<td>50.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>92,990</td>
<td>396.1</td>
<td>81.3</td>
</tr>
<tr>
<td>Chile</td>
<td>17,315</td>
<td>335.9</td>
<td>71.3</td>
</tr>
<tr>
<td>Colombia</td>
<td>10,306</td>
<td>204.3</td>
<td>29.5</td>
</tr>
<tr>
<td>Mexico</td>
<td>86,019</td>
<td>311.5</td>
<td>56.8</td>
</tr>
<tr>
<td>Peru</td>
<td>10,712</td>
<td>255.9</td>
<td>48.7</td>
</tr>
<tr>
<td>Venezuela</td>
<td>32,153</td>
<td>159.8</td>
<td>29.5</td>
</tr>
<tr>
<td>East and Southeast Asia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>24,734</td>
<td>116.3</td>
<td>18.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>13,354</td>
<td>93.4</td>
<td>10.7</td>
</tr>
<tr>
<td>Philippines</td>
<td>24,551</td>
<td>297.8</td>
<td>42.6</td>
</tr>
<tr>
<td>South Korea</td>
<td>37,330</td>
<td>131.6</td>
<td>22.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>12,238</td>
<td>130.0</td>
<td>20.6</td>
</tr>
</tbody>
</table>

aDebt service ratio: the ratio of a country’s interest and principal payments to its export income.


Payments on its debt to its export income. Countries with lower debt service ratios (and debt-to-export ratios) are more likely to meet their debt obligations. Table 11.1 shows that in 1982 the debt service ratios of Malaysia and Indonesia were as low as 10.7 and 18.1 percent, respectively, while the debt service ratios of Brazil and Chile were as high as 81.3 and 71.3 percent, respectively.

Those who question the orthodox liberal view that LDC behavior was the main factor explaining the debt crisis point out that LDC governments with good intentions often lacked the political capacity and support to institute economic reforms. They also argue that the debt crisis was systemic in nature; “the simultaneous onset of the crisis in more than forty developing countries” indicates that some contributing factors were external and largely beyond LDCs’ control. Furthermore, Asian LDCs such as Thailand, Malaysia, Indonesia, and South Korea, which liberals identified as following responsible policies during the 1980s debt crisis, experienced a severe financial crisis in the late 1990s (see later discussion).

The South’s Dependence on the North

Historical materialists argue that the 1980s debt crisis stemmed from the long-term structural nature of capitalism. Dependency and world-systems theorists view debt crises as extreme instances of a “debt trap” that exploits
LDCs in the periphery and binds them to DCs in the core. Some writers draw linkages between debt crises and the legacy of colonialism. The colonial powers established a division of labor in which the colonies provided agricultural products and raw materials to the metropole and served as markets for the metropole’s manufactures. This legacy still affects the exports and imports of many LDCs, preventing them from earning the foreign exchange necessary for development. Although some LDCs are industrializing, they cannot escape from their indebtedness because they continue to depend on DCs for technology and finance.\textsuperscript{21} Historical materialists also point to foreign aid as a cause of debt crises because more than half of all official development assistance (ODA) is disbursed as loans. A substantial share of World Bank financing is disbursed as \textit{hard loans} with high interest rates and shorter repayment periods (see Chapter 10). Development assistance is another mechanism for transferring surpluses from the periphery to the core, because a large share of foreign aid is required simply to cover LDC repayments of past aid disbursements. Thus, public as well as private external finance perpetuates LDC dependency:

If they seek official help on softer than commercial terms, they have to accept outside scrutiny . . . and accept conditions which doom their efforts at industrial, diversified development. If they accept suppliers’ credits on commercial terms in order to go through with their cherished projects, they are caught anyway when the payments come due before they are able to meet them.\textsuperscript{22}

Like other interpretations of the debt crisis, critics question the views of historical materialists. Liberals argue that dependency theorists attribute LDC debt problems solely to external causes beyond their control and avoid looking at the \textit{domestic} sources of LDC problems—traditional attitudes, domestic inefficiencies, corrupt political leaders, and a reluctance to follow liberal economic policies. It is safe to conclude that \textit{all} the preceding views on the origins of the debt crisis have some validity. Unexpected food and oil price increases during the 1970s encouraged LDCs to increase their borrowing, and the world recession after the 1979 oil price increases added to the debt load of many LDCs. Although these unexpected global changes contributed to the debt crisis, irresponsible behavior of commercial banks, DCs, and LDCs exacerbated the crisis. Furthermore, the South’s long-term structural dependence on the North increased the South’s vulnerability to protracted debt problems. A Mexican finance minister identified the multiple causes of the debt crisis and the widespread failure to foresee it, when he stated,

The origin of the debt itself is clearly traceable to a decision by both developing and developed countries that . . . resulted in the channeling of tens of billions of dollars to the debtor community of today. . . . The whole world congratulated itself on the success, smoothness, and efficiency with which the recycling process was achieved. \textit{We all were responsible}.\textsuperscript{23}
THE FOREIGN DEBT REGIME

Before discussing the world reaction to the 1980s debt crisis, we describe the foreign debt regime that monitored and managed the crisis. A debt regime was more evident in the 1980s than in the 1930s because a global hegemon (the United States) and an institutional framework (the IMF and World Bank) existed to deal with the 1980s crisis. The mechanisms for coping with a debt crisis before World War II included unilateral actions by the creditors or debtors and two-party solutions in which debtors and creditors negotiated agreements. Postwar debt settlements, by contrast, have been three-party affairs involving IOs such as the IMF and World Bank and informal groups such as the Paris and London Clubs. The United States has acted as a third-party hegemon in the postwar period, pressuring for debt settlements and coordinating settlement efforts. In recent years the members of the G7/G8 summits have supplemented U.S. hegemony by taking collective responsibility for dealing with foreign debt issues.

Some regimes encompass only one sector or issue while others are broader in scope, and specific regimes are nested within more diffuse regimes; for example, the textile and agricultural trade regimes are nested within the global trade regime. Although the global trade regime principles, norms, and rules provide a general framework, textile and agricultural trade have their own unique characteristics. This chapter views the 1980s foreign debt regime as a specific regime nested within a more diffuse balance-of-payments financing regime because foreign debt crises are a specific, more extreme type of balance-of-payments problem. Although creditors and debtors have negotiated agreements throughout the postwar period, pressures resulting from the 1980s foreign debt crisis produced more coordinated, longer-term efforts to establish rules and decision-making procedures that we associate with an international regime. A first principle of the balance-of-payments financing regime is that an adequate but not unlimited amount of financing should be available to states to deal with their balance-of-payments deficits. A second principle is that those providing the financing may attach conditions to it to ensure that recipient states correct their balance-of-payments problems. The balance-of-payments regime principle of conditional lending was threatened in the 1970s because private banks recycled petrodollars as loans to debtor countries with minimal conditions and very low interest rates. Although these bank loans were readily available to middle-income countries (MICs) and NIEs during the 1970s, low-income countries (LICs) lacked creditworthiness and remained dependent on loans from the IMF and donor governments. Thus, Table 11.2 shows that private bank loans in 1980 accounted for only 6 percent of LIC debt but for 38 percent of MIC debt and 65 percent of NIE debt. ODA, by contrast, accounted for 67 percent of LIC debt in 1980 but for only 25 percent of MIC debt and 4 percent of NIE debt. The willingness of private banks to provide finance to the more creditworthy LDCs limited the IMF’s ability to set conditions for these borrowers.
TABLE 11.2

Total Debt, and Share of Debt Based on ODA and Private Bank Loans for Nonoil LDCS

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Total Debt $</th>
<th>Percentage ODA</th>
<th>Total Debt</th>
<th>Percentage ODA</th>
<th>Total Debt</th>
<th>Percentage ODA</th>
<th>Total Debt</th>
<th>Percentage ODA</th>
<th>Total Debt</th>
<th>Percentage ODA</th>
</tr>
</thead>
<tbody>
<tr>
<td>LICs</td>
<td>$18</td>
<td>74</td>
<td>$40</td>
<td>73</td>
<td>$86</td>
<td>67</td>
<td>$110</td>
<td>69</td>
<td>$144</td>
<td>24</td>
</tr>
<tr>
<td>MICs</td>
<td>$25</td>
<td>45</td>
<td>$40</td>
<td>33</td>
<td>$107</td>
<td>25</td>
<td>$144</td>
<td>24</td>
<td>$266</td>
<td>3</td>
</tr>
<tr>
<td>NIEs</td>
<td>$32</td>
<td>16</td>
<td>$72</td>
<td>9</td>
<td>$192</td>
<td>4</td>
<td>$266</td>
<td>3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

aTotal debt figures in billions.
Abbreviations: ODA = official development assistance
LICs = low-income countries
MICs = middle-income countries
NIEs = newly industrializing economies

However, private banks responded to the 1980s debt crisis by quickly limiting their loan exposure, and the MICs and NIEs therefore had to look to the IMF, World Bank, and government aid agencies for assistance with their growing debt problems. This dependence on official financing provided the IOs and the U.S. government with considerable leverage in establishing the foreign debt regime. As with the pre-1970s balance-of-payments regime, the basic principle of the debt regime revolved around conditionality—the provision of new loans and debt rescheduling were contingent on the debtor countries’ commitment to market-oriented reforms. However, the 1980s debt regime differed from the pre-1970s balance-of-payments regime in several respects. First, the IMF (with U.S. backing) adopted a new role when it pressured private commercial banks in the 1980s to continue providing loans to debtor LDCs. Second, creditor groups such as the Paris and London Clubs met more frequently in the 1980s and 1990s than in earlier periods. Third, both the IMF and World Bank provided structural adjustment loans to indebted LDCs and transition economies. These SALs were conditioned on more demanding requirements—that loan recipients adopt orthodox liberal reforms such as deregulation, privatization, and greater openness to trade and foreign investment. The following sections discuss two other groups of actors in the global debt regime—the transition economies of Eastern Europe and the FSU that became debtors along with the LDCs, and the Paris and London Clubs that coordinated the actions of creditors. The changing roles of the IMF and World Bank in the foreign debt regime are examined later in the chapter.

The IMF, the World Bank, and Transition Economies

Chapter 2 noted that the Soviet bloc countries were not IMF and World Bank members for most of the early postwar period. Before examining the role of these countries in the foreign debt regime, this chapter discusses how they joined these institutions; a country cannot join the World Bank (“the Bank”) without first becoming a member of the IMF. As Table 11.3 shows, Yugoslavia was a founding member of the IMF and the Bank; it defected from the Soviet Bloc in 1948 and developed a nonaligned foreign policy. Yugoslavia also adopted worker self-management and market socialist policies that were more compatible with the liberal economic orientation of the Bretton Woods institutions. In contrast to Yugoslavia, Poland and Czechoslovakia left the IMF and the Bank in 1950 and 1954 (Czechoslovakia was expelled for not paying its dues), because membership was incompatible with their status as satellite countries in the Soviet bloc. Table 11.3 shows that Romania joined these institutions in 1972. Although Romania was still a Soviet bloc member, it had distanced itself politically from the Soviet Union and viewed the Soviet-led Council for Mutual Economic Assistance (CMEA) as hindering its development. As an IMF and Bank member, Romania could receive their loans, upgrade its economic relations with the West, and further its political objectives. Western states admitted Romania despite its slow moves toward economic reform and its sizable foreign debt, because its membership produced new divisions within the
Soviet bloc. Although Romania provided sensitive economic information to the IMF and the Bank, they agreed not to disclose this information in their statistical reports.\textsuperscript{28}

The IMF and the Bank treated the case of the People's Republic of China (PRC) as a representation rather than a new membership issue, and in 1980 they permitted the PRC to take the China seat from Taiwan. The PRC’s decision to “return” to these institutions followed a radical change in its policies. Mao Zedong had adopted an inward self-reliance policy in the 1950s, and China’s policies became even more autarkic from 1966 to 1969 during the
Cultural Revolution. However, the Cultural Revolution created so many political and economic problems that China began to adopt more open policies. China’s commercial contacts with the North increased, and the UN General Assembly voted to seat the PRC delegation in 1971. After Mao’s death in 1976 and the arrest of cultural revolutionaries, the PRC launched the Four Modernizations program to increase economic productivity, and it viewed IMF and Bank membership as a means of gaining access to capital for its development.

Several factors facilitated China’s reentry application, including U.S. support and a compromise agreement on the Taiwan issue. After the PRC’s takeover of the China seat in 1980, Hungary and Poland requested accession in 1981. Unlike Romania, Hungary was much closer to meeting the IMF’s normal economic requirements. Hungary’s New Economic Mechanism (NEM) had increased its economic decentralization, outward economic orientation, and international competitiveness in the late 1960s; and in the 1970s and 1980s it introduced other economic reforms. Hungary sought IMF membership to safeguard these reforms and get assistance with its foreign debt, which resulted partly from its development plans. Poland’s debt problems were more serious, because it had borrowed in international financial markets during the 1970s instead of introducing meaningful economic reform. Poland needed to reassure the financial community that it would service its debt in the early 1980s, and IMF membership would be helpful in this regard. Although Hungary was admitted to the IMF and the Bank in 1982, Poland’s application was stalled by its imposition of martial law in 1981; it was not until 1986 that Poland was admitted to the Bretton Woods institutions (see Table 11.3).

Poland was the last Eastern European country to become an IMF and Bank member before upheaval in the Soviet bloc transformed East–West relations. Mikhail Gorbachev’s attempts to revive the Soviet economy through economic restructuring (perestroika) and political openness (glasnost) failed. However, his policies contributed to a series of revolutionary changes, including the disintegration of Communist regimes in Eastern Europe in 1989, the unification of Germany in 1990, and the dissolution of the Soviet Union in 1991. Czechoslovakia and Bulgaria joined the IMF and the Bank in 1990 and 1991, but the most significant change was the accession of Russia and other FSU republics in 1992 and 1993. Russia was facing an economic crisis, and the IMF and Western donors offered it a $24 billion assistance package in return for its commitment to decrease its budget deficit and inflation rate.

The Bretton Woods institutions have helped the transition economies move toward market reform. The IMF has taken the lead in this process, estimating financing needs, providing policy advice, and setting conditions for reform. The Bank has offered technical assistance and funding for infrastructure, the development of market incentives, the privatization of state monopolies, and the creation of a legal framework for the emerging private sector. However, tensions have existed between the transition economies and the Bretton Woods institutions because of their different economic outlooks. The addition of so many new members has also put pressure on IMF and Bank resources, and LDCs sometimes charge that the transition economies receive better treatment.
These charges seem to have some validity. For example, one study revealed that Romania, Poland, and Hungary received more IMF loans than expected on the basis of economic criteria; and Russia was able to borrow more funds in relation to its IMF quota than other countries when it joined the IMF in 1992. This favored treatment demonstrates that security as well as economic factors affect IMF lending decisions. However, the charges of favored treatment do not seem to apply to all transition economies; for example, a 1990 study concluded that the IMF and the Bank did not give special treatment to China.

The Paris and London Clubs

Three types of negotiations occurred between creditors and debtors to deal with the 1980s foreign debt crisis. First, the IMF and the Bank agreed to provide SALs to debtor governments in exchange for the debtors’ commitment to follow specific policies to reduce their balance-of-payments deficits. The other two types of negotiations involved meetings between the debtors and creditor groups: the Paris and London Clubs. The Paris Club is an informal group of creditor governments, which in most cases are OECD members. The London Clubs (also called private creditor committees and bank advisory committees) are composed of the largest commercial banks. The Paris and London Clubs have no charters or formal institutional structures, and their memberships vary with each rescheduling negotiation. The ad hoc nature of these clubs stems from the creditors’ view that negotiations should be low profile and that debt reschedulings should be unusual occurrences. Thus, the Paris Club has no legal status or written rules, no voting procedure (decision making occurs by consensus), and no regular office (meetings are usually held in the French Ministry of Finance). The Paris Club’s origins stem from a 1956 meeting of 12 European creditor states to negotiate a rescheduling of Argentina’s foreign debt. Argentina was in arrears to the governments, and the meeting provided a multilateral rescheduling forum instead of uncoordinated bilateral reschedulings. Initially the Paris Club seldom met, but their meetings became more frequent as debt problems increased. Thus, the Paris Club concluded more than twice as many agreements in the 7 years from 1978 to 1984 as it did in the previous 22 years, and the 1978 to 1984 agreements deferred $27 billion of debt service obligations. Participants in Paris Club meetings include the debtor government; the main creditor governments; and representatives of the IMF, the Bank, UNCTAD, and regional development banks. Three basic principles guide its deliberations—imminent default, conditionality, and burden sharing:

- The **imminent default principle** limits debt rescheduling to states with a serious, justifiable need. To avoid unnecessary negotiations, the Paris Club will not even consider a request unless the debtor has substantial external payments arrears and is likely to default on its payments.
- The **conditionality principle** stems from the creditors’ concerns that the debtor services its debts on schedule. Thus, the debtor must conclude
an IMF arrangement with conditionality requirements before the Paris Club will negotiate. In the rare cases where a debtor was not an IMF member at the time of rescheduling (e.g., Poland, Cuba, and Mozambique), the Paris Club established its own conditionality.

- The burden sharing principle requires all creditor states to provide relief in proportion to their loan exposure to the debtor state. This principle helps avoid the problem of free riding, and it applies to creditor banks as well as states. Thus, the Paris and London Clubs cooperate with each other.\textsuperscript{34}

The London Clubs received their name because many of their meetings were held in London in the 1980s. Like the Paris Club agreements, a single debtor and its creditors negotiate London Club agreements, and the debtor must commit to IMF adjustment policies. However, the coordination problems for London Club meetings are greater because there are so many more private creditors than creditor states. Private creditors coordinate their activities by establishing bank advisory committees for the various debtor countries which include the largest international banks (those holding the most loans outstanding). The international banks on each committee bargain with each other and with the debtor country to reschedule debts and then present the agreement to smaller creditor banks for ratification. Although the largest creditors would like to limit their loan exposure to a troubled debtor, they realize that the debtor state could default if all creditors withheld loans. The major international banks have a common interest in debt restructuring because of their high loan exposure and their long-term interest in the stability of international capital markets. Smaller creditor banks, by contrast, have fewer loans at risk and less interest in maintaining the international credit system; thus, they are reluctant to support restructuring agreements that require them to provide additional loans. Because smaller creditor banks often think on the basis of individual rationality (see prisoners’ dilemma in Chapter 4), there is a danger that all banks could defect and that massive debtor default could disrupt the international banking system. To prevent a Pareto-deficient outcome, the large international banks pressure the smaller banks to avoid free riding and participate in the debt restructuring agreements.\textsuperscript{35} As discussed in the next section, the private creditor committees worked effectively in earlier years but were insufficient to deal with the 1980s debt crisis.

As historical materialists note, creditors can exert strong pressures on debtor states in the Paris and London Clubs, because a single debtor meets with its major creditors at the bargaining table. The case-by-case approach of the Paris and London Clubs also prevents debtors from developing a united front, and it ignores the systemic nature of the 1980s debt crisis by assuming that each debtor’s situation can be treated individually. Furthermore, historical materialists criticize the two clubs for their emphasis on IMF conditionality as a prerequisite for negotiations.\textsuperscript{36} At the UNCTAD V conference in 1979 the G77 sought to replace the Paris and London Clubs with an international debt commission more attuned to LDC interests. Although the creditor governments agreed to invite an UNCTAD observer to future Paris Club negotiations, it refused to create an international debt commission. Thus, the creditors continue to set the rules and procedures for Paris and London Club negotiations.
STRATEGIES TO DEAL WITH THE 1980s DEBT CRISIS

The debt crisis was more prolonged than expected, and the creditor states and international institutions adopted more activist strategies when milder measures proved to be insufficient. The United States and the IMF were closely involved in devising and implementing the strategies. Although the IMF had lost some importance with the collapse of the pegged exchange rate system and the increase in private bank lending in the 1970s, the 1980s debt crisis put it “back at the center of the international financial system, first as a coordinator in a crisis, and then . . . as a source of information, advice, and warning on the mutual consistency of national policies.”

