International Political Economy

INTERESTS AND INSTITUTIONS IN THE GLOBAL ECONOMY

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market, about the relative gains of labor and firms in a capitalist economy, and about the state's proper role in the economy. They have played a much less important role during the last 15 years, however, in shaping the explanatory theories that students of international political economy have developed to explain the foreign economic policies that governments adopt. I use an analytical framework based on the interaction between interests and institutions. This approach allows me to draw heavily on contemporary scholarship. In addition, the approach allows me to develop a number of distinct explanations covering a large number of countries all of which start from the same point: governments' foreign economic policies reflect the interaction between societal interests and political institutions.

The result, I hope, is a book that bridges the gap between international political economy as practiced by scholars and international political economy as presented to undergraduates. No such book is the work of a single person. I have benefited immensely from the advice and support of a large number of people. A few deserve special mention. Eric Stano of Longman Publishers supported this project from its initial conceptualization through to the final production. I am grateful for his encouragement and his patience as this project evolved through its many iterations. Roland Stephen went well beyond the call of duty as a friend and colleague in entertaining my questions, providing suggestions about how to improve the text, and using early versions of this text in his class at North Carolina State University.

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Thomas Oatley

CHAPTER 1

INTERNATIONAL POLITICAL ECONOMY

International economic events play an increasingly important role in international politics. Two recent episodes help illustrate the growing prominence of such events. Between the spring of 1997 and the late fall of 1998, the international financial system experienced a major crisis, probably the largest it had experienced since the Great Depression. The crisis began when commercial banks and other private financial institutions that had previously been optimistic about investment opportunities in Southeast Asia and other so-called "emerging markets" took a closer look at financial systems in these countries. Worried by what they saw, banks began to move their money out of these countries to safer locations. The crisis hit Thailand first and then spread into Malaysia, Indonesia, South Korea, and the Philippines. Having wreaked havoc in Southeast Asia, the crisis swept through Latin America, where it destabilized financial markets in Brazil, Argentina, Chile, and Mexico. From Latin America the crisis swept into Russia, where outflows of financial capital caused the Russian government to default on its foreign debt. The crisis was ended, and major disruptions of financial systems in the industrialized world were prevented through coordinated action by the International Monetary Fund, the United States, the European Union, and Japan. Why did private financial institutions turn suddenly against the Southeast Asian, Latin American, and Russian economies? What, if anything, could governments in these countries have done to prevent the crisis? Why did the United States take the lead in resolving the crisis? Could changes be made to the international financial system that would make such crises less likely in the future?

In the second case, a vocal opposition to globalization has begun to emerge in many advanced industrialized countries since the mid-1990s. Organized opposition to globalization first emerged in 1997 in response to efforts by governments in the United States, Western Europe, and other advanced industrialized countries to negotiate an international agreement called the Multilateral Agreement on Investment, which would establish rules governing foreign investment. Fearing that such an agreement would be too oriented toward business interests and would ultimately lead to a weakening of environmental protection regulations, opponents of globalization organized

protests, rallies, and other activities designed to convey their opposition to governments. In 1998, governments abandoned the proposed agreement, in part because of public opposition. Opponents of globalization claimed victory and pushed their campaign forward in late November and early December of 1999. The occasion was a meeting of representatives of more than 100 countries in Seattle, Washington. The goal of the meeting was to establish an agenda for the Millenium Round of trade negotiations that were to be held under the aegis of the World Trade Organization (WTO). The effort to establish an agenda failed, however, because the Clinton Administration's efforts to incorporate discussion of international labor standards in the WTO—one of the demands of the protesters in Seattle—met strong resistance from developing countries' governments. International trade, and globalization more generally, are issues that have rarely been high on the list of public concerns. Why have they suddenly become flashpoints sparking angry and sometimes violent protests?

These episodes represent two of the most visible instances in which international economic issues dominate international politics, but they are hardly unique. A close reading of major newspapers reveals countless others. For example, during the late 1990s the United States and the European Union became embroiled in a heated trade war over bananas, which neither the United States nor Western Europe actually produces. Why are Europe and the United States engaged in a trade war over an agricultural commodity that neither produces? To give yet another example, in the fall of 2001 the People's Republic of China and the other members of the World Trade Organization reached a final agreement on the terms of China's entry into the WTO. Why has the world's one remaining Communist great power entered into what may be the ultimate symbol of global capitalism?

While hundreds of other episodes could be mentioned, these few are sufficient to make two important points. First, whereas 15 years ago Superpower conflict and the management of the nuclear balance dominated international politics, today international politics are increasingly dominated by economic competition and cooperation. While the Cold War defined international politics during the last 50 years, the dense network of international economic relationships commonly referred to as globalization may well define international politics during the next 50 years. And just as the Cold War pushed the study of nuclear strategy and international conflict to the forefront in the discipline of international politics, globalization now may well do the same for international political economy, the study of economic cooperation among and economic competition between governments. Second, many of the things that governments do in the international economy are puzzling: why do governments pursue particular policy objectives, why do the policies governments adopt sometimes lead to good outcomes and sometimes lead to bad outcomes? International political economy tries to resolve these puzzles.

This book is designed to introduce you to international political economy as a lens through which to examine developments in the global economy. To accomplish this goal it focuses on two broad issues. The first is largely historical and descriptive and concerns the creation and evolution of the international economic system since the Second World War. Here we are primarily interested in learning how the current highly integrated global economy was created, as well as in understanding the patterns of production, trade, exchange rates, and financial flows that characterize activity within this international economic system. The second issue is theoretical in nature and concerns explanations of government behavior in the international economy. Here we are primarily interested in understanding how market and political processes interact to shape the foreign economic policy choices that governments make. Why do governments open their markets to international trade for some goods and close their markets to international trade in other goods? Why do governments sometimes fix their exchange rates and sometimes float their exchange rates? While these questions and others similar in nature comprise the central focus of the remaining chapters of this book, the rest of this chapter introduces international political economy as a field of study and then introduces the analytical framework that we will develop and use throughout the book.

What Is International Political Economy?

International political economy (IPE) is the study of how economic interests and political processes interact to shape government policies. Consider, for example, the decision by the Bush Administration to raise tariffs on imported steel in the spring of 2002. The decision to raise the steel tariff was prompted by lobbying by the owners of American steel firms and the United Steel Workers of America. The steel industry lobbied for the higher tariff because imported steel was capturing a large share of the American market, resulting in a large number of plant closings and layoffs. Thirty-four American steel mills filed for bankruptcy between 1997 and 2002, causing about 18,000 workers to lose their jobs. Steel producers and steel workers recognized that higher tariffs would protect them from competition with foreign steel producers, thereby reducing the number of American steel mills in distress and slowing the rate at which steel workers were losing their jobs. The higher steel tariff has negative consequences for other groups in society, however, and these consequences have generated political pressures aimed at reversing the decision. The tariff hurts American industries that use steel to produce goods, such as auto manufacturers, because these firms must now pay a higher price for the steel they use. These costs have motivated the Consuming Industries Trade Action Coalition (or CITAC), a business association that represents firms that use steel (and other imported inputs) to produce other goods, to pressure the Bush Administration and Congress to lower the steel tariff. The tariff also harms foreign steel producers, who now sell less steel in the American market than before the tariff was raised. These foreign firms have pressured their governments to take measures to force the United States to reverse the decision. In response, governments in the European Union and Japan have threatened to retaliate by raising tariffs on goods that the United States exports to their markets, and have initiated an investigation within the World Trade Organization (the international organization that has responsibility for such disputes). The ultimate fate of the American steel tariff depends on the result of these ongoing political processes. Does CITAC have more political influence than the steel industry, and will it therefore convince the Bush Administration to reverse the decision? Will the WTO rule that the steel tariff violates international trade rules and must therefore be reversed? If it does, will the Bush Administration comply with the ruling? The story of the steel tariff thus nicely illustrates

the central focus of international political economy as a field of study: how the interaction between economic interests and national and international political processes shapes the economic policies governments adopt.

The case of the steel tariff also highlights the many distinct elements that international political economy must incorporate when attempting to make sense of developments in the global economy. To fully understand the steel tariff, we need to know something about the economic interests of the businesses and workers that produce and consume steel. To understand these interests requires knowledge of economic theory. Moreover, we need to know something about how political processes in the United States transform these economic interests into trade policy. This requires knowledge of the American political system and the American trade policy process. In addition, we need to know something about how a policy decision made by the United States affects businesses and workers based in other countries (more economic theory for this), and we need to know how governments in these countries are likely to respond to these consequences (requiring knowledge about the political systems in these countries). Finally, we need to know something about the role that international economic organizations like the World Trade Organization play in regulating the foreign economic policies that governments adopt. More broadly, understanding developments in the global economy through the lens of international political economy requires us to draw on economic theory, explore domestic politics, examine the dynamics of political interactions between governments, and familiarize ourselves with international economic organizations. While this may seem to be a daunting task at this point, this book introduces you to each of these elements and helps you learn how to integrate them in order to deepen your understanding of the global economy.

One way scholars simplify the study of the global economy is by dividing it into distinct issue areas. Typically, the global economy is broken into four such issue areas: the international trade system, the international monetary system, multinational corporations (or MNCs), and economic development. Rather than studying the global economy as a whole, scholars will focus on one of these four issue areas in relative isolation from the others. Of course, it is somewhat misleading to separate these four issue areas and study each independently. MNCs, for example, are important actors in the international trade system. The international monetary system exists solely to enable people living in different countries to engage in economic transactions with each other. It has no purpose, therefore, outside consideration of international trade and investment. Moreover, problems arising in the international monetary system are intrinsically connected to developments in international trade and investment. Trade, MNCs, and the international monetary system in turn all play an important role in economic development. In other words, each of these four issue areas is deeply connected to the others. In spite of these deep connections, the central characteristics of each area are sufficiently distinctive that one can pull them apart to study each in relative isolation from the others, as long as one remains sensitive to the connections among them when necessary. We will adopt the same approach here.

The international trade system is centered upon an international institution called the World Trade Organization (WTO). Some 144 countries belong to the WTO, and through this international institution they have created a nondiscriminatory international trade system. This means that in the international trade system, each country

gains access to all other WTO members' markets on equal terms. In addition, the WTO and its predecessor, the General Agreements on Tariffs and Trade (GATT), have enabled governments to progressively eliminate tariffs and other barriers to the cross-border flow of goods and services. As these barriers have been dismantled, world trade has grown steadily. Today, goods and services worth about $7.6 trillion flow across national borders each year. During the last ten years, however, regional trading arrangements have arisen to pose a potential challenge to the WTO-centered trade system. These regional trade arrangements, such as the North American Free Trade Agreement (NAFTA), are trading blocs comprised of a small number of countries who offer each other preferential access to their markets. Scholars who study the international trade system investigate the creation, operation, and consequences of the WTO-centered system and the emerging regional trading frameworks.