The IMF’s central role stemmed largely from the U.S. administration’s view that multilateral institutions could best implement DC policies on debt issues. The IMF also could put pressure on LDC debtors and private banks without causing major protests over U.S. government interference. When G7 summit meetings began to address international debt issues in the late 1980s, the major economic powers to a degree replaced U.S. hegemony with collective responsibility for LDC debt problems.

The international debt strategies had three major objectives: to prevent the collapse of the international banking system, to restore capital market access for debtor countries, and to minimize economic dislocation and restore economic growth in debtor states. The strategies to achieve these objectives can be divided into four phases:

2. The Baker Plan, which continued the private involuntary lending and put new emphasis on official lending (1986–1988).
4. Initiatives for the poorer LDCs (1996 to the present).

Emergency Measures and Involuntary Lending: 1982–1985

The United States, the IMF, and other creditors first reacted to the debt crisis with a “firefighting” strategy, providing short-term emergency loans to Mexico, Brazil, and other LDCs to avert a 1930s-style financial collapse. The BIS provided some bridging finance to LDC debtor states until IMF loans were approved. This emergency lending was followed by a medium-term strategy, in which the IMF induced private banks to engage in involuntary lending (politely termed concerted lending in official circles). Involuntary lending refers to “the increase in a bank’s exposure to a borrowing nation that is in debt-servicing difficulty and that . . . would be unable to attract new lending from banks not already exposed in the country.” Before the debt crisis, the London Clubs functioned effectively because the largest international banks induced smaller banks to engage in involuntary lending when necessary in debt restructuring agreements. Only nine states had to restructure their commercial debts from the mid-1970s to 1982, so interbank coordination was sufficient to manage the debt situation.
Although the IMF helped supervise debtor economic policies, its involvement was quite limited during this period. However, the large international banks could not cope with the massive scope of the 1980s debt crisis, and many small banks in the U.S. Southwest with loans outstanding to Mexico were unwilling to increase their loan exposure. Thus, the IMF had to intervene:

In November 1982, the Fund’s Managing Director . . . took the unprecedented step of establishing mandatory levels of forced private lending before the IMF would sign a stabilization agreement with Mexico. This bold action, repeated in the Brazilian case, was a turning point in the treatment of sovereign debt. It staked out a new leadership role for the Fund, and a new relationship between the Fund and private banks.\(^{41}\)

The IMF also insisted that debtor states develop adjustment programs as the price for debt rescheduling and new lending. Thus, realists argue that creditor states operating through the IMF managed the debt crisis; the crisis posed such a major threat to the international financial system that only states could mobilize sufficient resources to deal with it. Only official pressures could induce banks to continue lending to debtors and force debtors to meet conditionality requirements. Liberals, by contrast, emphasize the IMF’s role as an international institution in managing the debt crisis, and they reject the realist view that the IMF was simply following creditor state instructions. The IMF and creditor states in these early years assumed that the debt crisis was a short-term problem stemming from the temporary inability of LDCs to service their debts. However, many LDCs could not resolve their debt problems even after adjusting their policies. Although the firefighting tactics dealt with the immediate crisis, economic activity and investment in most debtor states declined, and adjustment programs in LDCs hindered their economic growth. Private commercial banks were also reducing their loan exposure despite IMF pressures, and this forced the IMF to assume an increasing share of the lending risk. When James A. Baker III became U.S. Secretary of the Treasury in 1985, he therefore adopted a more structured approach to the debt crisis.


In 1985, Secretary Baker provided a formula for dealing with the debt crisis and extended debt repayments over a longer period; but he did not change basic assumptions about the best strategy. As was the case in the 1982–1985 period, the Baker Plan underestimated the insolvency problem confronting many LDCs and did not offer any debt forgiveness. Instead, the Baker Plan emphasized the postponement of debt payments, the provision of new loans, and changes in debtor country policies. This strategy rested on the assumption that “debtor countries could grow their way out of debt and could expand their exports enough to reduce their relative debt burdens to levels compatible with a return to normal credit market access.”\(^{42}\) The Baker Plan focused on 17 middle-income heavily indebted LDCs as the target group for international debt measures. As Table 11.4 shows, 12 of the “Baker-17” states were Latin
American and Caribbean, and the list did not include low-income LDCs that were heavily indebted to official (rather than private) creditors. Table 11.4 lists these 17 countries in order of their gross external debt in 1985, shortly before the Baker Plan was instituted. As Table 11.4 shows, the four countries with the highest debts in 1985 (Brazil, Mexico, Argentina, and Venezuela) were all Latin American. However, a country’s debt servicing abilities also depend on its debt service ratio (see Table 11.1) and its debt as a share of GNI. Table 11.4 shows that the LDCs with the highest gross external debts ranked well below some poorer and smaller LDCs in terms of debt as a percent of GNI. Thus, external debt as a percent of GNI for the three largest debtors in 1985, Brazil, Mexico, and Argentina, was 50.3, 55.2, and 84.2 percent, respectively. The debtors on the list with the highest debt-to-GNI ratios were Jamaica (234.9 percent), Bolivia (176.6 percent), and Cote d’Ivoire (154.2 percent).

### Table 11.4

**Gross External Debt and External Debt as a Percent of GNI for the Baker-17 Countries, 1985 and 1997 (US$ Millions)**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Brazil</td>
<td>106,148</td>
<td>50.3</td>
<td>198,023</td>
<td>23.8</td>
</tr>
<tr>
<td>Mexico</td>
<td>96,867</td>
<td>55.2</td>
<td>148,702</td>
<td>38.3</td>
</tr>
<tr>
<td>Argentina</td>
<td>50,946</td>
<td>84.2</td>
<td>128,411</td>
<td>44.8</td>
</tr>
<tr>
<td>Venezuela</td>
<td>35,334</td>
<td>–</td>
<td>35,797</td>
<td>41.5</td>
</tr>
<tr>
<td>Philippines</td>
<td>26,622</td>
<td>89.1</td>
<td>45,683</td>
<td>53.4</td>
</tr>
<tr>
<td>Former Yugoslavia</td>
<td>22,251</td>
<td>48.2</td>
<td>10,968</td>
<td>–</td>
</tr>
<tr>
<td>Chile</td>
<td>20,384</td>
<td>143.3</td>
<td>22,809</td>
<td>31.4</td>
</tr>
<tr>
<td>Nigeria</td>
<td>19,550</td>
<td>25.1</td>
<td>28,455</td>
<td>83.7</td>
</tr>
<tr>
<td>Morocco</td>
<td>16,529</td>
<td>136.6</td>
<td>20,195</td>
<td>62.6</td>
</tr>
<tr>
<td>Peru</td>
<td>12,884</td>
<td>85.3</td>
<td>29,265</td>
<td>50.6</td>
</tr>
<tr>
<td>Colombia</td>
<td>14,245</td>
<td>42.6</td>
<td>31,800</td>
<td>30.5</td>
</tr>
<tr>
<td>Cote d’Ivoire</td>
<td>9,745</td>
<td>154.2</td>
<td>15,609</td>
<td>158.1</td>
</tr>
<tr>
<td>Ecuador</td>
<td>8,703</td>
<td>77.4</td>
<td>15,419</td>
<td>81.8</td>
</tr>
<tr>
<td>Bolivia</td>
<td>4,805</td>
<td>176.6</td>
<td>5,237</td>
<td>68.0</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>4,401</td>
<td>120.8</td>
<td>3,476</td>
<td>27.6</td>
</tr>
<tr>
<td>Jamaica</td>
<td>4,068</td>
<td>234.9</td>
<td>3,920</td>
<td>56.9</td>
</tr>
<tr>
<td>Uruguay</td>
<td>3,919</td>
<td>89.7</td>
<td>6,710</td>
<td>31.8</td>
</tr>
</tbody>
</table>

*EDT/GNI%: Total external debt as a percentage of gross national income.
*Latin American and Caribbean countries.

Although the Baker Plan focused mainly on middle-income LDCs and underestimated the severity of the debt problem, it recognized that the debt crisis was a longer-term issue. The Baker Plan therefore shifted emphasis from short-term balance-of-payments adjustment to long-term structural change, and the World Bank and Inter-American Development Bank (IDB)—with their longer-term loans—assumed a more central role. The Baker Plan proposed that the multilateral development banks double their lending to $20 billion over three years and that the private banks also lend $20 billion. In return, the debtors were to liberalize their trade and investment policies and privatize state firms; this marked a major change from Latin America’s protectionist import substitution policies.

Unexpected changes in the global economy created major problems for the Baker Plan. For example, international oil prices collapsed shortly after the plan was announced; this upset the recovery plans of oil-exporting debtor states such as Mexico and gave oil-importing LDCs less incentive to adopt economic reforms. The Baker Plan also failed to stimulate LDC economic growth, and many LDC debtors refused to comply with IMF conditionality requirements (e.g., Brazil declared a moratorium on paying its debts in 1987). Furthermore, commercial banks sought to reduce their loan exposure, and the lending risks continued to shift to governments and multilateral agencies. The multilateral development banks also disbursed less funding than the Baker Plan had anticipated, and debt repayments began to exceed the funding LDCs received in new loans. The net transfer of financial resources to LDCs fell from $29 billion in 1982 to $34 billion by 1987, and to the Baker-17 countries from $11 billion to $17 billion.43 From 1981 to 1988, real per capita income in most South American LDCs declined in absolute terms, and living standards in many LDCs fell to levels of the 1950s and 1960s. Thus, some analysts refer to the 1980s as a “lost development decade.” Although the Baker Plan’s failure resulted partly from unforeseen events such as the collapse of international oil prices, critical theorists view the plan as an “attempt to maintain the fiction that the debt crisis was only temporary and could be surmounted if all parties cooperated.”44 Many debtors were caught in a vicious circle in which their debt burdens hindered their economic growth, and their slow growth prevented them from overcoming their debt problems.


The Baker Plan’s failure to promote economic recovery raised concerns about U.S. exports to Latin America and about the effects of debt problems on the revival of democratic governments in the region. Riots in Caracas, Venezuela, in February 1989 in reaction to government austerity measures provided further evidence that the Baker Plan was insufficient. In March 1989, U.S. Secretary of the Treasury Nicholas Brady introduced the Brady Plan, which sanctioned the idea of debt reduction, or forgiving some LDC debts to commercial banks. After the major economic powers resolved
their differences on this issue at the 1989 G7 summit, the IMF adopted the Brady Plan and the G7 finance ministers became much more involved in foreign debt issues. Mexico was the first LDC to conclude a Brady Plan debt reduction agreement because it had the largest debts, was liberalizing its economy, had a good record of adjustment, and was strategically important to the United States.45

Like the Baker Plan, the Brady Plan handled debt on a case-by-case basis with each debtor negotiating separately with its creditors, and it linked the easing of credit terms with the debtor’s acceptance of IMF and Bank conditions for liberal economic reform. However, the Baker Plan had assumed that banks would not lend to countries if they failed to pay their debts, and that LDCs would be able to repay loans if the debt repayment period was extended. The Brady Plan, by contrast, recognized that extending the debt repayment period without debt reduction was not sufficient for some highly indebted LDCs. As a result, the Brady Plan stipulated that U.S. private banks that reduced the principal or interest on LDC debt would receive guarantees of repayment on the remaining portion of debt. The IMF and the Bank would help finance these guarantees, and Japan also committed funds for this purpose. Brady Plan agreements were concluded for 17 LDCs from 1990 to 1997.46 Although the Brady Plan was an improvement over the Baker Plan, it did not resolve all the debt problems of the Baker-17 countries. Table 11.4 compares the external debt for the Baker-17 in 1985 (the year before the Baker Plan was instituted) and 1997 (the last year that a Brady Plan agreement was concluded). As the table shows, the external debt for all but three of the Baker-17 (Yugoslavia, Costa Rica, and Jamaica) increased from 1985 to 1997. Most of these countries were Latin American, and the total foreign debt of Latin America’s states increased from $425 billion in 1987 to more than $600 billion in 1997. In 1997, Latin America was paying about 30 percent of its export earnings to service its debts, and it owed about 45 percent of its combined GNI to foreign creditors. However, a country’s creditworthiness depends more on its debt-to-GNI ratio than on its foreign debt, and the Brady Plan helped restore the creditworthiness of most of the Baker-17 countries. As Table 11.4 shows, the external-debt-to-GNI ratio was lower in 1997 than in 1985 for most countries other than Nigeria, Cote d’Ivoire, and Ecuador. (IMF data were not available for Venezuela and the former Yugoslavia.)

The Brady Plan’s greatest shortcoming was that it dealt only with commercial bank debt. It offered little to low-income LDCs because most of their debt was to governments and international financial institutions. Thus, 11 of the 17 Brady Plan agreements were concluded with the Baker-17 (mainly middle-income LDCs), and 2 of the agreements were with Eastern European countries (Poland and Bulgaria). In the 1990s, the debt situation was far worse for the low-income LDCs, and after the Brady Plan helped restore the creditworthiness of the Baker-17, “the G7 finally mustered enough political will in the mid-1990s to tackle the debt problems of the poorest countries.”47
Initiatives for the Poorest LDCs

The total external debt of Sub-Saharan African countries increased from $56.2 billion (U.S.) in 1980 to $147 billion in 1990, and their external debt service payments on long-term loans rose from $4.5 billion to $11.1 billion. It was therefore evident by the early 1990s that the poorest LDCs needed more debt relief. The 1996 G7 summit in Lyon, France, addressed this problem by establishing the Heavily Indebted Poor Countries (HIPC) Initiative, a plan to alleviate the debts of the poorest LDCs to multilateral institutions. The IMF and the Bank had previously refused to permit debt rescheduling of their loans because this could damage their high credit ratings, and the presence of the IMF director general and World Bank president at the Lyon G7 summit facilitated agreement on the HIPC Initiative. The HIPC Initiative was designed to reduce the debts of eligible countries to a sustainable level so they could service them without incurring loan arrears or hindering their economic development. The HIPC countries have high debt-to-export ratios and debt-to-GNI ratios, and low enough incomes to be eligible for the Bank group’s soft IDA loans (see Chapter 10). Forty-one countries initially met these criteria: 33 in Sub-Saharan Africa and the other 8 in the Americas and Asia. The HIPC program involved a demanding two-stage process, with each stage lasting up to three years. During the first stage, the HIPC country had to implement an economic reform program. If the IMF and the Bank determined that debt relief was insufficient, the country entered the second stage, where it received some financial support from bilateral and commercial creditors and the multilateral institutions. The HIPC Initiative was therefore a slow process, and the debt situation of the poorest LDCs was not improving.

A London-based civil society organization with worldwide connections called Jubilee 2000 responded to the debt problems of low-income LDCs with a debt forgiveness campaign. Jubilee 2000 called for full debt relief for low-income LDCs by the year 2000 and outlined proposals to accelerate the HIPC process, increase assistance levels, and broaden the eligibility criteria. Jubilee 2000 also engaged in mass demonstrations; for example, it formed a human chain of 50,000 people around the convention center at the 1998 G7 summit. In response, the 1999 G7 summit agreed to establish an enhanced HIPC initiative, and the IMF and the Bank adopted the major elements of the G7 proposal. The enhanced initiative more than doubled the amount of debt relief and made the HIPC Initiative faster (LDCs received debt relief more quickly), broader (it applied to more countries), and deeper (it permitted more debt relief). However, the poorest LDCs continued to have serious debt problems. In 2005, the World Bank listed 27 of the low-income LDCs as “severely indebted,” 17 as “moderately indebted,” and only 14 as “less indebted.” Although the Bank also listed a number of middle-income LDCs as severely and moderately indebted, most of them had re-established their creditworthiness as a result of the Baker and Brady plans.

In view of the continuing problems of the poorest LDCs, the 2005 G8 Summit proposed that they be eligible for 100 percent cancellation of their debt owed to the major multilateral lenders. The IMF and World Bank refined
this proposal and established the Multilateral Debt Relief Initiative (MDRI) in 2006. IMF members with low per capita incomes that have their debts reduced under the enhanced HIPC initiative are eligible to have the rest of their debt to the IMF, World Bank, and African Development Bank cancelled under the MDRI.\textsuperscript{51} Despite the gradual expansion of debt relief programs for the low-income LDCs, it remains to be seen whether they can overcome the internal and external structural problems underlying their debt problems. It is therefore necessary to look at the overall effectiveness of the debt reduction strategies.

**Assessing the Effectiveness of the Debt Strategies**

The international debt strategies had three main objectives: to prevent the collapse of the international banking system, to restore capital market access for the debtors, and to restore economic growth in the debtor countries. The Baker and Brady plans were most successful in achieving the first two objectives. In regard to the first objective, by the late 1980s “the banks were no longer in the serious jeopardy that they faced at the outset of the debt crisis.”\textsuperscript{52} From 1982 to 1992, the loan exposure of U.S. banks to the Baker-17 countries fell from 130 percent of the banks’ capital and reserves to only 27 percent; the loan exposure of French banks fell from 135 to 23 percent. In regard to the second objective, Latin American debtors were able to return to the international financial markets far more rapidly after the 1980s debt crisis than after the 1930s crisis. Liberal economic theorists view these two criteria as the most important for assessing the effectiveness of the debt strategies, and they believe that the Baker and Brady plans were fairly successful.\textsuperscript{53}

Some liberals question whether debt reduction for the poorest LDCs in the HIPC and MDRI initiatives is necessary, because the two main liberal objectives of the debt strategies have been achieved. They argue that debt reduction is “too easy to get,” thus allowing countries “to persist with bad economic policies.”\textsuperscript{54} Historical materialists and some interventionist liberals by contrast see the third objective—restoring economic growth in LDC debtor countries—as the most important, and they considered the Baker and Brady plans to be largely ineffective. For example, one critic argued that the IMF and major creditor states were concerned with increasing “the immediate payment capacity of the debtor nations and not their development.”\textsuperscript{55} Historical materialists also believe that the debt strategies required more sacrifice from LDCs than from DCs and international bankers, and they argue that “the debt crisis is by no means over yet; a banking crisis may have been tidied up, but a development crisis is in full swing.”\textsuperscript{56}

The Baker and Brady plans did have serious shortcomings in regard to the third objective of restoring LDC economic growth. This was especially true for the low-income LDC debtors that were not on the Baker-17 list. As discussed, the Baker and Brady plans focused on debt to commercial banks, and they did not provide relief for debt to the IMF and World Bank. Because the poorest LDCs were highly dependent on IMF and Bank loans, the Baker and Brady plans were of little use to them. The North should be credited for gradually
developing more assertive debt strategies, shifting from debt rescheduling under the Baker Plan to debt reduction under the Brady Plan to debt relief for the poorest LDCs under the HIPC and MDRI initiatives. However, it always took a new crisis before the IMF, the Bank, and DCs upgraded their debt relief efforts, and it remains to be seen whether the new initiatives will deal with the debt problems of the poorest LDCs. The HIPC and MDRI initiatives recognize that debt relief is sometimes necessary, but successful debt management requires more than debt reduction. It “depends on a country’s ability to achieve high growth and foreign-exchange generation—thereby containing debt-to-GDP, debt-to-exports and debt-to-revenues at reasonable (‘sustainable’) levels.”

**TRANSITION ECONOMIES AND FOREIGN DEBT**

To this point, we have discussed the effects of the debt crisis on LDCs. However, the transition economies in Eastern Europe and the FSU were also foreign debtors in the 1980s and 1990s. The Soviet bloc countries and LDCs contended with some common economic problems such as balance-of-payments deficits, declining terms of trade, and stagnating economic growth. The need for financing also caused Soviet bloc countries to look to the IMF and World Bank for support; for example, Hungary and Poland joined these institutions in the 1980s, partly to deal with their growing debt problems. Eastern Europeans had borrowed heavily on international financial markets in the 1970s to finance industrial investment. However, the oil price shocks, poor investment decisions, economic inefficiency, lack of export competitiveness, and high interest rates on their foreign debt created severe economic problems. For example, Poland had financed an ambitious industrial investment program with external funding, but its exports were insufficient to service its debt. In 1981, an acute foreign exchange shortage forced Poland to negotiate a rescheduling of its debt with official and private creditors.

Like the South, Eastern European countries followed different strategies to deal with their foreign debt; the two basic strategies were referred to as the Polish and Czech-Hungarian models. The Polish model involved large debt buildup followed by repeated debt reschedulings and eventually official debt reduction, partly based on political considerations. Poland’s debt to the DCs increased from $7.6 billion in 1975 to $22.1 billion in 1980, and in 1981 it had the highest debt and debt service ratio in the Soviet bloc. Poland’s growing economic problems resulted in severe economic austerity measures and the formation of the anti-Communist Solidarity Movement. When the Polish government responded to the Solidarity Movement by imposing martial law in December 1981, the West imposed trade sanctions and suspended debt repayment talks. Although private banks refinanced some Polish debt, Western governments did not resume rescheduling negotiations on official debt until Poland ended martial law in 1983. From 1981 to 1990, Poland had seven reschedulings of its commercial bank debt and five reschedulings of its official debt. When a democratically elected government replaced the communists in
early 1990, the West gave Poland assistance under the Brady Plan. Western
governments also offered Poland a 50 percent forgiveness of its official
bilateral debt at Paris Club negotiations in 1991; the Paris Club had previously
offered a maximum forgiveness of only 33 percent to LDCs. Under pressure
from the G7, commercial banks also agreed to reduce Poland’s private debt by
45 percent. Bulgaria followed the Polish model, and the private banks agreed
in principle to a substantial reduction of Bulgaria’s debt in late 1993 (most of
Bulgaria’s debt was private).

Czechoslovakia and Hungary were also affected by the debt crisis, but
unlike Poland and Bulgaria they tried to maintain their creditworthiness with
more prudent economic policies. In 1981, Hungary had the highest per capita
debt in the Soviet bloc and the second highest debt service ratio after Poland.
However, Hungary joined the IMF and the Bank in 1982 and instituted
ambitious economic reforms. As a result of their more prudent policies,
Hungary and Czechoslovakia did not require the debt relief measures that
were offered to Poland and Bulgaria.59

The different debt strategies of transition economies stemmed partly from
domestic economic and political factors. For example, Poland’s large debt
buildup followed political events that prevented the government from taking
decisive action to deal with its debt problems. Wladyslaw Gomulka’s removal
as first secretary of the Polish Communist party in 1970 resulted in decentral-
ization of the party and divisions within the top political leadership. Because
Poland’s political leadership was fractured, in the late 1970s workers were
able to resist austerity moves in response to high oil prices and declining
exports. The leaders tried to raise prices and hold down wages, but massive
strikes by workers forced them to reverse these moves. An austerity program
was introduced in 1981 when the military took control in Poland and
dominated the Solidarity Movement, but it resulted in hardship and further
protests.60 Unlike Poland, domestic politics in Hungary contributed to more
prudent economic policies. Although Hungary instituted some austerity
measures, it also adopted reforms to increase economic efficiency and give
profits and prices a larger role in resource allocation. The suppression of the
1956 Hungarian revolt had led to several developments that contributed to
these economic reforms. For example, Hungary turned from one-person
leadership to collective leadership and introduced a limited market
mechanism and a more balanced development strategy. Hungarian supporters
of economic reform also “sought not to weaken the [Communist] party but
to use it to pursue their particular economic goals.”61 Hungary’s earlier
reforms enabled it to meet its debt service obligations much more effectively
than Poland.

Despite the different development strategies of Eastern Europeans, their
debt problems also resulted from external events largely beyond their control.
For example, they suffered from increased dependence on imports from
nonsocialist states, the collapse of the Soviet bloc’s CMEA in 1991, and
deteriorating terms of trade as the Soviet Union ended subsidized oil exports.
Bulgaria is a prime example of a state affected by external events: The breakup
of CMEA had major consequences for Bulgaria because of its export dependence on the Soviet Union, the Gulf War adversely affected Bulgaria’s exports to Iraq, and the war in Yugoslavia disrupted Bulgarian export routes to Western Europe. The structural transition to market-oriented economies produced further instability in Eastern Europe, and domestic output fell by almost 25 percent in 1990 and 1991. Thus, a combination of internal and external factors contributed to Eastern Europe’s foreign debt problems.

**THE IMF, THE WORLD BANK, AND THE DEBT CRISIS**

The 1980s debt crisis altered the relationship between the IMF and World Bank as they adopted new overlapping functions. This was not the intention of the Bretton Woods negotiators, who wanted the IMF and the Bank to have separate functions; thus, they excluded specific references to the South in the IMF Articles of Agreement and assigned the development function to the Bank. Whereas the IMF was to provide short-term loans to any country with balance-of-payments problems, the Bank was to provide long-term loans for reconstruction and development. (The South was later mentioned in the second amendment to the IMF Articles of Agreement.) The only direct linkage between the two organizations was that membership in the IMF was a prerequisite for Bank membership. However, the Bank began to infringe on IMF territory in the 1960s. Diverging from its practice of providing loans for specific development projects, the Bank provided program lending to India for balance-of-payments support; and it linked its loans with conditions that India should reform its policies. The Bank justified its actions by asserting that India’s balance-of-payments deficit resulted from long-term development problems. However, the IMF argued that the Bank’s balance-of-payments funding with conditionality infringed on its functions. Although the two organizations signed an agreement to avoid further overlap in 1966, this did not fully differentiate their responsibilities.

Several changes in the 1970s increased the overlap between the IMF and Bank functions. First, the IMF lost its role of stabilizing exchange rates when the Bretton Woods system of pegged exchange rates collapsed. The IMF’s role of providing loans, in which there is potential overlap with the Bank, therefore became more prominent. Second, the IMF initially provided loans to all countries, but by the late 1970s it was lending almost exclusively to LDCs—the same countries receiving Bank loans. Third, the Bank’s Articles of Agreement (Article 3, Section 4) state that it should provide loans for specific projects “except in special circumstances”; but some LDCs needed development funding for other purposes. In 1971, the Bank therefore decided that program loans like its loan to India in the 1960s were sometimes appropriate. The Bank’s program loans to finance commodity imports are very similar to IMF loans for balance-of-payments problems. However, the main reason for increased overlap was the 1980s foreign debt crisis. The IMF’s short-term loans for balance-of-payments problems with 3–5 year repayment periods
were inadequate for LDCs with longer-term debt problems, and it began to provide medium-term SALs with repayment periods of 5–10 years. The Bank’s long-term loans for development projects with repayment periods of 15–20 years were also not what LDC debtors required to deal with more immediate balance-of-payments problems, and like the IMF, the Bank provided medium-term SALs to debtor countries. Although the IMF still provided short-term balance-of-payments loans and the Bank provided long-term development loans, they both were now providing medium-term SALs to indebted countries.64

The greater overlap of IMF and Bank functions has increased both conflict and collaboration. The overlap also raises questions as to whether two institutions are necessary, and the Economist predicted in 1991 that a merger between the two “makes sense, and in time it will happen.”65 Despite this prediction, the IMF and the Bank both perform important functions. First, the Bank group is composed of five institutions, and it is already too large for efficient management (see Chapter 10); joining the Bank and the IMF would compound the problems related to size. Second, development issues are highly complex, and a range of institutions are needed to provide advice and loans. Although historical materialists argue that IMF and Bank policies are virtually identical, liberal economists point to IMF–Bank disputes as an indication of competing perspectives. Third, IMF and Bank responsibilities extend well beyond providing loans. The IMF continues to advise states on monetary issues, and this role has become more important since the 2008 global financial crisis. As discussed in Chapter 10, the Bank is a source of economic expertise on development issues. Finally, the breakup of the Soviet bloc, the financial crises, and the economic problems in Sub-Saharan Africa provide sufficient economic challenges for both institutions. Whereas the IMF has coordinated actions to deal with Eastern European and FSU debt and the Asian financial crisis, the Bank has coordinated aid efforts in Sub-Saharan Africa.66

Although IMF–World Bank collaboration is partly designed to avert institutional conflict, the South is highly suspicious of these moves. Historical materialists and the debtors often see IMF conditionality as infringing on LDC sovereignty, and they argue that the liberal economic conditions on IMF and World Bank loans hinder LDC development. Moves toward IMF–Bank collaboration could result in cross-conditionality, in which an IMF decision that a loan applicant is uncreditworthy also prevents the applicant from receiving Bank funding. Although the IMF and the Bank rule out cross-conditionality in a formal, legal sense, they sometimes practice it informally.67 Critics also charge that IMF and Bank SALs put the onus of adjustment on LDC debtors and vulnerable groups within LDCs, even though the North shared responsibility for the debt crisis. The SAL prescription for improving LDC balance of payments is to reduce spending for social services, lower wages, produce more for export than for local consumption, and end subsidies for local industries. However, poorer LDC women who manage the household are the most severely affected by IMF and Bank
pressures for a reduction in funding for public services.\textsuperscript{68} IMF and Bank officials argue that structural adjustment aimed at market efficiency and decreased public sector involvement can be compatible with social welfare goals, but they have not convinced their critics.

\textbf{THE 1990s ASIAN FINANCIAL CRISIS}

This section on the 1990s East and Southeast Asian financial crisis (the “Asian financial crisis”) examines the challenges the crisis posed to the IMF and international financial stability, and proposals to improve the “international financial architecture.” Chapter 10 discusses this crisis in the context of international development. As discussed, international bank lending to LDCs sharply declined during the 1980s as a result of the foreign debt crisis. In the 1990s, private capital flows to middle-income LDCs increased again, but there was a change in the source of capital. Whereas commercial bank lending was the primary source of capital in the 1970s and 1980s, \textit{portfolio investment}, or the purchase of stocks, bonds, and money market instruments by foreigners, was much more important in the 1990s. \textit{Foreign direct investment}, or the foreign ownership or control of assets, also increased during the 1990s (see Chapter 9). Indeed, the net private capital flows to 29 \textit{emerging market economies} increased from $35 billion in 1990 to $334 billion in 1996.\textsuperscript{69} This revival of capital flows resulted from LDC economic reforms in response to the debt crisis, the success of the Brady Plan debt reductions, higher interest rates in the South, and a freeing of capital controls on investment in LDCs. However, some economists warned that these capital flows were volatile and “could be reversed easily.”\textsuperscript{70} Their concerns were soon realized when capital flows to Mexico halted rather suddenly in 1994. This section focuses mainly on the 1997–1999 Asian financial crisis, which “was the sharpest financial crisis to hit the developing world since the 1982 debt crisis.”\textsuperscript{71}

The Asian financial crisis began in Thailand in July 1997, when there was a massive run on its currency, the \textit{baht}. The roots of this crisis can be traced to the early 1990s, when capital inflows to Thailand rose sharply even though its current account deficit was increasing, its property prices were declining, and Thai banks were incurring a sizable foreign currency debt. Like other East Asian currencies, the baht was pegged to the U.S. dollar, and Thai exports became less competitive when the dollar’s exchange rate rose against the Japanese yen. Thus, Thailand had to allow its baht to float because of downward pressure on the currency. Despite government efforts to bolster the baht, capital outflows caused the currency to lose 48.7 percent of its value over the next six months, and this resulted in a sharp decrease in the country’s assets and growth. After the baht began to depreciate, the currencies of Indonesia, South Korea, Malaysia, the Philippines, and Singapore also came under severe downward pressure. The widening of the crisis from Thailand to other Asian countries is referred to as \textit{financial contagion}, or the transmission of a financial shock from one market or
country to other interdependent markets or countries. The financial contagion was manifested in several ways. All of these countries experienced rapid outflows of capital, depreciation of their currencies, and dramatic declines in their stock markets. Most of these countries also had recessions, banking crises, and lower economic growth rates. Thus, Thailand, Indonesia, and South Korea had to seek IMF and World Bank loans to bolster their currencies and economies. The economic problems also led to political problems, with major demonstrations leading to the resignation of Indonesia’s president Suharto, and transfers of power in Thailand, South Korea, and the Philippines.  

The main problems in the 1980s debt crisis were the overall indebtedness and high debt-service ratios of many LDC governments. However, in the Asian financial crisis the debts of governments such as Thailand, Indonesia, and South Korea to private and official creditors were relatively small. Domestic banks and private companies in Asia, by contrast, had borrowed heavily from foreign creditors, and when capital flows were reversed the Asian governments faced the challenge of overhauling insolvent banking systems and restructuring corporate debt. In sum, while the 1980s debt crisis resulted from “unsustainable current account deficits and poor macroeconomic fundamentals,” the Asian crisis was basically a “capital account crisis.”  

Although the financial crisis proved to be only a temporary setback and the Asian economies generally resumed their rapid growth rates, there were concerns that financial crises could recur because of the increased capital flows. Thus, the major DC governments proposed a number of reforms to strengthen global governance in finance, or the international financial architecture.  

The annual G7 summits played an important role in the architecture exercise, which began in 1995 in response to the Mexican financial crisis and evolved in response to the Asian crisis and a financial crisis in Russia. The architecture exercise led to the creation of new IMF lending facilities, efforts to strengthen the financial infrastructure in LDCs and transition economies, and a debate regarding the role of the IMF and its conditionality requirements. The main objectives were to develop better strategies to prevent and resolve financial crises. Crisis prevention involved identifying vulnerable countries before they experienced crises and fostering compliance with international standards to increase financial stability. Crisis resolution involved reforming IMF policies and involving private creditors in efforts to resolve financial problems of LDCs and transition economies.  

Prescriptions for the best measures to reform the international financial architecture depend on one’s theoretical perspective, and the following discussion compares the views of four groups:  

1. Orthodox liberals.  
2. Those combining orthodox and institutional liberalism.  
3. Those combining interventionist and institutional liberalism.  
4. Historical materialists.  

The first group of scholars are orthodox liberals who see the problems with international finance as stemming from inadequate domestic institutions and policies, not from the freeing of capital flows. From this perspective, the
1994 Mexican peso crisis resulted from an overvalued exchange rate and inadequate attention to the country’s trade and budget deficits and foreign debt; the 1997 Asian financial crisis stemmed from inaccurate financial reporting, pegged exchange rates, and banks offering questionable loans to businesses with political connections. Freer global capital flows were not responsible for the Asian financial problems. On the contrary, capital flows maximize efficiency because they are directed to countries with balanced budgets, stable markets, and low inflation rates. International regulation to limit risky behavior in capital markets would be harmful, and all capital controls should be abolished. Some economists believe that a lender of last resort is necessary for states with financial problems and that the IMF could perform this function if it had more financial resources. A lender of last resort “is an institution that is willing and able to supply unlimited amounts of short-term credit to financial institutions when they are threatened by a creditor panic.” However, orthodox liberals argue that the best way to prevent capital flight and speculative attacks on a state’s currency is to eliminate the problem of moral hazard. Moral hazard refers to the idea that protection against risk encourages a person or state to engage in riskier behavior. If a lender of last resort exists, states facing financial crises are more likely to engage in risky behavior because they can count on the lender to rescue them. Some orthodox liberals criticize the IMF and the Bank for contributing to moral hazard by providing development assistance, debt bailouts, and balance-of-payments support.

The second group of scholars combines orthodox and institutional liberalism. Like the first group, they believe that inadequate domestic policies increase a country’s vulnerability to financial crises, and that the Asian financial crisis stemmed more from “crony capitalism” or overly close connections between business and government than from financial contagion. Unlike the first group, however, they also see an important role for the IMF and World Bank in ensuring that LDCs and transition economies follow transparent, liberal economic policies. They favor strong IMF conditionality requirements to ensure that states are subject to the discipline of the marketplace, and IMF policies that “legitimize financial liberalization” and block efforts to increase “state regulation of international financial flows.”

The third group combines interventionist and institutional liberalism. As liberals, they assume that the failure of countries to follow liberal economic policies interferes with efficiently functioning markets. As interventionist liberals, they believe that unrestrained markets are not beneficial and that measures must be taken to protect society (see Chapter 4). In finance, currency traders often buy and sell for profit without taking account of fundamental economic conditions, and this produces volatility in capital flows and foreign exchange markets. Thus, financial markets are likely to perform better when regulated. The third group also emphasizes the need for a well-funded international lender of last resort to prevent financial crises from damaging global economic efficiency and development in LDCs and transition economies.

Theorists in this group have been actively involved in debates regarding the
the international financial architecture. For example, some members of this group responded to the Asian financial crisis by supporting the Tobin tax, which Nobel Laureate James Tobin first proposed in 1972. Tobin’s proposal called for “an internationally uniform tax on all spot conversions of one currency into another, proportional to the size of the transaction.” Although Tobin recommended a tax of only 1 percent, he believed that it would discourage short-term speculative capital flows and generate revenue that could be used for purposes such as combating world poverty. Supporters of the Tobin tax argue that it would reduce the risk of global financial crises and provide the international community with some of the profits flowing from international capital mobility. However, critics of the Tobin tax range from orthodox liberals who insist there is nothing wrong with the financial markets, to others who argue that such a tax would not be effective. Whereas currency traders in times of crisis would disregard a small tax, a larger tax would seriously interfere with financial markets. As institutional as well as interventionist liberals, the third group proposes numerous reforms in IMF and World Bank transparency, accountability, and conditionality requirements. They also support the idea that the IMF should become a lender of last resort.

The fourth group of scholars are historical materialists who view the Asian financial crisis as another example of the corrupting power of international capital. Unlike interventionist liberals, they see the IMF and the Bank as unreformable, and (like some orthodox liberals) they therefore favor the abolition of these institutions. For example, one study concludes that “the international financial institutions require Third World countries to adopt policies that harm the interests of working people.”

Until recently, the second group (orthodox and institutional liberals) had the most influence in discussions of the international financial architecture. However, the third group (interventionist and institutional liberals) has been gaining more influence as a result of the global financial crisis which began in the first decade of the twenty-first century.

**THE 2008 GLOBAL FINANCIAL CRISIS**

The global financial crisis is different from the 1980s foreign debt crisis and the 1990s Asian financial crisis because it began in the North rather than the South. However, there are similarities between these crises, regardless of their origins. As discussed, the 2008 crisis began with a subprime mortgage crisis in the U.S. housing market that resulted in a global credit crunch and financial failures in many countries. U.S. housing prices and home ownership increased dramatically in the late 1990s, and investing in a house seemed to be a means of gaining financial security. An influx of cheap foreign capital resulting from the huge U.S. trade balance and current account deficits kept interest rates low, and contributed to steady increases in mortgage financing and in housing prices. A substantial share of this mortgage financing was through subprime mortgages, which are mortgages for borrowers who do not qualify for market interest rates.
because of income level, credit history, size of the downpayment, and/or employment prospects. The high prices made it profitable to build houses, but this resulted in an oversupply, and housing prices began to fall in mid-2006 at an accelerating rate. Lower “teaser” mortgage rates that lenders had initially provided to entice possible homeowners were also coming up for renewal at higher rates. Many subprime borrowers who could not pay the higher rates had to default on their loans, and they ended up owing more than the value of their houses because of the declining prices. The result was a growing list of foreclosures and evictions of people from their homes.