The international monetary system enables people living in different countries to conduct trade and financial transactions with each other. People living in the United States, for example, who may want to buy goods produced in Japan must be able to determine what a good produced in Japan and priced in yen will cost in dollars. In addition, American workers earn and spend dollars, but Japanese producers want yen for the goods they sell to Americans. These international payments involve not only the physical transfer of money from one country to another, but also the exchange of one currency into another. People and businesses will not be able to engage in international economic transactions unless these functions are performed well, and it is the task of the international monetary system to perform them. The international monetary system has changed during the last 50 years in two important ways. First, in the first 20 years following World War II, governments attempted to maintain relatively stable or fixed exchange rates. Then in the early 1970s, governments abandoned this system and have since allowed the value of their currencies to be determined largely by financial markets with only occasional government intervention. Second, during the early postwar period governments restricted the flow of financial capital into and out of their national economies. Many governments have dismantled these restrictions since the late-1970s and now allow financial capital to flow freely across national borders. As a result, international capital flows have increased sharply. Scholars who study the international monetary system focus on the creation, operation, and consequences of this system.

Multinational corporations occupy a prominent and often controversial role in the global economy. A multinational corporation is a firm that controls production facilities in at least two countries. The largest of these firms are familiar names such as Ford Motor Company, General Electric, and General Motors. In all, the United Nations estimates that there are more than 60,000 MNCs operating in the contemporary global economy. These firms together control more than 600,000 production plants and employ about 86 million people across the globe. Together they account for about one quarter of the world's economic production and about one-third of the world's trade. MNCs have been controversial in part because of their size, but more importantly because they extend managerial control across national borders. Corporate managers based in the United States, for example, make decisions that affect economic conditions in Mexico and other Latin American countries, in Western Europe, and in Asia. Scholars who study MNCs focus on why these large firms exist, on what impact they

have on the countries that host their operations, and on what measures governments have taken to attempt to regulate their activities.

Finally, a large body of literature studies economic development. Throughout the postwar period, developing country governments have adopted explicit development strategies that they believed would raise incomes by promoting industrialization. The success of these strategies has varied. Some countries, such as the Newly Industrializing Countries (NICs) of East Asia (Taiwan, South Korea, Singapore, and Hong Kong) have been so successful in promoting industrialization and raising per capita incomes that they can no longer be considered developing countries. Other countries, particularly in sub-Saharan Africa and in parts of Latin America, have been much less successful. Governments in these countries adopted different development strategies than the NICs throughout much of the postwar period and realized much smaller increases in per capita incomes. Students of the politics of economic development focus on the specific strategies that developing countries' governments adopt and attempt to explain why different governments adopt different strategies. In addition, these students are concerned about which development strategies have been relatively more successful than others (and why), and about whether participation in the international economy facilitates or frustrates developing countries' efforts to industrialize.

Those who study the global economy through the lens of international political economy are typically interested in doing more than simply describing government policies and contemporary events in these four issue areas. In particular, scholars aspire to make more general statements about how politics shape the foreign economic policies that governments adopt in each of these issue areas. Moreover, most scholars want to draw more general conclusions about the consequences of these policies. As a consequence, two abstract and considerably broader questions typically shape the study of trade, money, MNCs, and development. First, how do politics shape the decisions that societies make about how to use the resources that are available to them? Second, what are the consequences of these decisions? Because these two over-arching questions are central to what we cover in this book, it is worth taking a closer look at each of them now.

How do politics shape societal decisions about how to allocate available resources? For example, how does a society decide whether the labor and capital it has available are to be used to produce semiconductors or clothing? While this question might appear quite remote from the issue areas discussed above, the connections are actually quite close. The foreign economic policies that a government adopts—its trade policies, its exchange rate policies, and its policies toward MNCs—affect how that society's resources are used. A decision to raise tariffs, for example, will encourage business owners to invest and workers to seek employment in the industry that is protected by the tariff. A decision to lower tariffs will encourage business owners and workers currently employed in the now-liberalized industry to seek employment in other industries. A change in tariff policy, therefore, will affect the uses to which society's resources are put. Foreign economic policies are in turn a product of politics, the process through which societies make collective decisions. Thus, the study of international political economy is in many respects the study of how politics shape the decisions that societies make about how to allocate the resources they have available to them.

These decisions are complicated by two considerations. On the one hand, all resources are finite. As a result, choices about how to allocate resources will always be made against a backdrop of scarcity. Any choice in favor of one use of a resource therefore necessarily implies a choice to forgo another possible use. On the other hand, in any society different people will have different ideas about how available resources should be used. Some groups will want to use these resources to produce cars and semiconductors, for example, while other groups will prefer to use these resources to produce clothing and agricultural products. Societies will therefore always confront competing demands for their finite resources. One of the important goals of international political economy as a field of study is to investigate how such competing demands are aggregated, reconciled, and transformed into foreign economic policies.

The second abstract question asks what are the *consequences* of the choices that societies make about resource allocation? These decisions have two very different consequences. On the one hand, decisions about resource allocation have **welfare consequences,** that is, they determine the level of societal well being. Some choices will maximize societal welfare, that is, they will make society as a whole as well off as is possible given existing resources. Other choices will cause social welfare to fall below its potential, in which case different choices about how to use resources would raise social welfare. On the other hand, decisions about resource allocation have **distributional consequences,** that is, they influence how income is distributed between groups within countries and between nations in the international system. Both consequences are evident in the impact of the American steel tariff. Because the tariff makes it more profitable to produce steel in the United States than it would be otherwise, some investment capital and workers that might otherwise be employed in highly efficient American industries such as information technology or biotechnology will be used in the less efficient American steel industry. The tariff thus causes the United States to use too many of its resources in economic activities that it does less well and too few resources in activities that it does better. As a consequence, the United States is poorer with a high tariff on steel than it would be without it. The steel tariff also redistributes income. Because the tariff raises the price of steel in the United States, it redistributes income from the consumers of steel, such as American firms that use steel in the products they manufacture and the American consumers who purchase goods made out of steel, to the steel producers. In addition, because the tariff makes it more difficult for foreign steel firms to sell in the American market, it redistributes income from foreign steel producers to American steel producers. The steel tariff, like many economic policies, affects both the level and the distribution of income within a society.

These two abstract questions give rise to two very different research traditions within international political economy. One tradition focuses on explanation, while a second focuses on evaluation. **Explanatory studies,** which relate most closely to our first abstract question, are oriented toward explaining the foreign economic policy choices that governments make. Such studies most often attempt to answer "why questions." For example, why does one government choose to lower tariffs and open its economy to trade while another government continues to protect the domestic market from imports? Why did governments create the World Trade Organization? Why do some governments maintain fixed exchange rates while others allow their

currencies to float? Why do some governments allow MNCs to operate in their economies with few restrictions, while other governments attempt to regulate MNC activity? Each of these questions asks us to explain a specific economic policy choice made by a government, or to explain a pattern of choices within a group of governments. In answering such questions, we are most concerned with explaining the policy choices that governments make and pay less attention to the welfare consequences of these policy choices.

Evaluative studies, which are related most closely to our second abstract question, are oriented toward assessing policy outcomes, making judgments about them, and proposing alternatives when the judgment made about a particular policy is a negative one. A **welfare evaluation** is primarily interested in whether a particular policy choice raises or lowers social welfare. For example, does a decision to liberalize trade raise or lower national economic welfare? Does a decision to turn to the International Monetary Fund and accept a package of economic reforms promote or retard economic growth? More broadly, do current policies encourage the society to use its available resources in ways that maximize economic welfare, or would alternative policies that encouraged a different allocation result in higher economic welfare? Because such evaluations are concerned with the economic welfare consequences of policy outcomes, they are typically based on economic criteria and rely heavily upon economic theories. Other scholars evaluate particular outcomes in terms that extend beyond considerations of economic welfare. In some instances, scholars evaluate outcomes in terms of their distributional consequences. For example, many of the groups that are members of the contemporary backlash against globalization are highly critical of international trade because they believe that workers lose and business gains from trade liberalization. Implicit in this criticism is an evaluation of how liberal trade in the global economy distributes income across groups within countries and across countries within the international system. Evaluations may also extend the frame of reference within which outcomes are evaluated beyond purely economic criteria. For example, even those who agree that international trade raises world economic welfare might remain critical of globalization because they believe that it degrades the environment, disrupts traditional methods of production, or has other negative social consequences that outweigh the economic gains. Explanation and evaluation both play an important role in international political economy. This book, however, focuses primarily upon explanation and secondarily upon evaluating the welfare consequences of government policies. I devote little attention to evaluating outcomes in terms that extend beyond economic welfare considerations.

Studying International Political Economy

Scholars working within the field of international political economy have developed a large number of theories to answer the two questions posed above. Three traditional schools of political economy—the mercantilist school, the liberal school, and the Marxist school—have shaped the development of these theories over the last one hundred years. Each of these three traditional schools offers distinctive answers to the two questions and these differences have structured much of the scholarly and public debate about international political economy. While these traditional schools remain influential, more and more often students of international political economy are developing theories to answer our two questions from outside the explicit confines of these traditional schools. One prominent approach, and the approach that is developed throughout this book, suggests that the foreign economic policies that governments adopt emerge from the interaction between societal actors' interests and political institutions. We begin our examination of how people study international political economy with a broad overview of these alternative approaches. We look first at the three traditional schools, highlighting the answers they provide to our two questions and pointing to some of the weaknesses of these schools that have led students to move away from them. We then examine the broad logic of the interests and institutions approach developed here to set the stage for the issue-area specific explanations we develop in the remainder of the book.

Traditional Schools of International Political Economy

Historically, theories of international political economy have been developed in three broad schools of thought: mercantilism (or nationalism), liberalism, and Marxism. **Mercantilism** is rooted in seventeenth and eighteenth century theories about the relationship between economic activity and state power. The mercantilist literature is large and varied, and yet mercantilists do generally adhere to three central propositions. First, the classical mercantilists argued that national power and wealth were tightly connected. National power in the international state system is derived in large part from wealth. Wealth in turn is required to accumulate power. Second, the classical mercantilists argued that trade provided one way for countries to acquire wealth from abroad. Wealth could be acquired through trade, however, only if the country ran a positive balance of trade, that is, if the country sold more goods to foreigners than it purchased from foreigners. Third, the classical mercantilists argued that some types of economic activity are more valuable than others. In particular, mercantilists argued that manufacturing activities should be promoted while agriculture and other nonmanufacturing activities should be discouraged. "Modern" mercantilism applies these three propositions to contemporary international economic policy. Modern mercantilists argue that economic strength is a critical component of national power. Trade is to be valued for exports, but governments should discourage imports whenever possible. In addition, contemporary mercantilists argue that some forms of economic activity are more valuable than others. Manufacturing is preferred to the production of agricultural and other primary commodities, and high technology manufacturing industries such as computers and telecommunications are preferable to mature manufacturing industries such as steel or textiles and apparel.

The emphasis on wealth as a critical component of national power, the insistence on maintaining a positive balance of trade, and the conviction that some types of economic activity are more valuable than others leads mercantilists to argue that the state should play a large role in determining how society's resources are allocated. Economic activity is too important to allow decisions about resource allocation to be made through an uncoordinated process such as the market. Uncoordinated decisions can result in an "inappropriate" economic structure. Industries and technologies that may

be desirable from the perspective of national power might be neglected, while industries that do little to strengthen the nation in the international state system may flourish. In addition, the country could develop an unfavorable balance of trade and become dependent upon foreign countries for critical technologies. The only way to ensure that society's resources are appropriately used is to have the state play a large role in the economy. Economic policy can be used to channel resources to those economic activities that promote and protect the national interest and away from those that fail to do so.

Liberalism, the second traditional school, emerged in Britain during the eighteenth century to challenge the dominance of mercantilism in government circles. Adam Smith and other liberal writers, such as David Ricardo (who first stated the modern concept of comparative advantage), were scholars that were attempting to alter government economic policy. The theory they developed to do so, liberalism, challenged all three central propositions of mercantilism. First, liberalism attempted to draw a strong line between politics and economics. In doing so, liberalism argued that the purpose of economic activity was to enrich individuals, not to enhance the state's power. Second, liberalism argued that countries do not enrich themselves by running trade surpluses. Instead, countries gain from trade regardless of whether the balance of trade is positive or negative. Finally, countries are not necessarily made wealthier by producing manufactured goods rather than primary commodities. Instead, liberalism argued, countries are made wealthier by making products that they can produce at relatively low cost at home and trading them for goods that can be produced at home only at relatively high cost. Thus, according to liberalism, governments should make little effort to influence the country's trade balance or to shape the types of goods the country produces. Government efforts to allocate resources will only reduce national welfare.

In addition to arguing against substantial state intervention as advocated by the mercantilists, liberalism argued in favor of a market-based system of resource allocation. Giving priority to the welfare of individuals, liberalism argues that social welfare will be highest when people are free to make their own decisions about how to use the resources they possess. Thus, rather than accepting the mercantilist argument that the state should guide the allocation of resources, liberals argue that resources should be allocated through voluntary market-based transactions between individuals. Such exchange is mutually beneficial—as long as it is voluntary then both parties to any transaction will benefit. Moreover, in a perfectly functioning market, individuals will continue to buy and sell resources until the resulting allocation offers no further opportunities for mutually beneficial exchange. The state plays an important, though limited, role in this process. The state must establish clear rights concerning ownership of property and resources. The judicial system must enforce these rights and the contracts that transfer ownership from one individual to another. Most liberals also recognize that governments can and should resolve **market failures,** which are instances in which voluntary market-based transactions between individuals fail to allocate resources to socially desirable activities.

Marxism, the third traditional school, originated in the work of Karl Marx as a critique of capitalism. It is impossible to characterize briefly the huge literature that has expanded on or been influenced by Marx's ideas. According to Marx, capitalism is characterized by two central conditions: the private ownership of the means of production, or capital, and wage labor. Marx argued that the value of manufactured goods was determined by the amount of labor used to produce them. However, capitalists did not pay labor the full amount of the value they imparted to the goods they produced. Instead, the capitalists that owned the factories paid workers only a subsistence wage and retained the rest as profits with which to finance additional investment. Marx predicted that the dynamics of capitalism would lead eventually to a revolution that would do away with private property and with the capitalist system that private property supported.

Three dynamics would interact to drive this revolution. First, Marx argued that there is a natural tendency toward the concentration of capital. Economic competition would force capitalists to increase their efficiency and increase their capital stock. As a consequence, capital would become increasingly concentrated in the hands of a small, wealthy elite. Second, Marx argued that capitalism is associated with a falling rate of profit. Investment leads to a growing abundance of productive capital, which in turn reduces the return to capital. As profits shrink, capitalists are forced to further reduce wages, worsening the plight of the already impoverished masses. Finally, capitalism is plagued by an imbalance between the ability to produce goods and the ability to purchase goods. Large capital investments continually augment the economy's ability to produce goods, while falling wages continually reduce the ability of consumers to purchase the goods being produced. As these three dynamics interact over time, society becomes increasingly characterized by growing inequality between a small wealthy capitalist elite and a growing number of impoverished workers. These social conditions eventually cause workers (the proletariat, in Marxist terminology) to rise up, overthrow the capitalist system, and replace it with socialism.

In contrast to liberalism's emphasis on the market as the principle mechanism of resource allocation, Marxists argue that capitalists make decisions about how society's resources are used. Moreover, because capitalist systems promote the concentration of capital, investment decisions are not typically driven by market-based competition, at least not in the classical liberal sense of this term. Instead, decisions about what to produce are made by the few firms that control the necessary investment capital. The state plays no autonomous role in the capitalist system. Instead, Marxists argue that the state operates as an agent of the capitalist class. The state enacts policies that reinforce capitalism and thus the capitalists' control of resource allocation. Thus, in contrast to the mercantilists who focus on the state and the liberals who focus on the market, Marxists focus on large corporations as the key actor that determines how resources are to be used.

The three traditional schools of political economy thus offer three distinctive answers to our question of how politics shape the allocation of society's resources. Mercantilists argue that the state guides resource allocation in line with objectives shaped by the quest for national power. Liberals argue that politics ought to play little role in the process, extolling instead the role of market-based transactions among autonomous individuals. Marxists argue that the most important decisions are made by large capitalist enterprises supported by a political system controlled by the capitalist class. These three traditional schools also offer distinctive frameworks to evaluate the consequences of resource allocation. Mercantilists focus on the consequences of resource allocation for national power. The central question a mercantilist will ask is, "Is

Table 1.1
Three Traditional Schools of International Political Economy

	Mercantilism	Liberalism	Marxism
Most Important Actor	The State	Individuals	Classes, Particularly the Capitalist Class
Role of the State	Intervene in the Economy to Allocate Resources	Establish and Enforce Property Rights to Facilitate Market-Based Exchange	Instrument of the Capitalist Class Uses State Power to Sustain Capitalist System
Image of the International Economic System	*Conflictual:* Countries compete for desirable industries and engage in trade conflicts as a result of this competition	*Harmonious:* The international economy offers benefits to all countries. The challenge is to create a political framework that enables countries to realize these benefits	*Exploitative:* Capitalists exploit labor within countries; rich countries exploit poor countries in the international economy
Proper Objective of Economic Policy	Enhance Power of the Nation-State in International State System	Enhance Aggregate Social Welfare	Promote an Equitable Distribution of Wealth and Income

there some alternative allocation of resources that would enhance the nation's power in the international system?" Liberals rely heavily upon economic theory to focus principally upon the welfare consequences of resource allocation. The central question a liberal will ask is, "Is there some alternative allocation of resources that would enable the society to improve its standard of living?" Marxists rely heavily upon theories of class conflict to focus on the distributional consequences of resource allocation. The central question a Marxist will ask is, "Is there an alternative political and economic system that will promote a more equitable distribution of income?" Thus, liberalism emphasizes the welfare consequences of resource allocation, while mercantilism and Marxism each emphasize a different aspect of the distributional consequences of these decisions.

These very different allocation mechanisms and unique evaluative frameworks generate three very different images of the character of the international political economy. Mercantilists argue that the international political economy is characterized by distributional conflict as governments compete to attract and maintain desired industries. Liberals argue that international economic interactions are essentially harmonious. Because all countries benefit from international trade, power has little impact on national welfare, and international economic conflicts are rare. The central problem, from a liberal perspective, is creating the international institutional framework that will enable governments to enter into agreements through which they can create an international system of free trade. Marxists argue that the international political economy is characterized by distributional conflict between labor and capital within countries and by distributional conflict between the advanced industrialized countries and developing countries within the international arena.

These three traditional schools have structured studies of and debate about the international political economy for a very long time. And while the presence of all three will be felt in many ways throughout the pages of this book, we will spend little more time examining them directly. In their place, we will emphasize an analytical framework that has been developed during the last 15 years or so that focuses on how the interaction between societal interests and political institutions determine the foreign economic policies that governments adopt.

Interests and Institutions in International Political Economy

To explain the policy choices made by governments, this book concentrates on the interaction between societal interests and political institutions. This approach suggests that to understand the foreign economic policy choices that governments make, we need to understand two aspects of politics. First, we need to understand where the interests, or economic policy preferences of groups in society come from, Second, we need to examine how political institutions aggregate, reconcile, and ultimately transform competing demands into foreign economic policies and a particular international economic system. Each of these aspects warrants further elaboration.

Interests are the goals or policy objectives that the central actors in the political system and in the economy—individuals, firms, labor unions, other interest groups, and governments—want to use foreign economic policy to achieve. In focusing on interests we will assume that individuals and the interest groups that represent them always prefer foreign economic policies that raise their incomes to policies that reduce their incomes. Thus, whenever a group confronts a choice between one policy that raises its income and another that lowers its income, it will always prefer the policy that raises its income. We focus on two mechanisms to explain the formation of these policy interests. First, people have **material interests** that arise from their position in the economy. We can summarize the essence of this approach in a simple statement: tell me where you work and what you do and I'll tell you what your foreign economic policy preferences are. Consider once again the American steel tariff. It is reasonable to expect that whether a particular individual supports or opposes this tariff depends upon where they work. If you are an American steel worker you probably favor the tariff because it reduces the likelihood that you will lose your job. You are also likely to favor the tariff if you own an American steel mill, because the tariff helps ensure a market and a relatively high price for the steel you produce. Suppose instead, however that you were an American autoworker or that you owned a substantial share of General Motors. In this case it is not unreasonable to expect that you would oppose the steel tariff. The higher steel prices caused by the tariff means that it costs more to produce cars. As cars become more expensive, fewer are sold and consequently fewer are produced. The tariff thus increases the

chances that autoworkers will be laid off and it causes GM to earn smaller profits. These are compelling reasons for autoworkers and their employers to oppose the higher steel tariff. In short, one's position in the economy powerfully shapes one's preferences about foreign economic policy. As we shall see, economic theory enables us to make some powerful statements about the foreign economic policy preferences of different groups in the economy.