Although the subprime crisis began in the United States, one can draw some parallels between U.S. subprime borrowers and LDCs in the previous two crises, because subprime borrowers (like LDCs) are poorer and more vulnerable to financial distress. Critical theorists pointed to “loan pushing” by international banks recycling OPEC petrodollars as a cause of the 1980s debt crisis, and mortgage pushing by highly assertive lenders was also a cause of the current crisis. As with the international banks in the 1970s, the mortgage lenders did little to assess borrowers’ ability to repay their loans, and they encouraged people who were credit risks to borrow in the subprime mortgage market. Subprime lenders also sought to persuade legislators to forgo regulations restricting lending to borrowers with poor credit ratings. For example, one of the largest U.S. subprime lenders (Ameriquest Mortgage Company) spent more than $20 million on political donations. Rating agencies such as Moody’s, Standard and Poor’s (S&P), and Fitch issued some warnings about emerging problems in the subprime market, but their warnings were too little and too late. U.S. House Committee hearings on the subprime crisis have pointed to conflicts of interest because of services that the rating agencies provide to mortgage lenders. Mortgage buyers also bear some responsibility for the subprime crisis just as LDC borrowers bore some responsibility for the 1980s debt crisis. Many mortgage buyers were complacent about their personal debts, accustomed to living beyond their means, and inclined towards having unrealistic expectations. As Robert Shiller points out, mortgage buyers as well as sellers were susceptible to an irrational “contagion of ideas” that the housing boom would continue indefinitely. As was the case with the 1980s debt crisis and the 1990s financial crisis, this contagion of ideas seemed to blind both the credit agencies and those in responsible positions such as Alan Greenspan of the Federal Reserve, Ben Bernanke of the Council of Economic Advisers, and President George W. Bush to the severity of the emerging problems. The “experts” also overlooked long-term trends that made the United States more vulnerable to the 2008 crisis. From 1980 to 2006, the U.S. household personal savings rate had declined from 8 percent to 0 percent, and total private sector debt (households, and financial and nonfinancial businesses) had increased from 120 percent to 300 percent of GDP.

Before the U.S. subprime crisis, many academics and practitioners had assumed that “improvements in financial engineering and the conduct of monetary policy had done much to tame the business cycle and limit the risk of financial contagion.” However, they were proved wrong because the U.S.
subprime mortgages were packaged and sold to investors in many countries. For example, investors in Japan, Germany, and elsewhere sought higher returns in the U.S. subprime market than they could get from investing in domestic real estate. When U.S. subprime borrowers defaulted on their payments, there were serious repercussions for investors around the globe. This was a prime example of financial contagion, because the U.S. subprime crisis spread across international borders to become a global financial crisis.\textsuperscript{88}

It is important to note that some of the U.S. problems leading to the subprime crisis were also present in other countries. First, many DCs in Europe and elsewhere (such as Iceland) had their own problems of real estate bubbles with inflated housing prices. Second, many European countries had large current account deficits and had been borrowing capital from abroad and living beyond their means. This was especially true for countries in the southern part of the eurozone such as Greece, Portugal, Spain, and Italy (and also for Ireland). When these countries adopted the euro, confidence in their economic prospects increased and their interest rates declined to the level of the eurozone's economically stronger members such as Germany and France. The sense of confidence and lower interest rates encouraged investors and consumers in these countries to spend freely and accrue more debts. The increase in domestic demand contributed to rapidly rising wages that outpaced productivity, and the external competitiveness of these countries declined. With the recession and collapse of tax revenues that accompanied the 2008 global financial crisis, overspending in these countries and their declining export competitiveness decreased hopes for recovery. As discussed in Chapter 7, members of the eurozone cannot devalue their currencies to increase their competitiveness. Greece was the first country in the eurozone to require assistance to service its debt, and there was a risk of contagion to other countries in the euro bloc. Although the 2008 financial crisis began in the North, the resulting credit crunch has been felt strongly in the South. Many LDCs have turned to the IMF for assistance, as they did in the 1980s debt crisis and the 1990s Asian financial crisis.\textsuperscript{89}

We can find both similarities and differences between the possible solutions to the three crises. As with the 1980s debt crisis and the 1990s financial crisis, it was first necessary to have a “firefighting strategy” to deal with the immediate problems created by the bursting of the housing bubble and its aftermath. An immediate problem in all three of the crises was the inability or reluctance of banks and other lending agencies to provide credit and finance. In the 2008 global crisis, DCs and some LDCs and transition economies instituted huge bailout programs for their banks and other institutions. Whereas the G7/G8 provided the political support for dealing with the earlier debt and Asian financial crises, the G20 is providing the political support for addressing the 2008 crisis. This is an indication of the growing power of emerging countries such as the BRIC economies, and of a shift in economic power from the West to Asia. Differences of view on how to remedy the 2008 global financial crisis are more evident because the G20 is larger and more diverse than the G7/G8. For example, while some countries argue that
more assistance should be provided to stimulate the global economy, others assert that too much assistance could result in “moral hazard.” Whereas European countries and Canada argue that it is time to focus on fiscal tightening to increase investor confidence, the U.S. administration has urged other countries to continue stimulating their economies. The June 2010 G20 meeting in Toronto, Canada, endorsed goals to cut government deficits in half by 2013 and to stabilize public debts by 2020, but the United States, Japan, and India insisted that this was an expectation rather than a firm deadline.

The regulation of banks and other financial institutions is another contentious issue. The EU and the United States have pressured for a universal bank tax to cover the cost of bailouts from financial crises; but Canada and many emerging economies such as Mexico, Russia, India, and China oppose such a tax. Most of these countries avoided the banking practices that created major problems for European and U.S. banks. They are also concerned that a universal bank tax would increase the problem of moral hazard, encouraging banks to continue risk taking because they would know a pool of money was available for future bailouts. These countries call for better regulation of banks, instead of burdening them with more taxes. Despite the U.S. and EU pressures for a universal bank tax, the G20 decided that each state should form its own policies on the bank tax issue; this was a clear sign of some shift in influence from the United States and the EU to the emerging economies.

After the immediate problems are dealt with, there is the more difficult problem of restructuring the global financial, monetary, and trade regimes to prevent a recurrence of the problems. Several issues are central to the task of global restructuring. First, there is a need for further reform of the “international financial architecture” (a term initially used in reference to the 1990s Asian financial crisis). In the current crisis, there is a need for greater transparency and tighter regulation of the banking and financial industry. However, the G20 countries disagree on what banking and financial activities should be controlled, and on whether there should be international regulation or simply more national regulation to coordinate and harmonize banking rules. Second, IMF and World Bank decision making must change to reflect the new global realities. With the massive foreign debt of the United States and some EU countries, and the growing foreign exchange reserves of emerging economies such as China, South Korea, and some OPEC members, IMF and Bank lending resources will depend more on the emerging economies. IMF and Bank members agree that changes are necessary in the weighted voting to reflect the shifts in economic power. In addition, there is growing support for the idea that the IMF and World Bank heads should be selected on the basis of merit alone, and not by nationality.

Third, the 2008 global financial crisis demonstrates that global governance requires more attention to the linkages between trade and financial issues. A major factor in the financial crisis was trade imbalances, with some states such as China having huge balance of trade surpluses and others such as the United States having huge deficits. China has become the largest single-country merchandise exporter, and it increases its competitive edge by pegging the value of its currency, the yuan (or renminbi), to the U.S. dollar. The trade
imbalances contributed to China’s massive reserves, the United States’ massive borrowing, and the global financial crisis that followed. Shortly before the June 2010 G20 meeting, China indicated that it would let the yuan gradually rise in value; but when this will occur and by how much remains to be seen. Finally, the 2008 financial crisis raises questions about the adequacy of the unrestrained market, and there has been a shift back toward interventionist liberalism. As the authors of a recent study on the 2008 crisis phrase it, we cannot rely only on Adam Smith’s invisible hand of the market; to prevent future crises, it is “time for a visible hand.” As part of the visible hand, there is an important role for the international financial institutions. The 1990s Asian financial crisis resulted in strong criticisms of the IMF to the point where some observers were questioning the future of the organization. The 2008 crisis by contrast has given the IMF a new sense of purpose, because the G20 has decided to give it a substantial increase in resources to deal with the financial problems.

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**Considering IPE Theory and Practice**

What is the relevance of the IPE theoretical perspectives for the 1980s foreign debt crisis? Most observers agree that unexpected changes such as the food and oil crises of the 1970s were a major cause of the debt crisis. However, warning signs leading up to the crisis were clearly overlooked, and orthodox liberals also see imprudent borrowing and inefficient domestic policies of LDCs as major causes. Historical materialists focus instead on the irresponsible behavior of commercial banks and creditor governments, and on the long-term dependency of LDCs. In response to the debt crisis, DCs, the IMF, and the World Bank induced the debtors to adopt liberal economic policies, and views sharply differ regarding the effects of these policies. Liberal economists argue that the policies prevented the collapse of the international banking system and restored capital market access for many indebted states. Although the debtors’ policy changes caused hardship for some groups and individuals, the long-term effects of the shift to economic openness benefited LDCs and transition economies. Realists and historical materialists, by contrast, argue that liberals ignore the effect of inequality among states on the debt issue. Although globalization facilitated the transmission of liberal values to the DCs, these values were imposed on LDC debtor states. Furthermore, historical materialists argue that the debt strategies required much more sacrifice from LDC debtors than from international banks, and that IMF and World Bank conditionality requirements served the needs of international capital. IMF requirements that debtors reduce social expenditures, increase exports, remove restrictions on capital flows, and devalue their currencies had a negative impact on the poorest and weakest societal groups.

Assessments of the 1990s Asian financial crisis also depend on one’s theoretical perspective. Orthodox liberals attributed the Asian financial crisis to inefficient domestic policies, and they opposed international controls on capital flows. Whereas
some extreme orthodox liberals argue that the IMF and the Bank should be abolished because they contribute to moral hazard, others encourage these institutions to strengthen their conditionality requirements to ensure that LDCs and transition economies are subject to market discipline. Interventionist liberals by contrast call for some control over capital flows, institutional reforms to make the IMF and the Bank more transparent and accountable, and a lender of last resort. The harshest critics of international capital flows are historical materialists, who see the IMF and the Bank as agents of international capital and as unreformable. Interventionist liberals are the most supportive of developing a new international financial architecture to provide more transparency and regulation, sufficient international liquidity in crisis conditions, and mechanisms for orderly debt management and development finance. However, progress in developing a new financial architecture has been limited largely because of differences between DCs on the one hand and LDCs and transition economies on the other.

The 2008 global financial crisis differed from the other two crises because it originated in the North. As with the previous crises, there are competing views of the causes of the U.S. subprime mortgage crisis, with orthodox liberals often blaming the subprime borrowers, realists pointing to the failure of the state to regulate financial transactions, institutional liberals pointing to inadequate regulation by international institutions such as the IMF, and historical materialists and some interventionist liberals blaming the subprime lenders and the unrestrained market. Many theorists also attribute the crisis to the marked trade and payments imbalances, with some blaming the overspending habits of the United States and some EU countries, and others blaming the currency manipulation and accumulation of large reserves by China. There is also a lack of agreement on the best means of dealing with the crisis, with some warning that bailing large banks and corporations out will lead to “moral hazard” and others warning that the banks and corporations are “too big to fail.”

The main global actors failed to establish a new international financial architecture after the 1990s financial crisis, and it remains to be seen whether they will be more successful in reforming international finance after the 2008 global financial crisis.

QUESTIONS

1. What are the competing theoretical views regarding the causes of the 1980s foreign debt crisis?
2. Do liberals and historical materialists believe that the debt strategies have successfully dealt with the worst aspects of the debt crisis? Do you think that debt reduction is necessary or that it contributes to moral hazard?
3. How did the 1980s debt crisis differ from the 1990s Asian financial crisis? What are the similarities and differences between the 2008 global financial crisis and the two earlier crises discussed in this chapter?
4. What are the views of orthodox, institutional, and interventionist liberals and historical materialists regarding the best means for reforming the international financial architecture? Was a new financial architecture developed as a result of the 1990s Asian financial crisis?
5. What is the relationship among the London Clubs, the IMF, and the Paris Club in dealing with foreign debt? Why do you think some of the most important institutional groupings such as the Paris Club, the London Clubs, the G7/G8, and the G20 are so informal?

6. What were the strengths and weaknesses of the Baker Plan, the Brady Plan, and HIPC and MDRI initiatives? How do you explain the fact that the Baker and Brady plans did not address the problems of the poorest LDC debtors?

7. What are the competing views of the causes, and remedies for, the 2008 global financial crisis? Which of these views do you find most convincing? Do you think that the 2008 global financial crisis is likely to have an effect on U.S. economic hegemony?

8. How have the roles of the IMF and World Bank, and the relationship between these two institutions, changed as a result of the foreign debt and financial crises?

**KEY TERMS**

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**FURTHER READING**


**NOTES**


Notes


52. Cline, International Debt Reexamined, p. 70.


66. James, International Monetary Cooperation, p. 326; Polak, The World Bank and the International Monetary Fund, pp. 44–45.


89. Reinhart and Rogoff, *This Time Is Different*, pp. 244–246.


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The last three decades of the twentieth century and the beginning of the twenty-first century have been marked by a series of disruptive developments in the global political economy. Some of the most notable developments have been the food and oil crises in the 1970s; the foreign debt crisis in the 1980s; the breakup of the Soviet bloc and Soviet Union in the 1980s and 1990s; the Asian financial crisis of the late 1990s; the terrorist attacks on New York and Washington, DC, in September 2001; and the global financial crisis of 2008. As globalization has increased, economic and security events in one part of the world are having a greater impact on distant areas, and predictions about the future of the global economy have become more hazardous. However, the historical and theoretical focus of this book enables us to speculate about current and possible future changes. Relying on the major themes of this book, Chapter 12 examines contemporary trends in the global political economy.
This book provides a comprehensive approach to the study of IPE, introducing students to the main theoretical perspectives and substantive issue areas. The realist, liberal, and critical perspectives have evolved and influenced each other over time, and some theoretical approaches such as hegemonic stability theory and regime theory draw upon more than one of these perspectives. Constructivist theory, feminist theory, environmental theory, and approaches that focus on domestic–international linkages are contributing to further changes in the study of IPE. To help link theory and practice, this book focuses on three main themes: globalization, North–North relations, and North–South relations. Issues related to Eastern Europe and the FSU are subsumed under these three themes because the Cold War has ended and the transition economies are becoming increasingly integrated in the capitalist global economy. Whereas the more developed transition states such as the Czech Republic and Hungary have levels of development comparable with some DCs, poorer transition states such as Moldova and Tajikistan face economic problems comparable with those of LDCs. This concluding chapter examines where we are with these themes of globalization, North–North relations, and North–South relations and speculates about the future.

**GLOBALIZATION**

Globalization is a process that involves the broadening and deepening of interdependence among societies and states throughout the world. Broadening refers to the geographic extension of linkages to encompass virtually all major societies and states, and deepening refers to an increase in the frequency and intensity of interactions. This book does not adopt an extreme view of globalization that we are entering a “borderless world” where MNCs are
losing their national identities and states are losing their distinctiveness.\(^1\) Thus, globalization affects some states and regions more than others, threatens the state’s autonomy in some respects but gives the state some new roles and does not prevent it from making policy choices, and contributes to fragmentation and conflict as well as unity and cooperation. Although states and societies were highly interdependent during the nineteenth and early twentieth centuries, globalization is more encompassing today than it was at any time in the past. Advances in technology, communications, and transportation are facilitating the globalization process as never before; the role of MNCs in generating FDI, trade, and technology is unprecedented; the capitalist economic system is spreading throughout the globe; and international economic organizations are becoming truly universal in membership.

Realists, liberals, and critical theorists have widely divergent views of globalization. Realists emphasize the importance of the state and often question whether globalization has significantly increased. Although realists acknowledge that interdependence is increasing in some areas, they see this as occurring only with the permission or encouragement of the most powerful states. Liberals, by contrast, view globalization as a significant force that is eroding state control, and they see the growth of interdependence as a positive development. Whereas realists believe that globalization occurs at the whim of the state, liberals see such factors as technological change and advances in communications and transportation as being beyond state control. Liberals also argue that domestic and transnational actors such as internationalist firms are a major force behind the increase of globalization.\(^2\) Critical theorists, like liberals, see globalization as having a significant impact, but they often view this in negative terms. For example, historical materialists see globalization as having negative consequences for lower classes and poorer states in the periphery. Some Gramscian theorists argue that globalization is leading to the development of a “transnational historic bloc” composed of MNCs, international banks, international economic organizations, and international business groups in the most powerful capitalist states. A crucial element of this historic bloc is the power and mobility of transnational capital, which is putting national groups such as labor unions on the defensive. The only way to counter this historic bloc is to develop a counterhegemony composed of labor, human rights, women’s, environmental, consumer, and development groups. This bloc would seek to replace the current corporate view of liberalization with a more democratic, participatory model based on socialism.\(^3\)

**Globalization and Triadization**

Globalization is in many respects more akin to “triaidization.” The integrative processes are most intense among DCs in three major regions: Europe, North America, and East Asia.\(^4\) Emerging economies such as China, India, South Korea, Russia, Brazil, and South Africa have been making inroads into the dominance of the DCs; but several of them are in the three major regions (China and South Korea in East Asia; Russia in Europe as well as North Asia). In 2008, the DCs accounted for 84.1 percent of total outward FDI stock and
for 68.5 percent of inward FDI stock (see Tables 9.1 and 9.2 in Chapter 9). China is the only LDC that vies with the largest DCs as a leading home as well as host country for FDI (see Table 9.4). Europe, North America, and East Asia also dominate global trade flows. In 2008, the leading merchandise exporters were the EU(27), China, the United States, Japan, and Russia, and the leading merchandise importers were the EU(27), the United States, China, Japan, and South Korea (see Table 7.4). Although the triad continues to be important, there are power shifts occurring within it; for example, U.S. economic hegemony is declining, and some economic power is shifting from North America and Europe to East Asia. Conflict within the triad on a wide range of security and economic issues has also increased in recent years. These changes within the triad and the implications for the global political economy are discussed later in this chapter (under North–North relations).

Problems have also arisen because LDCs and emerging economies both within and outside the three major regions sometimes react negatively to feelings of subordination and marginalization. As discussed in Chapter 10, Latin America is one of those areas. The United States’ decreasing emphasis on security issues in the 1980s, combined with Latin America’s turn toward market liberalism and democracy, led to hopes for more cooperative linkages. However, the United States devoted much less attention to Latin America after the September 11, 2001, terrorist attacks. Subsequently, efforts to establish a Free Trade Area of the Americas (FTAA) collapsed, some Latin American states turned against democratic practices and market liberalism, and the question arose as to whether the United States was “losing Latin America.” Like Latin America, Russia has also felt marginalized, particularly by the United States and the EU. As Russia’s economy has revived with revenues from energy and other commodity exports, Russia has adopted more hostile policies to the West on some issues and has demanded a greater role in the IMF and World Bank. The other BRIC economies (China, Brazil, and India), like Russia, are demanding a greater role in IMF and Bank decisions. Another problem area outside the triad is the Middle East and North Africa; there has been continued strife among states in the region, and growing tensions between Islamic and Western practices. Sub-Saharan Africa (henceforth, Africa) has been the most marginalized of the LDC regions. Most of the LLDCs are African, and Africa’s trade and investment flows have been very limited. For example, Africa accounted for only 3.4 percent of inward FDI stock in 2008, compared with 17.3 percent for Asia and Oceania and 7.9 percent for Latin America and the Caribbean (see Table 9.2). The HIV/AIDS virus has also had a devastating effect on Africa. Most of the 3 million people who died from HIV/AIDS in 2004 were from LDCs, and 70 percent of them were in Africa. Thus, triadization has had a negative effect on a number of marginalized areas.