Second, interests are often based on ideas. **Ideas** are mental models that provide a coherent set of beliefs about cause and effect relationships. In the context of economic policy, these mental models typically focus on the relationship between government policies and economic outcomes. Not surprisingly, therefore, economic theory is a very important source of ideas that influence how actors perceive and formulate their interests. By providing clear statements about cause and effect economic relationships, economic theories can create an interest in a particular economic policy. The theory of comparative advantage, for example, claims that reducing tariffs raises aggregate social welfare. A government that believes this theory might be inclined to lower tariffs in order to realize these welfare gains. Alternatively, a government might adopt high tariffs because a different economic theory (the infant industry argument, for example) suggests that tariffs can promote economic production in ways that raise national income. What matters, therefore, is not whether a particular idea is true or not, but whether people in power, or people with influence over people with power, believe the idea to be true. Thus, ideas about how the economy operates can be a source of the preferences that groups have for particular economic policies.

Understanding where interests come from will enable us to specify with some precision the competing demands that political leaders will confront when making foreign economic policy decisions. It does not tell us anything about how these competing demands are reconciled and transformed into foreign economic policies. To understand how interests are transformed into policies we need to examine political institutions. **Political institutions** establish the rules governing the political process. By establishing rules, they enable groups within countries, and groups of countries in the international state system, to reach and enforce collective decisions. On the one hand, political institutions determine which groups are empowered to make choices and establish the rules these "choosers" will use when doing so. In domestic political systems, for example, democratic institutions promote mass participation in collective choices, while authoritarian systems restrict participation to a narrow set of individuals. In international economic affairs, governments from the advanced industrialized countries often make decisions with little participation by developing countries. Political institutions also provide the rules that these groups use to make decisions. In democratic systems, the usual choice rule is majority rule, and policies are supposed to reflect the preferences of a majority of voters or legislators. In international economic organizations, the choice rule is often relative bargaining power, and decisions typically reflect the preferences of the more powerful nations. Political institutions thus allow groups to make collective decisions, and in doing so determine who gets to make these decisions and how they are to be made.

Political institutions also help enforce these collective decisions. In many instances, individuals, groups, and governments have little incentive to comply with the decisions that are produced by the political process. This is particularly the case for those groups whose preferences diverge from those embodied in the collective choice. And even in cases where a group or a country as a whole does benefit from a particular decision, it may believe it could do even better if it cheated a little bit. If such instances of noncompliance are widespread, then the political process is substantially weakened. This problem is particularly acute in the international state system. In domestic political systems, the police and the judicial system are charged with enforcing individual compliance with collective decisions. The international system has neither a police force nor a judicial system through which to enforce compliance, however. Consequently, it can be very tempting for governments to attempt to "cheat" on the international economic agreements they conclude with other governments. International institutions like the WTO and the IMF can help governments enforce the international agreements that they conclude.

A focus on interests and institutions will allow us to develop a set of reasonably comprehensive answers to our first question: how do politics shape societal decisions about how to allocate resources. The explanations we construct will almost always begin by investigating the source of competing societal demands for resources and then explore how political institutions aggregate, reconcile, and ultimately transform these competing demands into foreign economic policies and a particular international economic system. This approach may not always provide a full explanation of the interactions we observe in the international political economy, but it does provide a solid point of departure.

The Organization of the Book

In applying this framework to the international political economy, we employ three additional devices to help organize the subject matter. First, we divide the field of international political economy into distinct issue areas. The first half of the book is devoted to trade and production. We look at the creation and evolution of the multilateral trade system. We examine why this system was created following World War II, and how governments have used this system to liberalize trade. We try to make sense of the pattern of trade liberalization and protection that we see to understand why governments have been willing to liberalize trade in some areas but not in others. We also examine the position of the developing countries in this multilateral trade system. Finally, we examine the role of multinational corporations in the global economy. The second half of the book focuses on the international monetary and financial systems. We examine the creation and evolution of the postwar international monetary system, trying in particular to make sense of the exchange rate policies that governments have adopted. We also examine the developing countries' position in the international monetary and financial systems, with a particular focus on international debt and financial crises.

Second, each issue area is divided into chapters that focus principally on political economy in the international system and chapters that focus principally on political economy in the domestic arena. The examination of each issue area begins with a

chapter that focuses on the interaction between interests and institutions in the international system. In these chapters, we examine how the distribution of power in the international state system shapes international economic institutions such as the WTO and the IMF, as well as political and economic interactions within these institutions. In addition, we examine how international economic transactions, including international trade, the activities of multinational corporations, and international capital flows, as well as changes in the distribution of power, transform the global economy and the national economies upon which it is based. The second chapter in each issue area examines the interaction between interests and institutions in domestic politics. In each of these chapters, we develop two approaches to the domestic politics of foreign economic policy, one that is society-centered and one that is state-centered. A society-centered approach puts greatest emphasis on the impact of competing interests in explaining the foreign economic policies that governments adopt. Such an approach argues that politicians are highly responsive to demands made by private interest groups within their societies. As a consequence, foreign economic policies are determined by the balance of power among competing domestic interest groups. A state-centered approach puts greatest emphasis on state institutions in explaining the foreign economic policies that governments adopt. This approach argues that policymakers enjoy considerable autonomy from societal interest groups and can use this autonomy to make foreign economic policy independent of the narrow interests of particular groups. As a consequence, foreign economic policy typically is designed to promote the national interest. Of course, international political economy and domestic political economy do not function in isolation from each other. Thus, even as we separate them for the purpose of discussion, the book strives to make connections between international and domestic political economy in each chapter.

Third, the examination of each issue area is divided into chapters that focus principally on the advanced industrialized countries—the United States, Western Europe, Japan—and chapters that focus principally on developing countries. This division has little to do with the need to develop distinct theoretical frameworks for each group. Instead, the reason for this organization has more to do with the fact that the two groups differ on a number of important dimensions, and these differences give rise to different relationships with and policies toward the international economic system. The two groups have different economic structures. The advanced industrialized countries produce and export capital intensive and technology intensive goods and services while most developing countries are heavily dependent upon labor-intensive goods and primary commodities. In the international financial system, advanced industrialized countries are lenders while developing countries are borrowers. The two groups are not equally powerful. The advanced industrialized countries have more power and can use this power to shape the rules governing international trade and finance. The developing countries have less power, and have typically had to accept the rules of the system as given. As a result of these differences in economic structure and international power, the two groups have had very different experiences with the international economic system. For this reason, one chapter in each issue area focuses more heavily upon the advanced industrialized countries while another focuses more heavily upon the developing countries.

Key Terms

Distributional Consequences
Explanatory Studies
Evaluative Studies
Ideas
Interests
Liberalism
Market Failures
Material Interests
Marxism
Mercantilism
Political Institutions
Welfare Consequences
Welfare Evaluation

CHAPTER 2

THE MULTILATERAL TRADE SYSTEM

International trade has grown rapidly since World War II. The amount of goods exported by all countries has increased at an average rate of 6 percent per year since 1950. As a result, total world trade has grown from about $84 billion in 1953 to approximately $7.6 trillion in 2000 (World Trade Organization 2001, 9). To put this number in perspective, about one out of every four dollars of income in each country in the world is either earned by exporting goods and services to foreign markets or spent on goods and services produced in foreign countries. Not only has international trade steadily increased over the past 50 years, it has consistently grown more rapidly than world economic production. Thus, each year a larger share of the production and employment that create national incomes becomes dependent upon international trade. Never before in history has international trade grown so rapidly for so long, both in absolute terms and as a proportion of national economic activity.

This unprecedented postwar growth of international trade has been made possible by the multilateral trade system established in 1947. The multilateral trade system is both a political process and a set of political institutions through which governments regulate national trade policies. The political process is centered on negotiations among national governments. Since the mid-1940s governments have used these negotiations to create international rules to govern many national policies that affect international trade. Governments have also created a political institution, initially the General Agreements on Tariffs and Trade and now the World Trade Organization. These institutions have helped governments conduct trade negotiations and help ensure that governments live up to the agreements they make. International trade has expanded so rapidly since World War II because governments have used this political system to progressively eliminate national barriers to international trade. To understand international trade politics, we must examine the interaction between interests and institutions in this multilateral trade system.

This chapter focuses on four questions about the multilateral trade system. We begin with the simplest question: what is the multilateral trade system and how does it operate? Second, why was the multilateral trade system created in its current form,

and what factors will determine how long it lasts? The creation of the postwar trade system was in no sense inevitable, and the current system represents only one of many possible ways to organize international trade. Third, we ask what purpose does the multilateral trade system serve? That is, if international trade is such a good thing, why do governments need a specialized international institution to achieve it? We end by exploring the consequences of the multilateral trade system: how has trade liberalization and the growth of world trade altered the global economy, and what impact have these developments had on national economies and on national politics? In other words, how has trade liberalization promoted globalization, and what impact has globalization had on national politics? Answers to these four questions will help us uncover the political dynamics of the multilateral trade system.

THE MULTILATERAL TRADE SYSTEM

The multilateral trade system is an international political system. International trade institutions stand at the center of this system. Throughout most of the postwar period, the General Agreement on Tariffs and Trade (GATT), which was created in 1947, was the principle international trade institution. In 1994, the GATT was folded into a new international institution called the **World Trade Organization** (WTO). In contrast to the GATT, which was a treaty, the WTO is an international organization that enjoys the same legal status as other international organizations such as the United Nations, the World Bank, and the International Monetary Fund. Based in Geneva, Switzerland, the WTO is relatively small compared to other international organizations. Although 144 countries are members of the WTO, the organization has a staff of only 500 people and a budget of only about $225 million in the year 2000. Its functions include providing a forum for trade negotiations among its member governments, administering the trade agreements that governments conclude, and providing a mechanism through which governments can resolve trade disputes. And although the WTO is now the institutional center of the world trade system, the GATT has not disappeared. The GATT continues to provide many of the rules governing international trade relations. The creation of the WTO, therefore, represented an organizational change, but it did not produce a wholly new set of international trade rules. The rules that provide the foundation of the multilateral trade system are those that were initially established in 1947 and that have been gradually revised and amended ever since.

The multilateral trade system can be broken down into three individual components: an intergovernmental bargaining process, a set of rules and principles governing international trade relations, and a dispute settlement mechanism. As an intergovernmental bargaining process, the WTO focuses on trade liberalization. Trade liberalization refers to the elimination of government policies that make it difficult for goods and services produced in one country to be sold in another. Such policies include **tariffs,** which are taxes that governments impose on foreign goods coming into the country. They also include a wide range of **nontariff barriers** such as health and safety regulations, government purchasing practices, and many other government regulations. Trade liberalization has been achieved through a series of bargaining rounds that have been conducted since 1947. Eight such rounds have been held, and a ninth, called The

Millennium Round, began in 2001 (see Table 2.1). These bargaining rounds are extended affairs. The Uruguay Round, for example, was officially launched in 1986 (though it had been discussed since 1982) and was not concluded until December 1993. Each of these bargaining rounds brought WTO-member governments together to negotiate an agreement covering a specific set of trade-related issues. Negotiations under the Uruguay Round, for example, included tariff reductions in manufacturing as well as efforts to create brand new rules to govern international trade in services and to protect intellectual property.

Through these bargaining rounds, governments have progressively reduced tariffs on manufactured goods and begun to eliminate some nontariff barriers as well. Tariffs were the principal focus of the first six GATT rounds (Table 2.1). At the end of the Second World War the governments belonging to the GATT imposed tariffs on manufactured goods that averaged 40 percent. Such tariffs were a major obstacle to international trade, as they meant that a foreign product such as a bicycle or a watch cost 40 percent more than a bicycle or a watch produced by a domestic firm. It is not hard to imagine that when faced with such large price differences, consumers would buy few foreign watches or bicycles. Governments have progressively reduced these tariff rates through successive GATT rounds. Average tariffs had fallen to 9 percent by the early 1970s with the implementation of the Kennedy Round agreement, and today the average tariff on manufactured goods is only 4 percent. Tariffs on manufactured goods are now so low that they have ceased to be an important barrier to international trade in manufactured goods (Jackson 1998).

Governments have also used the GATT/WTO process to develop multilateral rules for other trade-related issue areas. During the Tokyo Round, for example, governments addressed nontariff barriers to trade to lessen the dampening effect of these practices on international trade. But the Uruguay Round was most exceptional because for the first time the negotiations focused most heavily on problems other than tariffs. During the Uruguay Round, governments created international rules in three new areas. Governments created international rules to protect **intellectual property** (see Ryan 1998; Sell 1998). According to the World Intellectual Property Organization (one of the United Nations' specialized agencies), intellectual property "refers to creations of the mind: inventions, literary, and artistic works, as well as symbols, names, images, and designs used in commerce." This includes such things as the Nike "swoosh," a Hollywood movie, and computer software. Intellectual property is protected through patents and copyrights that give the creator the exclusive right to profit from his or her invention or artistic work. It became apparent during the 1980s that many governments, particularly in developing countries, were making little effort to protect intellectual property created by foreign firms. As a result, firms and individuals were making counterfeit versions of Microsoft software, American movies, Nike and Adidas sneakers, Calvin Klein and Guess jeans, pharmaceutical products, and other items. The ease with which anyone could purchase counterfeit or pirated products at much reduced prices throughout the developing world indicated that largely Western creators were losing billions of dollars. Moreover, such piracy, many argued, reduced the incentive to invent new products. In negotiating Trade-Related Intellectual Property Rights (TRIPs), governments created multilateral rules that now require all governments to protect intellectual property to prevent such piracy.

Governments also used the Uruguay Round to create new rules to govern international trade in services. A **service** is an economic activity that does not involve manufacturing, farming, or resource extraction. Such a broad definition incorporates a wide range of economic activities, including financial services like banking and insurance, transportation services like shipping and tourism, business services like consulting and accounting, and telecommunications. The service sector accounts for about 60 percent of economic activity in the advanced industrialized countries, and for about 22 percent of world trade. Moreover, since the early 1980s international trade in services has grown more rapidly than trade in manufactured goods (Hoekman and Kostecki 1995, 127). Yet, in spite of the importance of the service sector, there were no international rules governing international trade in services and many national policies made it difficult for foreign firms to provide services in domestic markets. Such regulations prevent American telephone companies from providing telephone service in West European countries, for example, and limit the ability of foreign banks or insurance companies to operate in the domestic market. The General Agreement on Trade in

Table 2.1
Trade Negotiations within the GATT, 1947–1993

Name and Year of Round	Subjects Covered	Participating Countries
1947 Geneva	Tariffs	23
1949 Annecy	Tariffs	13
1951 Torquay	Tariffs	38
1956 Geneva	Tariffs	26
1960–1961 Dillon Round	Tariffs	26
1964–1967 Kennedy Round	Tariffs and antidumping	62
1973–1979 Tokyo Round	Tariffs	102
	Nontariff measures	
	Framework agreements	
1986–1993 Uruguay Round	Tariffs	123
	Nontariff measures	
	Rules	
	Services	
	Intellectual property rights	
	Textiles and clothing	
	Agriculture	
	Dispute settlement	
	Establishment of WTO	

Source: World Trade Organization 1995, 9.

Table 2.2
Average World Tariffs, 1947–2000

1947: GATT Established	38%
1962: Pre Kennedy Round	17%
1972: Post Kennedy Round	9%
1987: Post Tokyo Round	6%
1994: Post Uruguay Round	4%

Source: WTO 1995, 5.

Services (GATS), concluded in the Uruguay Round, removed a small number of these barriers and created a framework for negotiations aimed at further liberalization (Hoekman and Kostecki 1995, 141). Such negotiations have been ongoing in telecommunications, maritime transport, and financial services since 1995.

Finally, governments created a set of rules governing policies toward multinational corporations. Known as Trade-Related Investment Measures (TRIMs), these rules were designed to limit the ability of governments to regulate certain aspects of the activities of multinational corporations operating in their countries. We will examine TRIMs in greater detail in our discussion of multinational corporations in Chapter 5.

The multilateral trade system's rules provide the legal framework for international trade relations. They specify how governments are to treat each other and what types of trade policy measures they can and cannot use. These rules are quite extensive; since 1947 governments have negotiated about sixty agreements that together fill about 30,000 pages. The text of the GATT alone, which spells out the basic rules governing international trade in goods, is more than 50 pages long. Four principles embodied implicitly and explicitly in these rules provide the foundation for the multilateral trade system. **Market-based liberalism** is the broadest of these principles and provides the underlying rationale for the entire system. According to market-based liberalism, trade liberalization is a desirable objective because trade raises the standard of living in all countries. Moreover, this principle suggests that the gains from trade are greatest—for each country and for the world as a whole—when goods can flow freely across national borders unimpeded by government-imposed barriers. The claim that international trade benefits all countries is based on economic theories of international trade. Standard trade theories make one very simple point: if a good costs less to buy in a foreign market than it does to produce at home, a country is better off if it imports the good than if it produces the good itself. A simple example based on the logic of **absolute advantage** can help illustrate. A country has an absolute advantage when its production costs for a particular good are lower than all other countries' production costs for that same good. Imagine a barter economy (an economy without money in which one good is traded directly for another) in which two countries each produce two goods, say wine and cheese. In this barter economy we ask how much does one good, a pound of cheese, cost in terms of the second good, a bottle of wine? There are two prices for cheese in terms of wine. The domestic price tells us how much wine it costs to buy a pound of domestic cheese. The foreign price tells us how much wine it costs to buy a pound of foreign cheese. If the foreign price of cheese is less than the domestic price of cheese, the nation will gain if it stops producing cheese, specializes in wine production, and uses the wine it does not consume to buy foreign cheese. By specializing in this manner, the country can consume more wine and cheese than it could if it continued to produce both goods at home.

Trade theory suggests, however, that countries need not have an absolute advantage in any good in order to gain from trade. Instead, all countries will have a **comparative advantage** in some goods, and this comparative advantage is sufficient to generate gains from trade. Comparative advantage means that even when a country does not have an absolute advantage in any good, it will still produce some goods more cheaply than others. The country will gain from trade by specializing in the goods it produces more cheaply and importing the goods it produces at a higher cost. Another

Table 2.3
The Wine and Cheese Trade in Denmark and France

	Labor Cost of Production		Price of Cheese in Terms of Cheese	Price of Wine in Terms of Wine
	Wine	Cheese		
Denmark	2	4	1/2	2
France	1	3	1/3	3

simple example can illustrate the importance of comparative advantage as the source of the gains from trade (see Table 2.3). Suppose that in France it takes 1 unit of labor to produce a gallon of wine and 3 units of labor to produce a pound of cheese, while in Denmark it takes 2 units of labor to produce a gallon of wine and 4 units of labor to produce a pound of cheese. In this example, France has an absolute advantage in wine and cheese because it takes less labor to produce a gallon of wine and a pound of cheese in France than it does in Denmark. In spite of this absolute disadvantage, however, Denmark gains from trade with France if it specializes in the good in which it has a comparative advantage—cheese. In Denmark, a pound of cheese buys 2 gallons of wine. In France, however, a pound of cheese will buy 3 gallons of wine. By specializing in cheese and trading with France, therefore, Denmark can consume 1 additional gallon of wine for each pound of cheese it produces compared to what it would be able to consume if it produced both goods at home. France also gains from trade with Denmark even though it has an absolute advantage in both goods. In France, a pound of cheese costs 3 gallons of wine. In Denmark, however, a pound of cheese costs only 2 gallons of wine. By specializing in wine and importing cheese from Denmark, France can consume 1 additional pound of cheese for every 6 gallons of wine it produces compared to what it could consume if it continued to produce both goods. The theory of comparative advantage tells us, therefore, that all countries can gain from trade by specializing in the goods in which they have a comparative advantage and exchanging them for the goods in which they have a comparative disadvantage.

What is the source of comparative advantage? That is, why can cheese be produced more cheaply than wine in Denmark, and why is wine cheaper to produce than cheese in France? The **Hecksher-Ohlin model** (or H-O), named after two Swedish economists, Eli Hecksher and Bertil Ohlin, who first developed this approach, provides the standard answer to this question. The H-O model argues that comparative advantage arises from differences in countries' **factor endowments.** Factors are the basic tools of production. When firms produce goods, they employ labor and capital in order to transform raw materials into finished goods. While it is relatively obvious that labor refers to workers, capital needs a bit more explanation. Capital encompasses the entire physical plant that is used in production, including the buildings that house factories and the machines on the assembly lines inside these factories. Countries possess these factors of production in different amounts. Some countries, like the United States, have a lot of capital but relatively little labor. Other countries, such as India,

have a lot of labor but relatively little capital. These different factor endowments in turn shape the cost of using the different factors for producing goods. A country's abundant factor will be cheaper to employ in production than its scarce factor. In the United States and other advanced industrialized countries, capital should be relatively cheap and labor should be relatively expensive. In India and other developing countries, labor should be relatively cheap and capital should be relatively expensive.

Because countries have different factor endowments and face different factor prices, countries will hold a comparative advantage in different goods. In general, a country will have a comparative advantage in goods that are produced using a lot of their abundant factor and a comparative disadvantage in goods that are produced using a lot of their scarce factor. Let's look at an example to make this clearer. In the auto industry, payments to labor account for between 25 and 30 percent of the total cost of production. The much larger share of the costs of production arise from capital expenditures, that is, expenditures on the machines, assembly lines, and buildings required to build cars (Dicken 1998). In contrast, in the apparel industry the wages paid to workers account for the largest share of production costs while capital expenditures account for a much smaller share of the costs of production. It follows that countries like the United States and Japan that have a lot of capital and little labor will have a comparative advantage in producing cars and a comparative disadvantage in producing clothing. By the same logic, developing countries such as India and Bangladesh that have a lot of labor and little capital will have a comparative advantage in producing clothing and a comparative disadvantage in producing cars.