Globalization and the State

Liberals see globalization as causing state authority to leak “away upwards, sideways, and downwards.” Internationally, states must share authority with MNCs and international institutions; domestically, central governments must
share authority with NGOs and regional and local authorities. For example, globalization has constrained the ability of DCs to continue providing the social welfare benefits that citizens came to expect during the 1950s to 1970s, and neoliberalism has made such social expenditures seem less legitimate. Globalization also limits the ability of states to regulate the national economy. For example, the massive growth of international capital flows has contributed to volatility and misalignment in currency exchange rates. These exchange rate fluctuations interfere with the state’s ability to promote economic regulation and stability. Orthodox liberals view the increased capital flows as a positive development because financial markets impose necessary discipline on states, and global capital moves to the most productive locations. Interventionist liberals agree that increased capital flows are beneficial, but caution that states and IOs must adopt regulatory policies to limit the volatility of capital flows. Historical materialists see increased capital mobility as a negative development because the fear of capital outflows can induce governments to adopt policies that adversely affect the poorest and weakest in society. If states do not adopt capital-friendly policies, MNCs and international banks can shift their funds to more welcoming locations. Thus, MNCs locate their production facilities in states with the lowest wages, taxes, and environmental standards.

Realists are more inclined than other theorists to view reports of the state’s decline as “greatly exaggerated.” They argue that the increase in global financial flows has occurred with the permission or encouragement of the most powerful states and that these states continue to dictate the terms for such transactions. Some realists also argue that globalization has “enabling” as well as “constraining” effects on the state. Thus, many states have “increased direct tax yields, maintained or expanded social spending, and devised more complex systems of trade and industrial governance in order to cope with deepening integration.” The impressive economic growth rates of some states are closely related to their success in fostering a symbiotic relationship with the competitive marketplace. Although the state must vie with a range of nonstate actors, it continues to be the most important actor in the global economy.

The validity of the theoretical positions of different theorists depends partly on the states they are examining. For example, the 1990s Asian financial crisis demonstrated that LDCs are especially vulnerable to the freeing of capital flows. East and Southeast Asian states had opened their economies to capital flows in the years leading up to the crisis, and a surge of bank lending and portfolio investment contributed to risky and ill-advised investments in the region. When these states encountered economic problems, there was a “rush of international capital out of the region in 1997—a movement that was more frenzied than its mad rush to get into the area in earlier years.” Although domestic political and economic factors in the Asian economies contributed to the financial crisis, a major external factor was contagion, or “the spread of currency and asset market problems from one market to another.” As investor concerns spread, even sound financial institutions
were adversely affected. One Asian currency after another was depreciated, states experienced liquidity crises, and the IMF became deeply involved in providing finance. Even an IMF deputy managing director acknowledged that the “factors contributing to contagion suggest it has been excessive—and that a way should be found to moderate it.”14 Thus, a consensus developed that LDCs and transition economies should not open their capital markets too rapidly because it may be difficult for them to make adequate adjustments. Although major DCs are less vulnerable than most LDCs to financial globalization, the contagion effects of the 2008 global financial crisis show that capital volatility can also have a strong effect on DCs. It is difficult for states to coordinate their policies on regulating capital mobility for several reasons:

- States often give priority to their own national concerns over the need for policy coordination.
- It is questionable whether governments have the will to regain control over capital and foreign investment movements in the present climate of neoliberalism.
- Although there is general agreement that LDCs should be more careful in liberalizing capital flows, there is a lack of consensus on proposals for reform (see Chapter 11).

In sum, some aspects of globalization such as the freeing of capital flows pose a major challenge to the ability of states to regulate global market forces.

Globalization, Inequality, and Poverty

The World Bank has compiled a large body of statistics on global inequality and poverty, but critics from both the Right and Left often take issue with the Bank’s methodology and findings. These criticisms show that it is difficult to interpret the statistics on inequality and poverty, and that a researcher’s theoretical perspective often affects their methodology and findings. For example, one analyst criticizes the Bank’s methodology of putting “all the households in the world onto one chart to measure worldwide inequality of incomes,” because inequality matters most when people compare their income or wealth with others in their society:

What sense does it make to put a household in Mongolia alongside a household in Chile, one in Bangladesh, another in the United States, and still another in the Congo? These households do not belong to a ‘society’ in which they compare themselves with the others, and so a measure that includes all of them is practically a meaningless construct.15

Another analyst argues that “deep methodological flaws in the Bank’s poverty measurement methodology suggest that its figures may be quite inaccurate and that both the incidence and the trend may be worse than reported.” This researcher believes that the UNDP, which found greater increases in poverty than the Bank, has “a more plausible poverty measurement methodology.”16
Although the statistics are sometimes conflicting, it seems that globalization and liberalization in combination have contributed to greater inequalities both among and within many states. Thus, the World Bank reports that the average income in the richest 20 states is 37 times higher than the average income in the poorest 20 states—a gap that has doubled in the last 40 years. The growing inequalities are most evident between the North and South, with the OECD states’ share of the global GDP rising from 66 percent in 1970 to 78 percent in 1995. Whereas the real per capita GDP of the LDCs rose from $936 in 1980 to $1,417 in 2000, the increase for the DCs was from $20,397 to $30,557. However, there are also growing divisions among countries in the South, with some emerging economies such as the BRIC economies and NIEs posing a growing challenge to the North. Income inequality has also increased within many LDCs and transition economies. In 1997, the UNDP reported that a falling share of national income was going to the poorest 20 percent of people in several Latin American states (Argentina, Chile, the Dominican Republic, Ecuador, Mexico, and Uruguay) and that income distribution had worsened in 16 of 18 states in Eastern Europe and the FSU (excluding Estonia, Latvia, and Lithuania). The World Bank reported that inequality in China was much greater at the end of the 1990s than it had been in the early 1980s. Inequality has also increased within many DCs. From 1979 to 1997, unemployment in the EU more than doubled to 11 percent. The share of total income going to the top one percent of earners in the United States increased from 8.9 percent in 1976 to 23.5 percent in 2007.\textsuperscript{17}

How do IPE theorists interpret the statistics on inequality? Liberals recognize that globalization may contribute to inequality in the short term, but they believe that efficiency gains can reduce poverty even when inequality increases. Thus, one liberal asserts that “globalization does not appear to exacerbate poverty and may indeed contribute toward its reduction,” and another argues that “globalization . . . has improved the lot of hundreds of millions of poor people around the world.”\textsuperscript{18} Although the data on poverty give some support to the liberal view, the findings are ambiguous. For example, the number of people living in extreme poverty (less than $1 a day) declined between 1987 and 1998, but this resulted mainly from growth in China and India. In most other areas such as Africa, Eastern Europe, and Central Asia, extreme poverty was increasing. Furthermore, the UNDP reports that the number of chronically malnourished people increased from 800 million in 1990 to 850 million in 1995.\textsuperscript{19} Liberals also argue that globalization will reduce inequality over time. For example, one liberal asserts that “the late-comers to modern economic growth tend to catch up with the early-comers”; and another argues that “the economic gap between South Korea and industrialized countries . . . has diminished in part because of global markets.”\textsuperscript{20} Liberals believe that economies such as North Korea and Myanmar that isolate themselves from global markets will continue to be among the poorest LDCs.

Realists and historical materialists, by contrast, believe there are long-term losers as well as winners from globalization. Historical materialists see globalization as benefiting the most powerful capitalist states and MNCs in the core
CHAPTER 12

Concluding Comments

at the expense of peripheral states and vulnerable societal groups. Realists argue that the most powerful states have control over the pace and direction of globalization and that they use the globalization process “to reinforce their position and their relative power.” Globalization for less powerful states, by contrast, “is a process which is happening to them and to which they must respond.” Realists also assert that the policies of states as well as their positions in the global economy can make a difference. For example, some Asian LDCs such as China, India, Bangladesh, and Vietnam have reduced poverty to some extent while liberalizing their trade and investment policies. Variations among LDCs in the concentration of land ownership, the degree to which production is labor intensive, and other factors can influence the way in which globalization affects the distribution of wealth. Despite the difference of theoretical views, we have discussed the fact that the persistence of poverty and inequality has contributed to disillusionment with the Washington Consensus and the election of leftist governments committed to sharing the wealth in some regions such as Latin America.

Globalization and Democracy

Many liberals believe that globalization is promoting democracy throughout the world. They point to the spread of liberal democratic practices such as constitutional guarantees, freedom of speech, open elections, and multiparty systems in southern Europe during the 1970s, Africa and Latin America during the 1980s, and the transition economies of Eastern Europe and the FSU during the late 1980s and 1990s. However, historical materialists and some interventionist liberals note that the poorest individuals in the South lack employment, education, and health facilities. They view the economic right to an adequate standard of living as more important than Northern-oriented political rights such as free speech and democratic elections. Furthermore, income inequalities resulting from globalization contribute to disparities in political influence that limit opportunities for democratic policy making. These economic inequalities help explain the recent backlash against previous gains in representative democracy in some Latin American and African LDCs. Latin America and Africa have had the highest levels of income inequality, and “the situation deteriorated even further” in the 1980s and 1990s. Even in the North, globalization critics argue, political rights mean little to the poorest individuals who lack housing, employment, and other basic amenities. Critics also argue that globalization is transferring control from democratically accountable governments to MNCs, international banks, and IOs. Whereas national governments are accountable to domestic groups and individuals through periodic elections, international institutions lack such accountability. Thus, some scholars ask whether IOs such as the IMF, World Bank, and WTO are “accountable to those whom they directly affect.” Liberal supporters of globalization argue that democratization has occurred in the KIEOs in some important respects. For example, KIEO transparency has increased through the publication of minutes, decisions, and documents,
and the KIEOs have upgraded their relations with NGOs. Critics by contrast argue that KIEO accountability has not increased in significant areas, and they refer to the gap between national and international governance as a “democratic deficit.”

Globalization and Civil Society

Globalization has contributed to the growth of civil society groups committed to social change. As discussed, there are three types of civil society groups: Conformists largely endorse the behavior of the KIEOs and private actors such as MNCs; reformists accept the KIEOs and MNCs but believe that they should and can be reformed; and transformists or rejectionists see the KIEOs and MNCs as un-reformable, and want to downsize or abolish them. Reformists rely mainly on cooperative strategies to alter the behavior of the KIEOs and MNCs, whereas rejectionists engage in ideological—and sometimes physical—confrontation. Conformists and reformists are liberals, with reformists favoring embedded liberalism that takes account of the social effects of the market. Rejectionists, like historical materialists, are committed to transforming the capitalist system. Some NGOs employ reformist and rejectionist strategies simultaneously; for example, Greenpeace worked with companies to develop ozone-friendly refrigerators at the same time as it encouraged consumers to boycott Shell Oil because of its alleged involvement with state suppression in Nigeria.

In recent years, reformists and rejectionists have organized protests against the WTO, World Bank, IMF, G8, and G20 as purveyors of globalization. Civil society groups have used some of the trappings of globalization such as the World Wide Web in opposing it. As discussed in Chapter 9, the web was especially useful to protestors against the proposed MAI because it “facilitates networked sociopolitical relationships in important new ways, it (potentially) increases NGOs’ organizational effectiveness and political significance, and it helps to foster more broadly participatory (transnational) political processes.” The question arises as to whether a “global civil society” is likely to develop a counterhegemony in opposition to globalization in Gramscian terms. Civil society groups have had influence in certain cases such as their opposition to the proposed MAI, and a number of IOs and MNCs have responded to civil society pressures by expanding communication with NGOs. However, it is highly unlikely that a global civil society will establish a counterhegemony for several reasons. First, most civil society groups are conformists (a “silent majority”) that may be dissatisfied with some aspects of the global economic order but are not dissatisfied enough to seek major changes. Many conformists are also beneficiaries of the current global order. Second, civil society groups have a diverse range of objectives, and they find it easier to agree on what they are against than on what type of world order they favor. A third obstacle to the development of a counterhegemony relates to differences in strategies and tactics; that is, reformists and rejectionists have divergent views regarding the legitimacy of violent protests. Finally, the
terrorist attacks of September 11, 2001, have had a chilling effect on the activities of some civil society groups. In sum, civil society groups have had some influence in inducing international institutions and MNCs to alter top-down modes of decision making, but one should not overestimate their effect on the global political economy.

Globalization and “Newer Issues”: The Environment, International Migration, and Illegal Activity

Most IPE theorists associate globalization with the liberalization of trade, foreign investment, and capital flows. However, it is difficult to separate these explicitly economic processes from the effects of globalization on a variety of “newer” socioeconomic processes and issues. This section examines the effects of globalization on the environment, migration, and illegal activity.

THE ENVIRONMENT

Liberals see globalization as a positive force for the environment because it contributes to economic growth which is needed to pay for environmental improvements. Many liberals acknowledge that economic growth may increase environmental problems such as industrial pollution and the cutting of forests in the short term. In the longer term, however, growth is necessary to pay for environmental protection. Thus, one theorist asserts that “the overall historical pattern in industrial countries in the last century has been one of increasing and then decreasing emissions over time.”

Orthodox liberals believe that such improvements will occur naturally with the functioning of free and open markets; if there are fewer market distortions, we will be less likely to undervalue a natural resource. Interventionist and institutional liberals recognize that globalization has “enhanced our ability to exploit” resources “at a pace faster than our ability to manage them has grown.” They therefore see a greater role for the state and IOs in ensuring that development does not pose major damage to the environment. However, liberals are generally optimistic about solving global environmental problems through cooperation and technological advances. For example, they have lauded the success in reducing the amount of chlorofluorocarbons (CFCs) released into the atmosphere. CFCs were used in refrigerators, aerosols, insulation, and solvents, but scientists discovered that they were depleting the ozone layer which protects us from harmful ultraviolet sun rays. The 1987 Montreal Protocol on Substances that Deplete the Ozone Layer and subsequent amendments have resulted in significantly reduced CFC production.

Critical environmental theorists—the greens—argue that globalization is linked with a type of economic growth that results in environmental pollution and overconsumption of natural resources. They cite figures to show that global water consumption, deforestation, and pollutants such as carbon dioxide emissions from automobiles are increasing exponentially. Some greens see the world’s growing population as the main factor behind the environmental problems. Others see the main factor as global inequality, which results in overconsumption by the wealthy and the relegation of the more polluting
forms of production to poorer areas and LDCs. Many greens focus specifically on capitalist globalization, which “undermines the quest for an ecologically and socially sustainable future. The constant threat of international capital flight strips individual governments of important domestic regulatory powers.” Unlike liberals, the greens view the success in reducing production of CFCs as an exception, and they argue that progress on most environmental issues under the capitalist form of globalization has been extremely limited.

Realists are less involved in debates over globalization and the environment because of their preoccupation with security issues. They assume that the largest states can use globalization to improve their power positions vis-à-vis weaker states, and unlike the liberals and greens they argue that globalization has not systematically undermined state control. Realists see the environmental effects of globalization as depending more on the actions of states than on the market and international institutions. The main issue to realists is whether states establish mechanisms to protect the environment, and whether they are willing to transfer some authority to international environmental institutions.

Theorists from each of these perspectives have a point. As the greens point out, globalization-generated economic growth can result in environmental pollution and the overconsumption of resources. However, economic stagnation and poverty also pose environmental risks. Thus, liberals are correct in noting that economic growth can create the wealth necessary for dealing with environmental problems. Realists are also correct that environmental protection will ultimately depend more on the actions of states than on the market or international institutions. Whether states have the motivation and ability to cooperate to protect the environment is another matter.

INTERNATIONAL MIGRATION The United Nations estimates that there were about 200 million international migrants in the world in 2006, and international migration is closely linked with globalization. Would-be migrants have become more aware of economic disparities and opportunities through advances in communications, and advances in transportation have made migration cheaper and more widely accessible. It is quite common for societal groups and states to support some aspects of globalization they view as beneficial and to oppose other aspects of globalization that pose a real or presumed threat to them. Whereas many states and societal groups support freer trade and capital flows, they are much more resistant to the cross-border movement of people. Indeed, there are growing signs of anti-immigrant sentiment in a number of DCs. An EU public opinion survey in 1993 found that 52 percent of respondents thought there were too many immigrants, and a 1993 New York Times/CBS national telephone survey reported that 61 percent of Americans favored a decrease in the number of immigrants, compared with 42 percent in a 1977 Gallup poll. The September 11, 2001, terrorist attacks on the World Trade Center and the Pentagon added greatly to U.S. concerns about migration.

Although states and societal groups regulate cross-border migration because of valid concerns about illegal immigration and terrorism, they also
impose limits for more questionable reasons. For example, less skilled DC workers sometimes oppose immigration because of concerns that immigrants are taking away their jobs. There is no conclusive empirical evidence of a linkage between immigration from LDCs on the one hand and increased unemployment among semiskilled and unskilled workers in DCs on the other. Indeed, some analysts argue that migrants often enter low-wage occupations that do not attract the local population, that many migrants are self-employed and create their own jobs, and that migration can stimulate growth and thus reduce unemployment. Nevertheless, DC labor groups often express concerns about the effects of migration on employment. Hostility to immigrants is also heightened by groups with less legitimate objectives linked with extreme nationalism, racism, and suspicion of those who are different.

Despite these negative societal attitudes, the politics of immigration is complex, and there are also countervailing tendencies. For example, the market demand for certain types of foreign workers sometimes makes it difficult for political leaders to limit immigration. Countries that ignore these market signals may encounter increasing economic problems. For example, Japan’s economic problems in recent years stem partly from its highly restrictive immigration policies. “A rapidly aging populace, and the closing of is doors to immigration and the youthful labor and fresh ideas that can bring” have sapped Japan’s economic vitality. Although more immigration would bring economic benefits to many countries today, most IPE scholars who write about globalization do not even discuss migration because “no other issue remains so much under the thrall of states and so resistant to globalizing effects.” Nevertheless, as globalization increases, migration pressures will grow along with the pressures for other types of international interactions.

**ILLEGAL ACTIVITY** As discussed, global governance has not kept pace with economic globalization. As a result, increases in trade, finance, and migration have also given rise to the transnationalization of criminal activity. Illegal goods can be sourced from one continent, trafficked across another, and marketed in a third. Indeed, one analyst refers to “the five wars of globalization” as “the fights against the illegal trade in drugs, arms, intellectual property, people, and money.” A 2010 United Nations report on *The Globalization of Crime* estimates that the illicit trade in drugs, people, arms, fake goods and stolen natural resources has an annual value of about $130 billion; the trade in cocaine and heroin alone accounts for about $105 billion. A striking aspect of the global map of trafficking routes is that “most illicit flows go to, and/or emanate from major economic powers”; this demonstrates the degree to which the underworld has become closely tied with the global economy. Critical theorists argue that privatization, deregulation, and the growth of international trade and investment have made it more difficult for states to control global criminal activity. However, liberal interdependence theorists point out that purely national responses may either fail to deal with criminal activity or simply displace it to another country, because crime has become global. Regional organizations and INTERPOL have helped facilitate information sharing and
joint operations, but each criminal must be prosecuted in a national system. Recognizing the need for more global strategies, the United Nations enacted a Convention Against Transnational Organized Crime in 2003, and in 2004 a UN panel identified transnational organized crime as one of “six clusters of threats with which the world must be concerned.” However, governments and international institutions have a long way to go in developing the skills, laws, and mechanisms to address these issues.

**NORTH–NORTH RELATIONS**

The second theme of this book relates to the interactions among DCs of the North. The issue of international economic management has been mainly a North–North issue because only the Northern states have had the wealth and power to look after the management of the global economy. However, some emerging states such as the BRIC economies (Brazil, Russia, India, and China) are posing a major challenge to the North’s supremacy. The 2008 global financial crisis has sped up this transition, and the September 2009 decision that the G20 would replace the G8 as the main forum for discussing global economic issues was an indication that the South will have a greater role in the management process. This book discusses two factors contributing to international economic management: hegemony and international institutions.

**The Current State of U.S. Hegemony**

This book provides a mixed picture of the current state of U.S. hegemony. On the one hand, the United States continues to demonstrate a number of strengths as a global hegemon. With the breakup of the Soviet bloc, the United States has emerged as the unchallenged military power in the world. As long as the threat of violent conflict persists, a state with hegemony in security matters will also have a degree of power over economic areas. The U.S. dollar continues to serve as the main international currency, and the United States has the largest economy in the world, the largest market for other countries’ exports, and the most votes in the IMF and World Bank. The United States has also had a considerable amount of co-optive power (i.e., structural or soft power): It is often successful in getting “other countries to want what it wants.” For example, Part III shows that the United States had a central role in setting the agenda for the GATT Uruguay Round negotiations and in guiding DC policies on a range of issues extending from liberalizing capital flows to the foreign debt crisis and international development. However, Part III also provides a number of indications of U.S. hegemonic decline. The U.S. dollar shifted from top-currency to negotiated-currency status in the 1960s, and the United States has had chronic balance-of-trade deficits, serious foreign debt problems, and greater dependence on external capital. U.S. indebtedness has increased greatly as a result of stimulus funding required to deal with the 2008 global financial crisis, and this indebtedness is likely to weigh on the economy.
for years to come. Furthermore, U.S. soft power has declined in recent years. Although U.S. military predominance increased with the breakup of the Soviet bloc, even traditional U.S. allies resented its unilateral actions on security issues. These unilateral tendencies increased after the understandable outrage against the September 11, 2001, terrorist attacks on U.S. soil. U.S. president Barack Obama has tried to take a more consultative approach on global issues, but it is evident that U.S. soft power is not what it was in the past. The United States has also diverged from its customary role as a prime supporter of liberalization in some key economic areas such as trade. The lack of U.S. leadership in efforts to complete the WTO Doha Round is a further sign of its hegemonic decline.  

In sum, the United States continues to be the largest single-country economic power, but there are concerns that it may be losing its competitive edge. This is the position of the World Economic Forum’s Global Competitiveness Reports (the “Reports”). After several years at the top of the global competitiveness ranking, the U.S. rank fell to second place behind Switzerland in the 2009–2010 Report, and to fourth place behind Switzerland, Sweden and Singapore in the 2010–2011 Report. The United States ranks high in terms of its sophisticated and innovative companies, its excellent university system, and its large domestic economy. However, the Reports also point to some glaring weaknesses in the U.S. economy. First, since the 2008 global economic crisis the Reports give a much weaker assessment of U.S. private institutions such as its banks and financial markets. Second, the United States ranks poorly in terms of its debt burden and fiscal deficits. These macroeconomic imbalances have worsened because of the recent stimulus spending to prevent an even worse recession, and the 2010–2011 Report concludes that “mapping out a clear exit strategy will be an important step” in preserving U.S. competitiveness in the future. Third, there is less confidence in the U.S. system of governance. The business community is concerned that the government spends its resources wastefully, and the public today shows a strong distrust of politicians. The next section discusses whether there are possible competitors to the United States as hegemon.

Is There a Candidate to Replace the United States as Global Hegemon?

In the late 1980s, many analysts took a positive view of Japan’s hegemonic prospects. For example, one scholar wrote that “if any country surpasses the United States as the world’s leading economic power, it will be Japan.” By the mid-1990s, however, most analysts saw Japan as lacking the military power and ideological appeal of a hegemon and as unwilling to assume the responsibility of global leadership. Many hoped that Japan would set an example of reform during the 1990s Asian financial crisis because it shared some economic problems with other Asian states such as failing banks, questionable bookkeeping methods, and corrupt interlocking corporate relationships. However, political indecisiveness and inflexible economic and
social practices prevented Japan from adopting bold policies to reform the economy. Japan continues to have a major competitive edge in business innovation and sophistication, and a rate of patenting per capita that is second only to the United States. However, high budget deficits over several years have given Japan one of the highest public debts in the world, and Japan’s aging population and highly restrictive immigration policies compound its economic problems. China recently overtook Japan as the world’s second largest national economy, and it is highly unlikely that Japan will replace the United States as a global hegemon.

Some writers see the EU as a possible hegemon, and one economist predicts that “future historians will record that the twenty-first century belonged to the House of Europe.” The EU has expanded to include 27 member states, and the associate membership of the ACP (Africa, Caribbean, and Pacific) states gives the EU considerable influence among LDCs. The euro is becoming more important and it could eventually replace the U.S. dollar as the key international currency. The EU was also the largest global merchandise exporter and importer in 2008 (see Table 7.4). However, the EU is an unlikely hegemon unless it becomes a more cohesive unit. Only 16 of the 27 EU members have replaced their national currencies with the euro, and Britain has refused to join the monetary union. In trade, divisions on issues such as agriculture have prevented the EU from adopting a more important leadership role. The wide economic disparities between EU members have become more evident since the 2008 global financial crisis, and the 2010–2011 global competitiveness rankings of the 27 EU members range from Sweden and Germany (with rankings of 2 and 5, respectively) to Bulgaria and Greece (with rankings of 71 and 83, respectively). Serious economic problems of some eurozone countries such as Greece, Portugal, Spain, and Ireland also raise questions about the long-term viability of the euro as a key international currency. In sum, a combined effort of the member countries is essential if the EU is to remain “a prominent player in the 21st century.”

A third possibility is that China could become the global hegemon. With average annual growth rates of 9.7 percent since the late 1970s, China has developed and diversified its economy, reduced poverty, and raised the standard of living. China has become the world’s largest single country merchandise exporter and manufacturer, and it has the second largest economy after the United States. China’s export-led growth model has been highly successful, and its current account balance of plus $296.2 billion in 2009 was a stark contrast with the U.S. current account balance of minus $380.1 billion (see Table 6.2). Whereas the United States has become the world’s largest foreign debtor, China’s reserves reached $2.6 trillion by October 2010. China’s expanding power goes beyond economic areas, and its official statistics report a double-digit annual increase in its defense budget since 1989. The U.S. Pentagon asserts that these “officially published figures substantially underreport actual expenditures for national defense.” Despite the impressive changes in China, as an LDC it is more vulnerable than the major DCs to economic and political instability. Whereas some areas of China
are experiencing rapid growth, the western and northeastern regions of the
country have widespread poverty, with about 128 million people living on
less than $1 per day and many lacking clean water and health and education
facilities. Such inequalities are a source of political instability, and protests
have increased. China’s state-directed brand of capitalism has contributed
to development in important respects, but it could become a drawback as
domestic pressures for a more democratic lifestyle increase. Government
leaders fear that a more open system could encourage separatism in provinces
such as Tibet and Xinjiang. There are also questions whether China has
enough soft power to be accepted as a hegemon. China’s more assertive
policies in territorial disputes with Japan, India, and other Asian countries
have created animosity at the regional level; and globally China’s unwillingness
to permit its currency to float has contributed to growing instability in the
global economy. In the next 15 years, it is likely that China will overtake the
United States as the largest economy in the world, but questions remain as to
whether it will be able and willing to perform the role of hegemon with the
support of other major economies.51

A fourth possibility is that India could become a global hegemon. The
Economist reports that India’s economy is expected to expand by 8.5 percent
in 2010, and that India’s growth rate could exceed China’s by 2013.
Some economists also predict that India will grow faster than any other
country over the next 25 years. Several reasons are given for this optimism
about India’s economic prospects. First, India has a young and growing
workforce, whereas China’s demography is less favorable because of its
one-child policy and its aging population. Second, India’s more democratic
system has some disadvantages but in the longer term it will prove to be
more resilient than China’s authoritarian system. Third, India’s more
individualistic approach to capitalism may result in more long-term
productivity than China’s state-directed capitalism. However, India has a
long way to go before it could be considered as a likely global hegemon for
several reasons. First, the Global Competitiveness Report ranks India poorly
in terms of health care, with high rates of communicable diseases and high
infant mortality rates. Life expectancy in India is 10 years lower than in
Brazil and China. Second, India ranks poorly in terms of primary school
enrollment and in higher education. Third, infrastructure in India must be
upgraded, especially in regard to ports, roads, and electricity supply. Fourth,
India has problems with its economic performance, including its persistent
budget deficits, high public debt, and high inflation. Despite the view of
some economists that India’s growth will outpace that of other countries in
the longer term, it has many economic problems to overcome in the short to
medium term.52

Although China alone is unlikely to become the global hegemon in the
short to medium term, there has been a shift in economic power in recent
years from North America and Europe to the emerging economies,
especially in Asia. For example, the IMF predicts that by the end of 2011
China’s reserves will exceed $3 trillion, and the reserves of the emerging
North–North Relations

economies as a whole will exceed $6.8 trillion. At a personal level, the net wealth of Asian millionaires has surpassed the wealth of European millionaires for the first time, largely because of the relative health of stock markets in China, India, and Hong Kong (North American millionaires still have the most wealth).53

The Role of International Institutions

Institutional liberals believe that interdependence and globalization create a need for international institutions “to deal with the ever more complex dilemmas of collective action,” and international regimes and organizations have been an important part of IPE since the end of World War II.54 Although the North has the largest role in maintaining these regimes and IOs, emerging states are demanding a greater role. The IMF, World Bank, and GATT/WTO are the most important international economic institutions (the KIEOs). Whereas liberals see them as beneficial organizations that promote economic efficiency and openness, realists view them as creatures of the most powerful member states, and historical materialists see them as instruments the capitalist core states use to exploit weaker states in the periphery. This section assesses the current and possible future influence of the KIEOs.

The KIEOs have adapted to changing economic circumstances by altering their functions, and they are likely to continue having important roles in global economic management. As discussed in Chapter 6, the IMF lost one of its two main functions—looking after the pegged exchange rate system—when the major economic powers shifted to floating exchange rates in 1973. The IMF also became a less essential source of loans for middle-income LDCs in the 1970s when private banks recycled large sums of petrodollars to the South. During the 1980s, however, the IMF regained its stature when it took the lead role (along with the United States) in managing the LDC foreign debt crisis. The IMF also provided funding for transition economies after the breakup of the Soviet bloc, and it took the lead responsibility for dealing with the 1990s Asian financial crisis. Although the South resented the intrusive conditions the IMF attached to its structural adjustment loans, the IMF was secure as long as it retained the confidence of the North. However, the 1990s Asian financial crisis marked another turning point as DC economists and policy makers began to attack IMF stabilization programs. For example, critics charged that the IMF imposed the same conditions on loans to South Korea as it had imposed on foreign debtors in the 1980s, despite major differences in the two cases. Unlike debtors in the 1980s, South Korea’s foreign debt was low and its problems stemmed mainly from a temporary lack of liquidity. LDCs such as Brazil, Argentina, and Indonesia that benefited from surging commodity prices in the early twenty-first century were also able to forgo IMF loans and the strict demands that accompany them. Thus, IMF lending began to fall and some analysts asserted that the IMF itself was declining.55
However, the IMF’s fortunes revived again when the 2008 global financial crisis contributed to an acute shortage of capital flows and the G20 decided to give the IMF a central role in dealing with the crisis (see Chapter 11). Despite the criticisms of the IMF, most analysts believe that abolishing the organization is not the answer and that emphasis should be placed on refocusing it.\textsuperscript{36} The IMF provides official financing, and if it were dismantled another similar organization would probably be invented. A restructured IMF that gives more influence to the emerging economies, tempers its conditionality requirements for loans, and recognizes the important role of governments as well as the market is likely to continue to have an important role in the future. The IMF will focus some of its efforts on monitoring global currency imbalances and the rise of sovereign wealth funds (SWFs), and serving as a consultant on fiscal decisions and financial crises. Although the IMF is uncertain about the proper macroeconomic solutions, it is not alone in lacking definitive answers; many economists failed to foresee the 1980s debt crisis, the 1990s financial crisis, and the 2008 global financial crisis. It is therefore likely that the IMF will continue to adapt its functions to meet changing circumstances.

The World Bank initially provided long-term loans for European reconstruction and LDC development. When the United States launched the Marshall Plan, the Bank lost its reconstruction function and shifted entirely to development. The Bank’s importance stems partly from the fact that it is the largest source of multilateral finance for LDC development. The Bank also chairs a number of aid consultative groups where DC donors can coordinate their bilateral aid-giving. However, ODA as a percent of donor countries’ GNIs steadily declined from 1960 to 2000 (see Table 10.2) for several reasons: Aid agencies encountered obstacles in promoting economic development; the end of the Cold War removed the security rationale for providing aid; and states cut spending in an increasingly competitive global environment. The United States and other donors were also more reluctant to replenish funding for the Bank group’s soft-loan affiliate, the IDA. As Table 10.2 shows, ODA as a percent of GNI increased somewhat in 2007, but this “increase” resulted mainly from the fact that donor states are now counting the funds they provide for debt forgiveness as aid. Thus, the Bank’s importance depends on much more than its roles as an aid coordinator and as a source of development finance.

The 1980s foreign debt crisis gave the Bank as well as the IMF new functions to perform. However, both the IMF and Bank began to provide SALs to debtor states, and the IMF rather than the Bank was given responsibility for coordinating the response to the crisis. As the IMF and Bank functions increasingly overlapped, questions were raised about whether the Bank was redundant. Another problem confronting Bank officials has been the high degree of controversy surrounding their efforts to alter the institution’s policy outlook and mode of operation (see Chapter 10). However, the Bank group has been highly adaptable. As discussed, Sub-Saharan Africa has been facing a development crisis, and the Bank group is the IO with the most economic
resources and technical expertise to deal with the crisis. Thus, the Bank group’s soft loan arm, the International Development Association, has also been closely involved in providing assistance for the debt forgiveness programs. Another arm of the Bank group, the International Finance Corporation, helps to promote private enterprise in LDCs. Most important, the Bank has carved out for itself “a unique position as a generator of ideas about economic development.”

The WTO is in some respects the most important KIEO, but it too is in an uncertain position because of the suspension of the Doha Round. Unlike the IMF and World Bank, which impose conditions on borrowers, the WTO establishes rules for almost all the world’s major trading nations. The WTO moved closer to becoming a universal membership organization when China joined in 2001, and Russia should become a member in the future. The WTO’s predecessor, the GATT, became a permanent organization only by default when the proposed ITO was not approved, but the GATT’s informal nature permitted it to be highly adaptable. Although GATT negotiations were initially designed to lower tariffs, the trade organization also began to negotiate NTB reductions at the 1960s, and it expanded these negotiations in the Tokyo Round. The Uruguay Round was the most complex and ambitious GATT negotiation, resulting in agreements not only for trade in goods, but also for trade in services, intellectual property, and trade-related investment measures. Most important, the Uruguay Round created the WTO, a formal organization with a much wider range of regulatory functions than GATT.

Despite the WTO’s importance, there are some major threats to its legitimacy. Whereas the GATT oversaw eight rounds of multilateral trade negotiations, major differences have prevented the completion of the first round of WTO negotiations, the Doha Round. The Doha Round was to be “the development round,” but North–South divisions have posed the main obstacle to completion of the round. In addition to North–South divisions over substantive issues, tensions also exist over the South’s effort to upgrade its influence in the WTO. There are also differences within the North and within the South, and a major question is whether the WTO with its 153 members has become so large and diverse that it is impossible to reach a consensus on contentious issues. The WTO has a much stronger dispute settlement system than the GATT, but it is uncertain whether major trading powers such as the United States, the EU, Japan, and China would accept a series of major dispute settlement decisions against them. One of the most important challenges relates to the rapid increase of regional trade agreements. Although some RTAs such as the EU and NAFTA may serve as stepping stones to global free trade, the recent proliferation of bilateral FTAs threatens to fragment the global trade regime. The 2008 global financial crisis has also contributed to a rise in trade protectionism that poses an additional obstacle to the revival of the Doha Round. In sum, the WTO, like the IMF and the Bank, faces serious governance challenges.
NORTH–SOUTH RELATIONS

The South accounted for almost 65 percent of the world population in 1950, and by 1996 the South’s population had climbed to almost 80 percent of the world total. Furthermore, a number of transition economies are now receiving foreign debt and development financing and have characteristics in common with the South. Despite the growing population of the South, it has had relatively little influence in setting the agenda and making decisions regarding the global political economy. Some LDCs and transition economies have impressive economic growth rates, and they are pressuring for more influence in the world’s economic forums. For example, emerging countries such as the China, Russia, Kuwait, United Arab Emirates, and Saudi Arabia have accumulated large foreign reserves and SWFs, often from sales of oil and commodities, which enhance their influence under current conditions of capital shortages. Groups of LDCs such as the East Asian NIEs, BRIC economies, and OPEC countries all have members that are being viewed as economic “success stories.” However, these success stories tend to mask the poverty affecting many LDCs today. For example, the overall figures indicate that the number of people living on less than $1 per day declined from 1981 to 2001. Whereas the numbers living at this level fell dramatically in China and India, they increased in Sub-Saharan Africa, Europe, and Central Asia. The United Nations has identified 50 LDCs as “least developed” because they have extremely low per capita incomes, literacy rates, and shares of manufacturing; almost all of these countries are in Sub-Saharan Africa and South Asia. Poverty also has differential domestic effects in the South, with women and children most severely affected. Furthermore, globalization tends to marginalize the weakest states and societal groups, even as it contributes to growth in many stronger states. For example, the poorest LDCs, which have 20 percent of the world’s population, saw their share of world trade fall from about 4 percent in 1960 to less than 1 percent in 1990. Private investment flows to the South increased from $5 billion in 1970 to $173 billion in 1994, but about 75 percent of this investment went to only 10 LDCs, mainly in East and Southeast Asia and Latin America. The following discussion examines how the concept of development is changing and considers whether there is a “best” path to development.

Changing Concepts of Development

During the 1950s and 1960s, economic development was usually equated with the growth of a country’s GDP and per capita income. Orthodox liberals argued that Western industrial states with high per capita incomes had achieved successful development, and that LDCs could acquire similar wealth if they followed the path set by the North. Orthodox liberals were not concerned about redistributing wealth to the poorest LDCs and groups because the benefits from the efficient allocation of resources under free markets would “eventually trickle down from the top, alleviating the problem of poverty at the bottom.” Although the South experienced unprecedented
economic growth during the 1960s, unemployment, poverty, and the gap between rich and poor were increasing. A number of development specialists therefore rejected the orthodox liberal view that growth would trickle down to the poor and called for policies to redistribute income and meet basic human needs for health, education, food, and clean water. From this perspective, GDP and per capita income are not the only important development indicators, and human development indicators such as health and sanitation, literacy rates, education, employment, the position of women and children, and rural–urban disparities must also be considered. The human development approach demonstrates that development must be measured “through investment in people and not just in machinery, buildings, and other physical assets.”