The principle of market-based liberalism thus provides a compelling justification for international trade and for trade liberalization. The theory of comparative advantage tells us that all countries benefit from international trade, because every country—no matter how poor or rich, and no matter what its resource endowments—has a comparative advantage in something. As a result, eliminating barriers to international trade increases the welfare of the world as a whole and of every country that participates in this trade. It is upon this economic logic that the contemporary international trade system is based.

The principle of **nondiscrimination** is the second core principle of the multilateral trade system. It prohibits governments from using trade policies to provide special advantages to some countries at the expense of others. This principle takes a specific form called **Most Favored Nation** (MFN). MFN is found in Article I of the GATT and states that "any advantage, favour, privilege, or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties." Stripped of this somewhat obscure legal terminology, MFN simply requires each WTO member to treat all other WTO members as well as it treats its most-favored trading partner. For example, the United States cannot impose lower tariffs on goods imported from Brazil (a WTO member) than it imposes on goods imported from other WTO member countries. If the United States reduces the tariffs it imposes on goods imported from Brazil, it must extend these same tariff rates to all other WTO members. This principle thus assures that all countries have access to foreign markets on equal terms. No countries suffer discrimination, and no countries benefit from special advantages. The WTO does allow some

exceptions to the principle of nondiscrimination. Under the **Generalized System of Preferences** (GSP), enacted in the late 1960s, advanced industrialized countries can allow imports from developing countries to enter their markets at lower tariffs than imports from other advanced industrialized countries. The U.S. government has used this exemption to allow certain products from developing countries to enter the American market at a lower tariff rate than is imposed on the same good imported from Western Europe. Governments are also allowed to discriminate if they join a free trade area or customs union. In the North American Free Trade Agreement (NAFTA), for example, goods produced in Mexico enter the United States duty-free, while the United States imposes tariffs on the same goods imported from other countries. These exceptions aside, nondiscrimination is a fundamental principle of the multilateral trade system.

The third core principle of the multilateral trade system is the principle of reciprocity. **Reciprocity** was incorporated into the GATT in an attempt to ensure that the concessions that each government makes in multilateral trade negotiations are roughly the same size as the concessions it gains from its trading partners. For example, if the United States offers to reduce its tariffs on steel imported from Brazil, Brazil must offer to reduce tariffs on goods it imports from the United States, such as computers, rather than offer a reduction on something that the United States does not produce, like coffee (except for a little bit of Hawaiian Kona). Moreover, these reciprocal tariff reductions should result in an approximately equal amount of exports for the two countries. If the American tariff reduction is expected to raise Brazilian steel exports to the United States by $10 million, then the reciprocal Brazilian tariff reductions should result in about a $10 million expansion of American exports to Brazil.

Finally, the multilateral trade system incorporates the principle of domestic safeguards. **Domestic safeguards** are escape clauses that permit governments to temporarily suspend tariff reductions they have made within the WTO when continued compliance would result in serious damages to a domestic industry. For example, the world price of steel fell sharply during the late 1990s and early 2000s, resulting in a surge of steel imports into the United States. This import surge hurt American steel producers who began to lose domestic market share to foreign producers. The safeguards incorporated in the WTO allowed the United States to raise tariffs on imported steel temporarily in order to protect American steel producers from these imports. Governments cannot resort to such safeguards, however, without first investigating carefully to determine whether the problems that a domestic industry faces are in fact temporary and the consequence of a sudden import surge. In other words, even though the multilateral trade system allows governments to opt out of their commitments for short periods, it also limits their ability to do so.

The dispute settlement mechanism is the third central component of the trade system. A **dispute settlement mechanism** is a quasi-judicial tribunal that is used to resolve trade disputes between WTO member governments. Trade disputes arise when one government believes that another is failing to live up to obligations it has accepted as a member of the WTO. Such disputes can involve a violation of broad GATT rules such as nondiscrimination or the use of domestic safeguards or of a specific trade agreement. In February 2000, for example, Japan turned to the dispute settlement mechanism to challenge a U.S. decision to invoke the domestic safeguards rule in order to raise tariffs on Japanese steel imports. In such cases, the injured party can initiate a

WTO process that evaluates the legal merits of the complaint. If the panel of trade experts concludes that the country is violating one of its WTO obligations, that government must alter its policy to conform to WTO rules or compensate the government that is harmed by the policies. The dispute settlement mechanism thus provides a kind of court that helps WTO members resolve trade disputes. We will examine the WTO's dispute settlement mechanism in greater detail later in this chapter.

In short, the multilateral trade system is a political system. The WTO provides a set of international rules that govern countries' trade policies. These rules establish what governments can and cannot do to influence the flow of goods into and out of their countries. Within this multilateral framework, governments amend existing rules and create new rules through a process of intergovernmental bargaining. Throughout the postwar period, this bargaining process has progressively reduced tariffs on manufactured goods and created new multilateral rules to govern other aspects of international trade. The system also contains a dispute settlement mechanism that helps governments resolve trade disputes and make sure that all members comply with the international rules they have created.

Power, Interests, and the Multilateral Trade System

While the WTO has been integral to trade liberalization, it is certainly not an automatic outgrowth of international trade. The creation of the GATT following World War II was neither inevitable nor predetermined. There were no international trade institutions during the nineteenth century and none were created following World War I. An international institution dedicated to international trade cooperation is therefore an innovation of the post-World War II era. Second, the GATT/WTO is certainly not the only possible way to organize international trade. International trade could be organized regionally rather than globally, or on the basis of rules that promote global income equality rather than market-based liberalism. In addition, the continued existence of the WTO and the broader liberal multilateral trade system is not guaranteed. Most political systems have finite life spans, and the multilateral trade system is probably no exception to this tendency.

These broader issues raise three questions that we explore in this section: why was the GATT created following World War II, why did it take the specific form it did rather than some other form, and what factors will determine how long this system remains at the center of global trade? The answers that we develop draw on the interplay between power and interest. Political systems tend to reflect the interests of those who have created them, and in most instances it is the powerful actors within a society that create its political institutions. This is certainly the case in international politics, where powerful countries construct political institutions that embody their interests, and these institutions persist as long as the most powerful nations are willing to maintain them. And what applies to the international system more broadly applies with equal force to the international trade system. As we will see, the postwar multilateral trade system was established under American leadership after World War II, and thus reflected the economic interests of the United States and the other advanced industrialized countries. The contemporary multilateral trade system will persist for as long as the world's leading economic powers continue to believe that it provides the best way to organize world trade.

The Creation of the Postwar Trade System

The multilateral trade system was created under American leadership in the immediate aftermath of the Second World War. In conceptualizing and establishing this system, the United States was motivated by two considerations. First, by the early twentieth century the United States had emerged as the world's largest economic power with a clear interest in opening foreign markets to American exports. Great Britain dominated the world economy during the nineteenth century: it was the first country to experience the industrial revolution and by the mid-nineteenth century it produced 20 percent of the world's total manufacturing output (Kennedy 1989, 190). France, the world's second largest manufacturing economy at the time, produced less than half this amount. By the end of the nineteenth century, however, the United States had overtaken Great Britain and on the eve of the First World War, the United States' share of world manufacturing output was twice as large as Great Britain's (see Table 2.4). American economic power continued to rise during the next 20 years, and by the end of World War II, the United States was producing close to half of the world's manufactured goods.

The dominant position of the American economy in the international economic system, a dominance that is often referred to as American **hegemony,** created an American interest in liberal international trade. The United States had relied heavily upon protectionist barriers during much of the nineteenth century. Given British economic preeminence, the United States recognized that American manufacturers would find it difficult to compete against British manufacturers in foreign markets. Moreover, reducing U.S. tariffs would allow British producers to undersell American firms in the U.S. market, thereby making it difficult to develop a strong manufacturing base in the United States. As the United States caught and then overtook Great Britain, however, American trade interests changed. American government officials recognized that American industry could capture world markets and that lower tariffs at home posed little threat to American manufacturing firms.

American policymakers also came to believe that a liberal international trade system would be possible only under American leadership. This belief was formed by the experience of the interwar period. The international economy was unstable after World War I. The War greatly weakened the economies of Great Britain and the other European countries. While European governments attempted to reconstruct the world economy during the 1920s, the United States played little role in these efforts, choosing

Table 2.4
Shares of World Manufacturing Production

	1880	1900	1913	1928
United States	14.7	23.6	32.0	39.3
Great Britain	22.9	18.5	13.6	9.9
Germany	8.5	13.2	14.8	11.6
France	7.8	6.8	6.1	6.0

Source: Kennedy 1988, 259.

instead to retreat back into isolationism. When the New York stock market crashed in 1929 and the world economy subsequently moved into a depression, the fragile world trade system collapsed into rival trade blocs and rising protectionism. The United States raised tariffs sharply in 1930. Other countries formed discriminatory trade blocs. Britain created the Imperial Preference System in the summer of 1932, a trading bloc based on one underlying principle: "home producers first, Empire producers second, and foreign producers last" (Richardson 1936, 138). France began controlling imports with quotas—numerical caps for the imports of particular goods—and discriminated against American products in favor of those from its colonies (Jones 1934). Germany created similar arrangements in Eastern and Central Europe, and Japan followed suit in Asia and the Pacific. As protectionism rose, world trade fell sharply, from $35.6 billion in 1929 (the year before the depression hit) to $11.9 billion in 1932 (see Table 2.5). Of course, the collapse was not due entirely to the rise of protection. The Great Depression meant there was less demand for goods, and the decline in world trade reflected this reduced demand. Increased protectionism, however, contributed to the collapse of world trade and made it difficult to engineer an international recovery from the Depression. The United States concluded from this experience that American leadership would be required to establish a liberal system of world trade.

The United States began to exert leadership in the mid-1930s. The first change in American policy came in 1934 when President Franklin Delano Roosevelt asked the U.S. Congress for the authority to negotiate bilateral tariff agreements. Congress granted this authority through the **Reciprocal Trade Agreements Act** (RTAA). Under the RTAA, Congress authorized Roosevelt to reduce U.S. tariffs by as much as 50 percent in exchange for equivalent concessions from other countries. Cordell Hull, Secretary of State under Roosevelt, used the RTAA to negotiate bilateral treaties with 19 countries between 1934 and 1938 (Butler 1998, 183). Although these treaties did little to liberalize trade, the RTAA was significant for two reasons. The initiative was the first sign of American willingness to exercise leadership in the international trade system. In addition, two of the principles upon which these bilateral treaties were based, reciprocity and nondiscrimination, later became central components of the GATT. The second change in American policy occurred early in the Second World War. The Roosevelt Administration used the political leverage afforded by the lend lease agreements it signed with the allied powers to secure the commitment of European governments to postwar negotiations aimed at creating a nondiscriminatory and liberal international trading system (see Penrose 1953, 13–31).