Another change in development priorities came from those concerned about environmental degradation. Of particular importance is the *sustainable development* concept, which was popularized by some NGOs in the early 1980s and received multilateral approval in the 1987 report of the World Commission on Environment and Development (the Brundtland Report). The Brundtland Report describes sustainable development as a policy that “meets the needs of the present without compromising the ability of future generations to meet their own needs.” Sustainable development is a controversial concept because critics point out that the North did not adopt sustainable policies when it was developing, the North produces more pollutants than the South, and many in the South feel they cannot afford to divert resources from their immediate development needs to the environment. If the North expects the South to follow environmentally friendly policies, it must be willing to compensate the South with financial resources.

The prevailing concepts of development have a major effect on policy making, so it is essential that we opt for a broad rather than narrow concept of development for two reasons:

- Experience shows that rapid economic growth does not necessarily enrich people’s lives and may increase income gaps and poverty under some circumstances. A broader concept of development includes not only economic growth but also human development, poverty reduction, and environmental protection.
- As interdependence increases, the form of development can have major implications for the entire globe. For example, the World Bank estimates that more than 2 million people in China die each year from the effects of air and water pollution and that this pollution extends far beyond China’s boundaries. Aside from the United States, China is the largest source of greenhouse gases linked to global warming, and China and India are the two fastest growing sources of these gases.

In an age of globalization, we can no longer afford to adopt a development concept that is limited to economic growth. Thus, the North must assist LDCs that lack the capacity to transfer scarce resources from economic growth to other crucial objectives such as sustainability and the reduction of poverty.
Is There a “Best” Development Strategy?

Chapter 10 discussed several major development strategies, including ISI, socialist development, export-led growth, orthodox liberalism, and “bottom-up” strategies such as microfinance. Liberals, realists, and historical materialists disagree as to which strategy is best, and sometimes they even disagree as to the strategy a state is following. For example, when East Asian economies were growing rapidly under the export-led growth model in the 1970s and 1980s, liberals attributed their success to their outward market orientation; realists attributed their success to the existence of a strong developmental state that promoted an effective industrial policy; and historical materialists argued that the East Asians were still dependent and not as successful as the realists and liberals assumed. Experience indicates that none of the development strategies is always the best and that every strategy has strengths and weaknesses. Furthermore, in view of the diverse nature of the South, the best strategy for one LDC may not be feasible for another. A brief recounting of the strengths and weaknesses of various development strategies will help reinforce these points.

As discussed in Chapter 10, many LDCs adopted ISI as a development strategy during the 1950s and 1960s. The easier first stage of ISI resulted in economic growth and industrialization in a number of LDCs. However, LDCs in Latin America and elsewhere that continued on to a second stage of ISI encountered growing problems with balance-of-payments deficits, uncompetitive industries, and increased dependence on external finance. In response to the problems with ISI, some LDCs adopted more extreme inward-looking policies and followed the socialist planning model of the Soviet Union. Central planning contributed to increased industrial production in some LDCs, but even the largest of these LDCs—China—was plagued by inefficiencies, low-quality production, and lack of competitiveness. Smaller LDCs such as Tanzania, North Korea, Cuba, Ethiopia, Mozambique, and Vietnam were even less effective in instituting central planning. Although these states registered some gains in health care and education and reduced socioeconomic inequalities, socialist central planning in LDCs was largely unsuccessful.

The East Asian NIEs, which followed the Japanese model and turned from import substitution to export-led growth policies in the 1960s, were the most successful in promoting economic growth during the 1960s to 1980s. Although liberals and realists agreed that other LDCs should learn from the East Asian example, they had different interpretations of the reasons for the East Asians’ success. The realists were probably more accurate in their interpretations: The East Asian NIEs (other than Hong Kong) had strong developmental states that provided extensive guidance to the market, controlled investment flows, promoted the development of technology, and protected selected infant industries. A financial crisis during the 1990s, however, demonstrated that the developmental state was not as efficient and immune to political pressures as was earlier assumed. Thus, the crisis stemmed partly from the failure of governments to develop adequate regulations for banking and other financial institutions. It also became evident that the East
Asians had benefited from a unique set of circumstances in which the United States and Japan gave them favored treatment in aid, trade, and foreign investment. The East Asians had dependent linkages with the United States and Japan, and when these two countries’ policies changed in the 1990s, the East Asian states were highly vulnerable. Environmentalists also raised questions about the sustainability of rapid economic growth in East Asia, because little action was taken to prevent environmental degradation. In the late 1990s, the East Asian financial crisis resulted in rapid outflows of capital, recessions, banking crises, and lower economic growth rates. Thus, many analysts who had viewed the East Asians as “miracle economies” were now questioning the export-led growth model. As discussed, the East Asians recovered quite rapidly from the 1990s financial crisis and resumed their economic growth rates. However, the export-led growth model as practiced by China today has mercantilist aspects that can create serious trade imbalances; that is, China’s huge export surplus depends on the fact that others (i.e., the United States) will have massive trade deficits. China’s manipulation of its currency to promote its exports is a major source of friction with the United States and Europe, and has created concerns about a “global currency war.” Thus, for major economies such as China it is important to consider the external as well as domestic effects of export-led growth policies.

During the 1980s, the debt crisis and IMF and World Bank SALs ushered in yet another Southern development strategy based on neoliberalism (a return to orthodox liberalism). In marked contrast to import substitution and export-led growth, neoliberalism emphasized decreased government spending, privatization, deregulation, and open trade and foreign investment policies. The SALs to middle-income LDCs had some positive effects in reducing government budget deficits, increasing export earnings, and enhancing economic efficiency and growth. However, IMF and World Bank SALs had negative effects on the poorest LDCs in Sub-Saharan Africa and Asia and on vulnerable groups in LDCs such as women and children. Critics argued that structural adjustment programs underestimated the need to involve the state in development and to maintain social, health, and educational programs for vulnerable groups. However, supporters of neoliberalism asserted that LDCs would benefit from liberalizing their economies and following the path of Western Europe and North America.65

In view of the global spread of orthodox liberalism, the question arose as to whether we had reached the “end of history” for Southern development strategies and whether liberalism had become the only acceptable path to follow.66 This was clearly not the case. As discussed in Chapter 10, several Latin American states have reacted against orthodox liberalism, partly because of the stark inequalities between rich and poor, and this reaction could spread to other LDC regions as well. Even the World Bank has acknowledged that SALs will succeed only if they take account of the need for strong, stable LDC governments and include some distributional goals to assist the poorest and most vulnerable groups. As realists since Friedrich List have noted, strategies that provide an active role for the government may be necessary for states at earlier stages of development if they are to catch up with the leading states.
Two events in the twenty-first century have caused a revival of interest in the value of development strategies that have an important role for the government as well as the market. First was the rapid revival of the East Asian NIEs after the 1990s financial crisis. Despite the problems with depending too heavily on export-led growth, the East Asian developmental state model addresses the need to involve the state as well as the market in the development process. Second, the United States and other countries have reacted to the global financial crisis by depending on governments to stimulate economies with massive increases in public expenditures and tax cuts; some refer to this as an “undeniable shift to Keynes.”

In sum, we have not reached the end of history in terms of development strategies. The best strategy is likely to include realist and historical materialist as well as liberal characteristics. Moreover, the best strategy for some LDCs may not necessarily be the best strategy for others.

A FINAL WORD ON IPE THEORY AND PRACTICE
This book combines theory and practice in the study of IPE, and devotes considerable attention to the three traditional IPE perspectives of realism, liberalism, and historical materialism. As Chapters 3–5 show, these perspectives remain relevant because they have not been static; they have interacted with each other and evolved over time. However, the dramatic global changes outlined in this book have revealed a need to supplement the traditional perspectives with “new theoretical categorizations.” Thus, we also focus on some theoretical perspectives that are newer to IPE such as constructivism, feminism, and environmentalism. Each perspective has its own strengths and weaknesses, and a familiarity with a range of perspectives is necessary to gain a better understanding of the relation between IPE theory and practice. IPE theory will of course continue to evolve as it has in the past.

IPE as a university discipline only began to develop in the 1970s, and IPE theorists have made great strides since that time. In focusing on IPE issues, however, these theorists have often ignored security issues just as security theorists have ignored IPE. It is time that theorists devote more attention to the important linkages between IPE and security issues. The globalization phenomenon points to yet another direction theorists should follow: the development of theories that explore domestic–international interactions. With globalization, the sensitivity and vulnerability of national economies to changes in capital, foreign investment, and trade flows have dramatically increased, and policies that were traditionally considered to be domestic can have a major impact on outsiders. The IPE perspectives have devoted too little attention to domestic–international interactions. This book introduces students to a range of theoretical approaches and applies these theories to substantive IPE issue areas. As an international relations theorist has stated, “to think theoretically one must be constantly ready to be proven wrong.” This book shows that all theoretical perspectives have limitations, and that a
combination of perspectives is necessary to gain a more complete and accurate view of IPE. It is only through formulating and reformulating our theories that we can address anomalies and increase our understanding of the global political economy.

NOTES


45. Ibid., p. 23.
absolute advantage A country has an absolute advantage in a particular good if it can produce that good at a lower cost than another country. See comparative advantage.

absolute gains Emphasizes the gains of each state without concern for the gains of others. See relative gains.

antidumping duties (ADDs) Duties a country imposes on imported goods if it determines that the goods are being dumped and that this is causing or threatening material injury to its domestic producers. See dumping.

appreciation A market-driven increase in the value or price of a currency. See depreciation.

Association of Southeast Asian Nations (ASEAN) Established in 1967, ASEAN currently has 10 Southeast Asian members. The ASEAN Free Trade Area (AFTA) has made some progress toward free trade.

Baker Plan A plan proposed by U.S. Secretary of the Treasury James A. Baker III in 1985 to deal with the LDC foreign debt crisis. The plan emphasized the rescheduling of some debt service payments, the provision of new IMF and World Bank loans, and changes in debtor country policies.

balance of payments A summary record of all international economic transactions a country has over a one-year period. The most important components of the balance of payments are the current account and the capital account.

Bank for International Settlements (BIS) The oldest international financial institution, formed in 1930 to oversee German war reparations. Located in Basel, Switzerland, the BIS is the main forum for cooperation and consultation among central bankers in the OECD countries.

basic needs A foreign aid approach that focuses on health, education, family planning, rural development, and services to the poor and least developed countries. This approach became prominent in the 1970s and marked a shift from the emphasis on GNP growth in the 1960s.

bilateral aid Foreign aid that flows directly from a donor to a recipient government. The largest percentage of official development assistance is given bilaterally. See foreign aid.

bilateral investment treaties (BITs) Bilateral treaties that promote and protect foreign investment. BITs generally uphold the MFN and national treatment principles, often prohibit host-country performance requirements, and require prompt and adequate compensation in the event of nationalization.

Brady Plan A plan that U.S. Secretary of the Treasury Nicholas Brady proposed in 1988 because the Baker Plan was insufficient to deal with the foreign debt crisis. The Brady Plan introduced the idea that debt reduction was necessary for some LDCs with severe and protracted debt problems.

Bretton Woods Conference Bretton Woods, New Hampshire, was the location of the July 1944 meetings to establish the post-war international economic order. The IMF and International Bank for Reconstruction and Development (or World Bank) were established at Bretton Woods, as was the monetary regime of pegged exchange rates.

BRIC economies Four emerging economies namely, Brazil, Russia, India, and China that have increased their economic power and are challenging the economic dominance of the developed countries.

Cairns Group A group of smaller country agricultural exporters formed in 1986 that has pressured for agricultural trade liberalization in the GATT/WTO.

Canada–U.S. Free Trade Agreement (CUSFTA) Concluded in 1988, the CUSFTA resulted from a U.S. decision to participate in RTAs, and from Canada’s desire to gain more assured access to the U.S. market. The NAFTA replaced the CUSFTA in 1994. See North American Free Trade Agreement.

capital A factor of production, along with land and labor, that consists of physical assets such as equipment, tools, buildings, and other manufactured goods that can generate income and financial assets.
capital account  An item in the balance of payments that records the amount a country lends to and borrows from nonresidents. Transactions in the capital account include foreign direct investment and portfolio investment.

capital market  A capital market consists of institutions in a country (e.g., the stock exchange, banks, and insurance companies) that match supply with demand for long-term capital. (A money market deals with shorter-term loanable funding.) The World Bank floats bonds on capital markets to acquire funds for lending purposes.

central bank  A public authority responsible for managing a country's money supply, and for regulating and controlling its monetary and financial institutions and markets. Most countries rely on a central bank for such regulatory activities.

civil society  A wide range of nongovernmental, noncommercial groups that seek to either reinforce or alter existing norms, rules, and social structures.

collective action problem  A problem that occurs when the uncoordinated actions of individuals or states do not produce the best possible outcome for them.

customs union  (CU)  The second stage of regional integration in which the member states eliminate tariffs on all (or substantially all) trade with each other and develop a common external tariff toward outsiders.

countertrade (CT)  A barter system of exchange in which two countries trade goods and services with each other, usually on a reciprocal basis.

debt crisis  A crisis that occurs when some major debtor states lack sufficient foreign exchange to make the interest and/or principal payments on their debt obligations.

debt reduction agreements  Agreements that allow for a decrease in the overall debt burden; that is, they include some debt forgiveness.

debt rescheduling agreements  Agreements that defer debt service payments and apply longer maturities to the deferred amount.

debt service ratio  The ratio of a country's interest and principal payments on its debt to its export income. It is often used to assess a country's ability to repay its foreign debt. During the 1980s, East Asian NIEs were better able to service their foreign debts than Latin American NIEs because they had lower debt service ratios.
dependency theory A historical materialist development theory that sees the world as hierarchically organized, with the leading capitalist states in the core of the global economy exploiting the poorer states in the periphery.

depreciation A market-driven reduction in the value or price of a currency. See appreciation.

devolution A reduction in the official rate at which one currency is exchanged for another. When a country devalues its currency, the prices of its imported goods and services rise while its exports become less expensive to foreigners. See revaluation.

developmental state A term used in the early 1980s to describe the East Asian NIEs that provided extensive guidance to the market, identified development as their primary objective, invested heavily in education, and depended on a highly skilled technocratic bureaucracy.

diffuse reciprocity Unlike specific reciprocity, diffuse reciprocity does not require an immediate response to an action. Instead, it imposes a more general obligation on the recipient for repayment in the future.

dumping An act of selling a product in an export market at a price lower than is charged in the home market or below the cost of production.

Economic and Monetary Union (EMU) Formed in 1999, the EMU includes the countries in the EU that have adopted the euro and common monetary policies.

economic union An economic union has the characteristics of a common market, and also harmonizes the industrial, regional, fiscal, and monetary policies of the member states. A full economic union also involves the adoption of a common currency. See common market, customs union.

economism An overemphasis on the importance of the economic sphere along with an underemphasis on the autonomy of the political sphere.

emerging market economies Developing and transition economies that have achieved rapid growth and have adopted many elements of a free market system.

endogenous growth theory Posits that technological change is not simply the result of fortunate breakthroughs in knowledge exogenous to the factors of production; technological knowledge is an endogenous factor of production along with labor and capital that gives DCs major advantages over LDCs.

epistemic community A group of professionals with acknowledged expertise and a recognized claim to policy-relevant knowledge in a particular issue area.

Eurocurrencies National currencies traded and deposited in banks outside the home country, usually (but not only) in Europe.

European Coal and Steel Community (ECSC) Six Western European states formed the ECSC in 1951 to integrate their coal and steel resources and prevent renewed conflict between France and Germany.

European Community (EC) A regional integration agreement formed in 1957 by six Western European states. The EC’s goals were to establish a customs union and a common market. EC membership increased to 12 states by 1986, and in 1993 it was superseded by the European Union.

European Free Trade Association (EFTA) A free trade agreement formed in 1959 by Britain and six other European states that did not join the EC. Today, the EFTA has four remaining members (Iceland, Liechtenstein, Norway, and Switzerland).

European Union (EU) The EU became the successor to the EC in 1993, with plans to complete the creation of a single market by removing the remaining fiscal, nontariff, and technical trade barriers. The EU currently has 27 members.

exchange rates The number of units of one currency that can be exchanged for a unit of another currency. See fixed exchange rates and floating exchange rates.

export-led growth An economic development strategy that emphasizes the production of industrial goods for export. Export-led growth is associated with the economic success of the East Asian NIEs.

external debt The total public and private debt owed to nonresidents by residents of an economy.

fair trade A trading partnership that contributes to greater equity and sustainable development by securing more rights and better conditions for marginalized workers, especially in the South.

feminist theory A wide range of theories that address the problems of patriarchy and the inattention to gender issues in IR and IPE.

financial contagion The transmission of a financial shock from one market or
country to other interdependent markets or countries.

financial crisis  An escalation of financial disturbances, such as a sharp decrease in asset prices, the failure of large financial intermediaries, and disruption in foreign exchange markets.

fiscal policy  Fiscal policy affects the economy through changes in taxes and government spending. For example, a government may deal with a balance-of-payments deficit by lowering government expenditures and raising taxes.

fixed exchange rates  In a fixed-exchange-rate regime, currencies are given official exchange rates, and governments regularly take actions to keep the market rates of their currencies close to the official rates.

floating exchange rates  There are three types of floating exchange rates. With free floating, the market alone determines currency valuations; with managed floating, central banks intervene to deal with disruptive conditions such as excessive exchange rate fluctuations. The IMF considers managed floating legitimate, but it opposes manipulative floating, or a government’s manipulation of exchange rates to give it an unfair competitive advantage.

foreign aid  Refers to grants, loans, or technical assistance that donors provide to recipients on concessional rather than commercial terms. According to the OECD Development Assistance Committee, only grants and concessional loans with a grant element of at least 25 percent qualify as foreign aid. See concessional loans.

foreign direct investment (FDI)  Foreign investment that involves some ownership and/or operating control. The foreign residents are usually MNCs. See portfolio investment.

free trade area  The first stage of regional integration, in which member states eliminate tariffs on substantially all trade with one another, but each member can follow its own trade policies toward nonmembers.

GATT Article 24  A GATT provision that permits countries to form free trade areas and customs unions as an exception to MFN treatment, but seeks to ensure that they are more trade creating than trade diverting.

General Agreement on Tariffs and Trade (GATT)  A provisional treaty that became the main global trade organization in 1948 by default when a planned ITO was not formed. When the WTO was formed in 1995, GATT reverted to its original status as a treaty to regulate trade in goods.

General Agreement on Trade in Services (GATS)  An agreement under the WTO that begins the process of creating principles and rules for policies affecting access to service markets.

generalized system of preferences (GSP)  Under the GSP, individual DCs can waive MFN treatment and give preferential treatment to specific imports from LDCs. Thus, the import duties for some LDC products are lower than those levied on DC products.

Global Compact  A UN-led partnership mission comprising 10 principles on human rights, labor standards, the environment, and anticorruption that are designed to promote responsible global capitalism. The UN has invited MNCs to sign onto this voluntary compact.

global financial crisis (2008)  A financial crisis that began in 2008 as a result of a U.S. subprime mortgage crisis. The subprime mortgages were packaged and sold to investors in many countries and this had serious repercussions around the globe. The crisis was also related to the serious imbalance between major creditor and debtor countries. See financial crisis.

global governance  Formal and informal arrangements that provide a degree of order and collective action above the state in the absence of a global government. See governance.

globalization  A term that refers to the broadening and deepening of interdependence among people and states throughout the world.

gold exchange standard  A monetary system in which central banks fix the value of their currencies and hold international reserves in two forms—gold and foreign exchange—in any proportion they choose (e.g., the Bretton Woods regime).

gold standard  A monetary system in which central banks fix the value of their currencies in terms of gold and hold international reserves in gold. A gold standard regime existed from the 1870s to 1914.

governance  Formal and informal processes and institutions that organize collective action. See global governance.

greenfield investment  The creation of new facilities and productive assets by foreigners.
gross domestic product (GDP)  The total value of goods and services produced within a country’s borders during a given year. GDP counts income in terms of where it is earned rather than who owns the factors of production.
gross national income (GNI)  Virtually identical with the GNP. The GNI measures the income produced by the GNP rather than the value of the product itself.
gross national product (GNP)  The total value of goods and services produced by domestically owned factors of production during a given year. GNP counts income according to who owns the factors of production rather than where the income is earned.