The United States and Great Britain began discussing the form of the postwar trade system in 1942, and in 1945 these bilateral talks were extended into multilateral

Table 2.5
Collapse of World Trade
(Average Monthly World Trade, $U.S. millions)

1929	2,858
1930	2,327
1931	1,668
1932	1,122

Source: Kindleberger 1987, 140.

negotiations. By 1947, these negotiations had produced the **General Agreement on Tariffs and Trade.** The GATT was intended to form one component of a broader **International Trade Organization** (ITO). The ITO was intended to facilitate trade liberalization and to draw governments' attention to linkages between international trade, on the one hand, and employment and economic development on the other. The ITO charter called on governments to achieve and maintain full employment, and included a mechanism for intergovernmental consultation and policy coordination to achieve this objective. The charter also made economic development a responsibility of the industrialized countries as well as of the developing countries and provided developing countries significant exceptions to GATT rules, particularly concerning nondiscrimination. The United States Congress objected to the employment and development features of the ITO, however, and rejected American participation in the organization (Diebold 1952; Gardner 1969). Faced with congressional opposition, President Harry Truman never submitted the ITO Charter to the Senate for ratification. Without the participation of the United States, the ITO could not have succeeded and thus American opposition was sufficient to prevent the creation of the ITO. With the death of the ITO, the GATT, which did not require Senate ratification, became the central international trade institution.

The GATT embodied the interests of the United States and Western European countries, but largely neglected the concerns of developing countries. Few developing country governments played a role in the system's creation (many were not yet independent nation states in 1947). Those developing country governments that did participate in the negotiations fought hard to link trade to their broader concerns about economic development. For these governments, the ITO was very important because it explicitly recognized this link. When the United States effectively killed the ITO, developing country governments became critical of the GATT-centered trade system. We will examine these criticisms in greater detail in Chapter 4. Here we note that developing countries' governments believed that the liberal and nondiscriminatory international trade promoted by the GATT would limit their ability to develop the manufacturing industries that they believed were central to economic development. As a consequence, many developing countries withdrew from the GATT process of trade liberalization. They viewed the multilateral trade system as a "rich country club" that embodied the interests of the advanced industrialized countries but offered few benefits to the developing world.

The emergence of the Cold War in the late 1940s helped strengthen the new GATT-based trade system. The Cold War had two specific consequences for the emerging trade system. First, the United States began to assist economic reconstruction in Western Europe. The United States recognized that it needed a strong economic bloc in Western Europe to counter Soviet power and influence on the European continent. Through the Marshall Plan, the United States provided funds that allowed Europe to import critical goods from the United States. Through the Organization for European Economic Cooperation (OEEC), which was created as part of the Marshall Plan, the U.S. insisted that European governments begin to liberalize trade within Europe. Second, between 1948 and 1958 the United States engaged in asymmetric trade liberalization. Given their weak economic position, European countries were unwilling to open their markets to U. S. goods. As a result, the benefits from the four GATT rounds held in this period accrued largely to the Europeans. Tariff concessions negotiated within

the GATT were reciprocal, but because European governments relied heavily on quotas and other nontariff barriers to restrict imports, tariff reductions had little impact on American exports. As a result, the United States increasingly opened its market to European exports even though Western Europe continued to discriminate against American goods. By encouraging the United States to assist postwar reconstruction and to allow Europeans to export to the American market, the Cold War helped bring about economic recovery and impressive growth in Europe that made it possible to achieve more far-reaching, and more equitable, trade liberalization during the 1960s.

The postwar multilateral trade system thus reflected the interests of the powerful countries, and in particular the interests of a hegemonic United States. American leadership in creating the GATT-centered international trade system was motivated in part by the desire to gain access to export markets, an interest that emerged from the United States' position as the world's dominant economy, and in part by a determination not to repeat the mistakes made during the interwar period. The specific characteristics of the GATT-based system, in particular the decision to base the system on market liberalism, the emphasis on nondiscrimination, and the commitment to reciprocal tariff reductions, all reflected the economic interests of the United States and Western Europe. The emergence of the Cold War helped consolidate the postwar trade system by motivating the United States to help create robust Western European economies capable of participating in liberal international trade.

The Evolution of the Multilateral Trade System

While the multilateral trade system created in 1947 reflected the interests of a hegemonic America, the global balance of economic power subsequently changed considerably. America's dominant postwar position in the global economy diminished as Japan and Western Europe reconstructed their economies in the decades following the Second World War. The emergence of a much more competitive global economy during the 1960s and 1970s in turn altered the political dynamics of the multilateral trade system. We examine these developments here, looking first at the changing global balance of economic power and then turning our attention to the ways in which hegemonic decline has affected the multilateral trade system.

Hegemonic decline. American economic dominance has declined since 1960, due in large part to economic and political developments in Japan and Western Europe. During the 1960s, the Japanese economy grew at average annual rates of more than 10 percent, compared to average growth rates of less than 4 percent for the United States in the same period. Japan's rate of growth did slow during the 1970s and 1980s; but Japan continued to grow more rapidly than the United States. These differential growth rates narrowed the economic gap between Japan and the United States. In the early 1960s, the United States produced 40 percent of the world's manufactured goods while Japan produced only 5.5 percent. By 1987 the United States' share of world manufacturing production had fallen to 24 percent while Japan's share had increased to 19.4 percent (Dicken 1999, 28). In less than 30 years, therefore, Japan had transformed itself from a vanquished nation into a powerful force in the world economy.

Western Europe has also emerged as a powerful force in the world economy. Unlike Japan, however, no single European country has emerged as a global economic

power. Some countries, such as Germany, have maintained a stable share of world manufacturing output throughout the postwar period, while others, such as France and Britain, have seen their shares fall (Dicken 1998, 28, 30). What Western European countries have been unable to do individually, however, they have done collectively through the European Union (EU). Together, the four largest EU members (Germany, France, the United Kingdom, and Italy) produce about 22 percent of world output (Dicken 1998, 28). And, along with the other 11 members of the EU, they act as a single unit in the international trade system. There is a single EU market (the world's largest single market) and because the EU is a customs union, there is a single EU tariff that applies to all goods entering the EU market. In addition, EU countries negotiate as a single actor with a single negotiating position in multilateral trade negotiations. By pooling their combined economic potential, Western European countries have used the EU to emerge as a powerful force in the international trade system.

As Japan and the EU gained ground, American officials worried that the American economy was struggling to compete in this new global economy. The United States began to run trade deficits during the 1970s, that is, the United States began to import more goods from the rest of the world than it exported to the rest of the world, and this trade deficit continued to grow during the 1980s (see Figure 2.1). American policymakers interpreted the trade deficit as evidence of declining U.S. international competitiveness, particularly in high-technology industries. Measures of the United States' comparative advantage in high technology industries suggested that it was losing ground in mechanical equipment, electronics, scientific instruments, and commercial aircraft. And what the United States appeared to be losing, Japan appeared to be gaining. On the one hand, the United States ran its largest bilateral trade deficit with

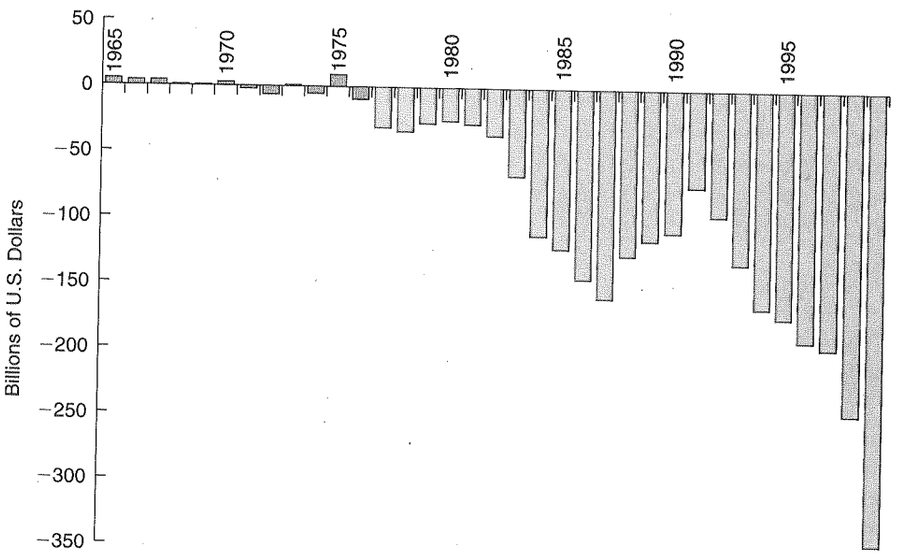

Figure 2.1 U.S. Trade Balance, 1965–1999.
Source: Economic Report of the President 2001, p. 392.

Japan. On the other hand, as the United States' share of global high-technology markets fell from 30 percent to 21 percent between 1970 and 1989, Japan's share of this market rose from 7 percent to 16 percent (Tyson 1992, 19). Thus, the trade deficit and the apparent decline in American competitiveness in high-technology industries seemed to point to identical conclusions: the United States was losing ground to Japan.

The postwar decades thus brought substantial changes to the global balance of economic power. The clear dominance enjoyed by the American economy immediately following World War II was eroded by the tremendous strides made by the Japanese economy and through the process of European integration. By the mid-1970s, the era of American economic hegemony had ended, replaced by a more equal distribution of economic power and by a much more competitive global economic environment. In this new, more competitive environment, we have seen notable advances but also substantial retrenchment in the liberalization of international trade.

The multilateral trade system after hegemony. The emergence of a much more competitive global economy altered the political dynamics of the multilateral trade system. While cooperation centered upon multilateral trade rounds continues, such cooperation has been accompanied by developments that are tugging at many of the central elements of the multilateral system. Four such developments have received the most attention: trade conflict among the advanced industrialized countries; a greater willingness by these same governments to adopt new forms of trade protectionism that reverse prior liberalization; the expanded membership in the World Trade Organization, and the growing importance of regional trading arrangements such as free trade areas and customs unions. We examine each of these developments and then consider what they portend for the current and future health of the multilateral trade system.