Group of 20 (G20)  There are two G20s: (1) The G20 finance ministers and central bank governors hold an annual summit to discuss key issues in the global economy, and also meet on extraordinary occasions such as the 2008 global financial crisis. Includes the G8, Australia, Turkey, the EU, and nine LDCs. (2) A G20 in trade includes 20 LDCs led by Brazil, China, and India that has called for an end to EU and U.S. agricultural export subsidies and for lower agricultural import barriers in Japan, Canada, and other DCs.

Group of 24 (G24)  Formed in 1972 to represent LDC interests on international monetary issues, the G24 includes eight finance ministers or central bank governors from each of the main LDC regions—Africa, Asia, and Latin America.

Group of 77 (G77)  The principal group representing the South’s economic interests in negotiations with the North. The G77 derives its name from the 77 LDCs that formed the group in 1964, but it now has 130 members.

Group of Eight (G8)  The G8 includes the G7 members plus Russia. Although Russia is a full member of the G8, it does not participate fully in the G7’s trade and financial deliberations.

Group of Five (G5)  The G5 includes the finance ministers and central bank governors of the largest developed economies: the United States, Japan, Germany, France, and Britain. It has played a role in coordinating monetary and other economic policies.

Group of Seven (G7)  The G5 plus Italy and Canada. The G7 includes seven large industrial democracies that account for about two-thirds of global output.

Group of Ten (G10)  The G10 includes the DCs that established the General Arrangements to Borrow with the IMF in 1962. Eleven countries are now G10 members—the G7 plus the Netherlands, Belgium, Sweden, and Switzerland. In addition to providing supplementary finance, the G10 discusses matters related to the international monetary regime.

hard power  Power based on the use of coercion and payments.

Heavily Indebted Poor Countries (HIPC) Initiative  A plan approved by the G7 in 1996 to provide relief for the debt of low-income LDCs to the IMF and World Bank. An enhanced HIPC initiative introduced in 1999 more than doubled the amount of debt relief available. See multilateral debt relief initiative.

Heckscher–Ohlin theory  Postulates that comparative advantage is determined by the relative abundance and scarcity of factors of production (land, labor, and capital). Capital-rich states should specialize in capital-intensive production, and states with an abundance of cheap labor should specialize in labor-intensive production.

hegemonic stability theory  Asserts that a relatively open and stable international economic system is more likely to exist when a hegemonic state is willing and able to lead. See hegemony.

hegemony  Leadership or dominance in the international system, usually (but not always) associated with a particular state. Gramscian theorists use the term to connote not only dominance but also the complex of “ideas” social groups use to legitimize their authority.

historic bloc  A Gramscian term referring to the congruence between state power, ideas, and institutions that guide the society and economy.

historical materialism  A critical theoretical perspective stemming partly from Marxism that is “historical” because it examines structural change over time, in terms of class and sometimes North–South struggles; it is “materialist” because it examines the role of material factors, especially economic factors, in shaping society.

horizontal integration  A horizontally integrated MNC extends its operations abroad by producing the same product or product line in affiliates in different countries. Firms often engage in horizontal integration to defend or increase their market share. See vertical integration.

human development index (HDI)  The UNDP’s measure of human development based on life expectancy at birth; the adult
literacy rate; primary, secondary, and tertiary school enrollments; and the PPP-adjusted per capita GDP.

**hyperglobalists** Hyperglobalists believe that globalization involves the creation of a “borderless world” in which MNCs lose their national identities, and regional and global markets replace national economies.

**import substitution industrialization** A strategy to promote economic development by replacing industrial imports with domestic production through trade protectionism and government assistance to domestic firms. Many LDCs followed ISI policies in the 1950s and 1960s.

**infrastructure** The underlying facilities, equipment, institutions, and installations crucial for the growth and functioning of an economy. Examples of infrastructure include transportation systems, public utilities, law enforcement, education, and research.

**institutional liberals** Institutional liberals favor outside involvement by strong international institutions as a supplement to the market.

**institutions** Persistent and connected sets of rules that prescribe behavior, constrain activity, and shape expectations.

**instrumental Marxism** A form of Marxism that views government institutions as responding in a passive manner to the interests and pressures of the capitalist class. See structural Marxism.

**interdependence** Mutual dependence in which transactions have costly effects that are reciprocal but not necessarily symmetrical.

**International Monetary Fund (IMF)** An international organization formed in 1944 to uphold the Bretton Woods system of pegged exchange rates (until the move to floating rates in 1973) and to provide countries with short-term loans for balance-of-payments problems. The IMF has had a leading role in dealing with foreign debt and financial crises.

**international organizations (IOs)** Formal institutional arrangements across national boundaries that facilitate cooperation among members. See institutions.

**international regimes** Institutions dealing with specific areas of international relations, in which actors’ expectations converge around a set of principles, norms, rules, and decision-making procedures. See institutions.

**internationalists** Internationalists recognize that interdependence is increasing, but they believe that the world is no more “global” than it was in the nineteenth century.

**interventionist liberals** An economic liberal who supports some government involvement to promote more equality and justice in a free market economy.

**intrafirm trade** Trade within a firm, often between an MNC and its subsidiaries.

**intraindustry trade** In intraindustry trade, products are traded within the same industry group.

**liberal intergovernmentalism** An integration theory that describes the EU as resting on a series of bargains among member states, which are self-interested and rational in pursuing outcomes that serve their economic interests.

**liquidity** The ease with which an asset can be used at a known price in making payments. Cash is the most liquid form of an asset.

**Lomé Convention** Trade and aid agreements between the EU and 71 ACP (African, Caribbean, and Pacific) countries that have associate status in the EU. In 2000, the Lomé Convention was replaced by the more WTO-compatible Cotonou Agreement.

**London Clubs** Informal groups in which the largest private creditor banks engage in debt rescheduling negotiations with individual LDC debtor countries. They are also called “bank advisory committees” or “creditor committees.” See Paris Club.

**market** A coordinating mechanism where sellers and buyers exchange goods, services, and factors of production at prices and output levels determined by supply and demand.

**market economy** An economy in which the market coordinates individual choices to determine the types of goods and services produced and sold as well as the methods of production.

**mercantilism** A policy of states from the sixteenth to eighteenth centuries to increase their relative power and wealth largely by maintaining a balance-of-trade surplus.

**Mercosur** Mercosur, or the Common Market of the Southern Cone, was formed in March 1991 when Argentina, Brazil, Paraguay, and Uruguay agreed to eventually establish a common market.

**microfinance** The provision of low-cost, short-term financial services, mainly savings and credit, to poor households that do not have access to traditional financial institutions.
**Millennium Development Goals (MDGs)** In 2000, the United Nations established eight MDGs to be achieved by 2015. It is, however, doubtful that some of these goals will be achieved.

**moderate globalists** Globalists who view the state as a viable actor, but who differentiate international relations among states from global relations that take place without regard to territorial boundaries.

**monetary policy** Monetary policy influences the economy through changes in the money supply. For example, a central bank may deal with a balance-of-payments deficit by limiting public access to funds for spending purposes.

**moral hazard** The idea that protection against risk encourages a person or state to engage in riskier behavior. For example, if a lender of last resort exists, states facing financial crises are more likely to engage in risky behavior because they can count on the lender to rescue them.

**most-favored-nation (MFN) principle** A principle stipulating that every trade advantage, favor, privilege, or immunity a WTO member gives to any state must be extended to all other WTO members. A major exception to MFN treatment is provided for regional trade agreements.

**multilateral aid** A type of foreign aid in which donor governments provide funding through international organizations (such as the World Bank) whose policies are collectively determined. See foreign aid.

**Multilateral Debt Relief Initiative (MDRI)** An initiative established by the IMF and World Bank in 2006. Low-income LDCs that have their debts reduced under the enhanced HIPC initiative are eligible to have the rest of their debt to the IMF, World Bank, and African Development Bank canceled under the MDRI. See Heavily Indebted Poor Countries Initiative.

**multinational corporations (MNCs)** Firms that own and control facilities for production, distribution, and marketing in at least two countries. Also referred to as transnational corporations or multinational enterprises.

**national treatment** A principle stating that all WTO members should treat foreign products—after they have been imported—as favorably as domestic products with regard to internal taxes and other internal charges and regulations.

**neofunctionalism** Describes economic integration in one sector as creating pressures for spillover into other sectors. Political activism by interest-driven actors is an essential element of spillover.

**neo-Gramscian analysis** A non-economic Marxist theory that draws on the ideas of Antonio Gramsci and Robert Cox.

**New International Economic Order (NIEO)** LDC demands for extensive international economic reform and DC concessions presented to the United Nations in the 1970s. The North ultimately rejected most of these demands.

**newly industrializing economies (NIEs)** A small number of rapidly growing and liberalizing economies in East Asia and Latin America that have presented a growing competitive challenge to the North.

**nontariff barriers (NTBs)** A large array of measures other than tariffs that limit imports, assist domestic production, and promote exports. As tariffs declined as a result of GATT negotiations, NTBs became relatively more important. NTBs are often more restrictive, ill-defined, and inequitable than tariffs.

**North American Free Trade Agreement (NAFTA)** An FTA formed in 1994 by the United States, Canada, and Mexico. NAFTA’s importance stems from the inclusion of the United States, the comprehensive nature of the agreement, and the fact that it was the first reciprocal FTA among DCs and an LDC.

**obsolescing bargain model (OBM)** A theory that postulates that an MNC loses some bargaining leverage once it invests in a host state because it commits itself to some immobile resources in the host state.

**official development assistance (ODA)** Flows of foreign aid to LDCs and multilateral institutions from official government agencies. See foreign aid.

**official development finance (ODF)** Official development loans that have too low a grant element to qualify as official development assistance. (IBRD loans are an example of ODF.)

**opportunity cost** The cost of producing less of one product in order to produce more of another product.

**optimum currency area** A region that maximizes the benefits of using a common currency. These regions are subject to common economic shocks, have a high degree of labor mobility, and have a tax-transfer system that relocates resources to economically weaker areas.
Organization for Economic Cooperation and Development (OECD) An organization of 33 mainly DCs located in Paris, France. The OECD conducts policy studies on economic and social issues, serves as a forum to discuss members’ economic policies and promote cooperation, and sometimes is a forum for negotiation or prenegotiation.

Organization for European Economic Cooperation (OEEC) An organization of Western European states formed in 1948 that distributed U.S. Marshall Plan funds and facilitated moves toward currency convertibility and trade liberalization. In 1960, the OEEC was replaced by the OECD, which also has non-European members.

Organization of Petroleum Exporting Countries (OPEC) An organization of LDC oil exporters formed in 1960, that acts as a resource cartel to manipulate oil supplies and prices.

Orthodox liberals Liberals who promote freedom of the market to function with minimal interference from the state.

Pareto-deficient outcome A condition in which all actors would prefer another outcome. See prisoners’ dilemma.

Pareto-optimal outcome A condition in which no actor can be made better off without making someone else worse off. See prisoners’ dilemma.

Paris Club Informal groupings of DC creditor governments that meet with individual LDC debtor governments to negotiate debt-rescheduling agreements. The Paris Club normally meets in the French Ministry of Finance. It has no legal status or written rules, no voting procedure, and no formal organizational structure. See London Clubs.

political union A union that has the characteristics of an economic union and also harmonizes members’ foreign and defense policies. A fully developed political union is more like a federal political system than an agreement among sovereign states.

Political union An overemphasis on politics and power and an underemphasis on economic structures and processes.

portfolio investment The purchase of stocks, bonds, and money-market instruments by foreigners to gain a financial return. It does not involve foreign ownership or operating control.

Poverty Reduction Strategy Papers (PRSPs) PRSPs are documents describing the economic and social policies of an LDC; they are required by the IMF and World Bank before the LDC can be considered for debt relief. The PRSP approach is more participatory than structural adjustment and eventually replaced IMF and World Bank structural adjustment programs.

prisoners’ dilemma A game that examines situations in which individual rationality induces a state to “cheat” regardless of the actions taken by others. Such actions do not produce the best collective outcome. See Pareto-optimal outcome and Pareto-deficient outcome.

public goods Also called collective goods, these are nonexcludable (all states have access to them) and nonrival (any state’s use of the good will not decrease the amount available for others).

purchasing power parity The number of units of a country’s currency needed to buy the same amount of goods and services in the domestic market as a U.S. dollar can buy in the United States.

rational choice Rational choice analysis assumes that individuals have goals and some freedom of choice and that they take actions they believe will achieve their goals. Individuals are “utility maximizers,” who seek to optimize their self-interest by weighing the expected costs versus benefits of their actions.

Reciprocal Trade Agreements Act (RTAA) The 1934 RTAA for the first time linked U.S. tariff levels to international negotiations instead of having Congress set tariffs on a unilateral, statutory basis.

reciprocity principle The principle that a country benefiting from another country’s trade concessions should provide roughly equal benefits in return. See specific reciprocity, diffuse reciprocity.

relative gains Emphasizes the effects of gains on the relative power positions of states. See absolute gains.

remittances The money that migrants earn abroad and send back to their home countries.

revaluation An increase in the official rate or value at which one currency is exchanged for another. See devaluation.

rules of origin Regulations to prevent importers from bringing goods into a free trade area through member states with lower duties and then shipping them to partner states with higher duties. Rules of origin sometimes provide an excuse for protectionism.
safeguards The safeguards principle permits WTO members to temporarily raise a duty above the maximum tariff binding to limit imports that may harm domestic producers.

seigniorage The profit and advantages a sovereign power gains from issuing money.

single undertaking A principle that acceptance of an agreement requires acceptance of all its parts. The GATT Uruguay Round Agreement was a single undertaking because it required LDCs to accept all parts of the agreement.

soft power Power based on attraction and co-option.

sovereign wealth funds (SWFs) Government investment funds that are managed separately from official currency reserves. SWFs may hold higher risk assets than official reserves.

special and differential treatment Special access that LDCs are given to DC markets, and LDC exemptions from some WTO trade regime rules.

special drawing rights Artificial international reserves created by the IMF and used among central banks. There have been three SDR allocations, the most recent one in 2009.

specific reciprocity A type of reciprocity that requires a simultaneous exchange of strictly equivalent benefits or obligations.

state A sovereign, territorial political unit.

Stolper-Samuelson theory Posits that trade liberalization benefits abundantly endowed factors of production and hurts poorly endowed factors of production in a state. The theory helps explain why some domestic groups are free trade oriented and others are protectionist.

strategic trade theory A realist theory that a state can successfully engage in industrial targeting to alter its comparative or “competitive” advantage vis-à-vis other states. The state tends to favor industries with advantages in research and development, technology, economies of scale, and market power.

structural adjustment loans Medium-term balance-of-payments financing the World Bank and IMF have provided to LDCs since the 1980s foreign debt crisis. To receive such loans, LDCs must agree to institute structural reforms.

structural Marxism Marxists who view the state as relatively autonomous from direct political pressure of capitalists, but who believe that the state acts in the long-term interests of the capitalist class.

subprime mortgages Mortgages for borrowers who do not qualify for market interest rates because of income level, credit history, size of the downpayment, and/or employment prospects.

sustainable development A policy focused on environmental conservation that calls for meeting the needs of the present without limiting the ability of future generations to meet their own needs.

tariffs Taxes levied on products that pass through a customs border. Although tariffs are usually imposed on imports, they may also apply to exports.

terms of trade The relative prices of a country’s exports and imports. During the 1940s-1950s, Raúl Prebisch argued that LDCs in the periphery had deteriorating terms of trade with DCs in the core of the global economy.

tied aid The percentage of bilateral aid that is tied to purchases from the donor country’s producers and employment of its technical experts.

Trade-Related Intellectual Property Rights (TRIPs) An agreement under the WTO that establishes minimum standards of protection for copyrights, patents, and other intellectual property, and offers remedies to members to protect these rights.

Trade-Related Investment Measures (TRIMs) The TRIMs is a rather weak and narrowly defined agreement under the WTO to impose some discipline over trade-related investment issues.

transfer prices Prices that a business firm uses for the internal sale of goods and services among its affiliates (i.e., for intrafirm trade). Transfer prices help an MNC manage its internal operations, but an MNC may manipulate these prices to shift its reported profits from high-tax to low-tax countries.

transnational advocacy networks (TANs) TANs include actors working internationally on an issue, who are bound together by shared values and exchanges of information and services. TANs, may include NGOs, social movements, the media, labor unions, consumer groups, religious institutions, intellectuals, and branches of government.

Triffin dilemma The conflict between the “liquidity” and “confidence” functions of the U.S. dollar as the top currency in the Bretton
Woods regime. U.S. balance-of-payments deficits decreased confidence in the U.S. dollar, but if the United States reduced its payments deficits, there would be a shortage of liquidity.

**two-level game theory** A theory that views international relations as a two-level game involving a state’s international interactions (level 1) on the one hand and domestic interactions (level 2) on the other.

**UN Conference on Trade and Development (UNCTAD)** A permanent organ of the UN General Assembly, created in 1964 as a result of the South’s dissatisfaction with international economic organizations such as GATT. UNCTAD is mainly concerned with promoting the South’s trade and development interests.

**variable-sum game** A relationship in which groups may gain or lose together. See zero-sum game.

**vertical integration** A vertically integrated MNC controls production of goods and services at different stages of the production process, with some affiliates providing inputs to other affiliates. Firms become vertically integrated to avoid uncertainty, reduce transaction costs, and limit competition. See horizontal integration.

**voluntary export restraints** A practice states used to circumvent the GATT Article 11 ban on import quotas by pressuring other states to “voluntarily” decrease their exports of specific products.

**Washington consensus** Refers to the neoliberal belief that countries can best achieve economic growth through free markets, a dominant private sector, democratic government, and trade liberalization.

**World Bank** An international organization formed in 1944 to give long-term loans for postwar reconstruction and development. It is also called the International Bank for Reconstruction and Development (IBRD).

**World Bank group** Consists of five multilateral institutions that provide development finance and facilitate private investment. These include the International Bank for Reconstruction and Development, International Finance Corporation, International Development Association, International Centre for the Settlement of Investment Disputes, and Multilateral Investment Guarantee Agency.

**World Economic Forum (WEF)** A private institution where business executives, political leaders, and multilateral institutions discuss global socioeconomic and political problems. In addition to an annual meeting in Davos, Switzerland, the WEF holds regional summits and issues publications.

**World Trade Organization (WTO)** The main global trade organization formed in 1995. Agreements under the WTO include the General Agreement on Tariffs and Trade, General Agreement on Trade in Services, the Agreement on Trade-Related Intellectual Property Rights, and the Agreement on Trade-Related Investment Measures.

**world-systems theory** A theory that views problems in the periphery as stemming from the capitalist, global economic system. It introduced the concept of the “semiperiphery” to explain why some states in the periphery are developing.

**zero-sum game** A relationship in which one group’s gain equals another group’s loss. See variable-sum game.
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Note: The letters ‘f’ and ‘t’ refers to figures and tables cited in the text.
*For Acronyms and Abbreviations, please see the list on pages xvii-xviii

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