Trade conflict. Trade conflicts among the advanced industrialized countries have occurred with considerable regularity since the mid-1970s. During the 1980s and the early 1990s, conflict between the United States and Japan occupied center stage. There was a widespread perception in the United States that Japanese economic gains had resulted from Japanese government policies that gave Japanese firms an unfair advantage in international competition (see, e.g., Tyson 1992; Prestowitz 1989). The Japanese government relied heavily upon industrial policy to promote economic development. **Industrial policy,** which we examine in greater detail in Chapter 3, is the use of trade protection, government subsidies, government procurement decisions, and other government policies to encourage certain types of economic activity and to discourage others. In the early 1970s, the Japanese government began to use industrial policy to promote the development of high-technology industries that could compete with American high-tech firms in the global market (see Okimoto 1989). The Japanese government targeted the computer and semiconductor industries, both of which were dominated by American firms, for development. It used tariffs, quotas, and regulations to keep American high-technology products out of the Japanese market whenever possible. In addition, government procurement practices provided a guaranteed market, as the Japanese government purchased its computers almost exclusively from Japanese firms regardless of price. The Japanese government also provided some direct financial assistance to Japanese firms that helped offset some of the research and development costs associated with high-technology products. The barriers to imports created by industrial policy were reinforced by a Japanese industrial

A Closer Look

Hegemonic Decline and American Trade Policy

Hegemonic decline pushed the United States toward more aggressive trade policies beginning in the early 1980s. This policy of "aggressive bilateralism" has been characterized by a growing American willingness to use bilateral negotiations rather than multilateral initiatives to pursue its trade policy objectives. In addition, in pursuing this policy the United States has been much more willing to use its market power to force changes in other countries' trade policies (Krueger 1995).

Aggressive bilateralism was given legal standing in the United States through Section 301 of The Omnibus Trade and Competitiveness Act of 1988. Section 301, which first appeared in the Trade Act of 1974, authorizes the president to take action against countries that impose "unjustifiable" or "unreasonable" barriers to American imports. Unjustifiable barriers are policies that directly violate specific WTO rules while unreasonable barriers are policies that American policymakers believe block American exports even though they may not violate any specific WTO rule (Nivola 1993, 92). Congress strengthened Section 301 in 1988 in an attempt to force the executive to confront the problem of "unfair" trade. This revised Section 301, called Super 301, requires the United States Trade Representative (USTR), the executive agency with responsibility for trade policy, to each year compile a list of countries that consistently use "import barriers and market distorting practices" (Nivola 1993, 104). The USTR was required to name "priority countries," based on "the 'number and pervasiveness' of their 'acts, policies or practices' that impeded U.S. exports" and then negotiate with these countries to eliminate these unfair practices (Destler 1995, 132–133). If negotiations fail to produce the desired results, trade sanctions are imposed. In the first Super 301 report, issued in May 1989, the USTR named Japan, Brazil, and India as unfair traders, and used the threat of being placed on this list to negotiate concessions from Taiwan and South Korea.

Japan was the principal target of American policy during the 1980s and early 1990s. The United States conducted a series of negotiations with Japan during the 1980s and 1990s aimed at opening the Japanese market to American exports. Bilateral discussions were initiated in 1985 with the Market Opening Sector Specific (MOSS) talks, which focused on telecommunications, supercomputers and computers, as well as other parts of the electronics industry, medical equipment, and pharmaceuticals. A separate series of negotiations were initiated for the semiconductor industry, leading to the Semiconductor Chip Agreement in 1986 under which Japan agreed to open its market to American chip firms. The Bush Administration launched the Structural Impediments Initiative in 1989, under which it addressed structural barriers to American exports, things like the Japanese retail and distribution system. Finally, the Clinton Administration initiated Framework Talks with Japan in 1994, under which it tried to convince the Japanese government to accept quantitative targets for imports of American goods in a wide range of industries (Destler 1995, 229).

These various bilateral negotiations shared three central characteristics. All were based on the belief that Japanese policies unfairly excluded American goods

Continued

from the Japanese market. In the MOSS talks, for example, American officials argued that Japanese regulations governing drug approval and the Japanese National Health Insurance System's procedures for the pricing of drugs and reimbursement of drug purchases blocked the sale of American drugs in the Japanese market. Telecommunications regulations blocked the use of American equipment in the Japanese network, thereby preventing American firms from selling their products in Japan (Tyson 1992, 63). American officials also argued that regulations gave Japanese producers an unfair advantage in international trade. Regulatory barriers that blocked imports provided Japanese producers with a protected market that allowed them to gain proficiency in high technology production. The skill gained in these protected markets allowed Japanese producers to become internationally competitive and capture international markets at the expense of American firms. Finally, American officials believed that threatening to close the American market to Japanese producers would force Japan to open its market to American goods. For example, the Reagan administration imposed a 100 percent tariff on Japanese laptop and desktop computers, color TVs, and power hand tools, in response to its belief that the Japanese government was not enforcing the 1986 Semiconductor Chip Agreement (Destler 1995, 130).

Critics have claimed that aggressive bilateralism threatens many of the core elements of the multilateral trade system. In pursuing this policy the United States has usurped the WTO's role in dispute resolution. The United States determines what policies constitute an unreasonable barrier to exports, what changes are required, and what sanctions are applied if policies are not changed. Moreover, the definition of an unreasonable barrier to trade contained in Super 301 is so expansive that it can accommodate "almost any kind of economic policy that the U.S. government might want to find objectionable" (Hudec 1990, 123). As Jagdish Bhagwati, a strong critic of aggressive bilateralism, has argued, "the U.S. is . . . claiming a unilateral right to judge others and to impose new disciplines on them without offering any concessions of its own" (Bhagwati 1998, 143).

Aggressive bilateralism also threatens the principle of nondiscrimination. In its bilateral negotiations with Japan, the United States has repeatedly sought agreements that regulate trade outcomes. In the Semiconductor Chip Agreement, for example, the United States tried to force the Japanese government to guarantee American chip producers a 20 percent share of the Japanese market. The Clinton Administration sought to expand this logic to a wider range of sectors by encouraging the Japanese to negotiate "Voluntary Import Expansion" agreements. Agreements that provide a specific market share for American producers are not consistent with the principle of nondiscrimination.

Finally, aggressive bilateralism can generate trade wars that reverse trade liberalization. The European Union's reaction to Super 301 illustrates this danger. The EU claimed that Super 301 was a violation of international law (a declaration supported by 51 GATT members in 1995), and declared that it would refuse to negotiate with the United States if it was placed on the list. Moreover, the EU stated that it would refuse to recognize the validity of any judgments reached under Super 301 authority. Moreover, if the United States imposed sanctions based on any such judgment, the EU would retaliate (Milner 1990, 178). The Japanese response was similar in nature and tone. In 1989, Japan "refused to negotiate [under Super 301] and condemned the United States action as unfair, unilateral, and a violation of international law" (Milner 1990, 178).

structure in which the firms that produced final goods developed long-term relationships with the Japanese firms that supplied their inputs. Such long-term relationships made it hard for American firms to break into the Japanese market. Critics charged that these Japanese policies kept American goods out of the Japanese market, gave Japanese producers an unfair advantage over American firms in international markets, and were to blame for deteriorating competitiveness. The United States initiated a series of bilateral negotiations through which it sought to open the Japanese market to American exports and to eliminate those practices that the United States considered unfair.

The United States and the EU have also engaged in recurrent trade conflicts during the last 20 years. Conflict over trade in agriculture has been the most serious. World trade in agriculture was excluded from the GATT process of liberalization early in the postwar period. The exclusion of agriculture resulted from the political influence enjoyed by farmers in many advanced industrialized countries. Farmers used their influence to force governments to adopt a range of policies that maintained high and relatively stable incomes for agricultural producers. Such policies can be effectively implemented only if trade barriers limit imports of agricultural commodities. This kind of agricultural protectionism has been most fully developed by the EU in its **Common Agricultural Policy** (CAP). Through the CAP, the EU uses tariffs to protect European farmers from cheaper farm products produced outside Western Europe, subsidizes West European farm production, and subsidizes agricultural exports. Such policies have hurt countries with a comparative advantage in agriculture, including the United States, by making it difficult to export agricultural products to the EU and by increasing EU agricultural exports to the rest of the world. For 30 years the United States has been pressing the EU to dismantle the CAP and to begin serious negotiations on the liberalization of world trade in agriculture. The political influence of farmers in Western Europe, however, continues to make European governments, and particularly the French government, reluctant to dismantle the CAP. The result has been a recurrent conflict between the United States and the EU over trade in agriculture.

Conflict between the United States and EU over the CAP is accompanied by other disputes. The EU has been reluctant to import American hormone-treated beef, for example, and has expressed broader concerns about genetically modified foods produced in the United States. The two sides are also embroiled in conflicts concerning some manufacturing industries. Most notably, the United States has accused European governments of using industrial policy to support Airbus Industries, the European commercial aircraft producer, thereby enabling it to capture market share from the American producer Boeing. We will look at this case in detail in Chapter 3.

New protectionism. Recurrent trade conflicts have been accompanied by a resurgence of protectionism, particularly in the United States and the EU. This resurgence can be attributed to a number of factors. In the United States, a sharp appreciation of the dollar, which rose in value against the Japanese yen and German mark by 50 percent between 1979 and 1985, made it very difficult for American firms to maintain market share. The price of imports into the United States fell while the price of American goods in world markets rose as a direct result of the dollar's appreciation, making it difficult for American manufacturing firms to compete at home and abroad. In addition,

the world economy grew very slowly during the late 1970s and much of the 1980s, meaning there was less expansion of demand for goods worldwide. At the same time, the emergence of new manufacturing economies in East Asia and Latin America during the 1970s, which we will explore in Chapter 4, imposed painful economic adjustments on manufacturing firms in the United States and Europe. These developments combined to produce a growing demand for protection from imports by American and European industries during the 1970s, 1980s, and early 1990s. In many instances, governments were willing to oblige these demands.

Because the multilateral trade system constrains the use of tariffs, however, the United States and the EU began to rely heavily upon nontariff barriers to provide this protection. One of the most popular nontariff barriers has been **voluntary export restraints** (VERs) (Greenaway 1983, 132). A VER is a bilateral agreement under which one country agrees to limit its exports to the other country's market. In January 1989, for example, the United States and Japan concluded a VER under which the Japanese government agreed to limit the number of Japanese cars exported to the U.S. market to 2.3 million units per year. The United States and the EU began to use antidumping and countervailing duty investigations to protect domestic firms from foreign competition. **Antidumping** investigations apply to cases in which a foreign firm is selling its products in international markets at a price that is below its cost of production. **Countervailing duty** investigations apply to cases in which a government subsidizes national firms' exports directly or indirectly. According to GATT rules, if a government can prove that foreigners are dumping or subsidizing exports *and* that these practices are injuring domestic producers, it can raise tariffs in response. The United States and the EU have often used a relatively liberal standard to determine what constitutes dumping or an export subsidy, thus finding a way to protect domestic producers even when foreign governments were not subsidizing and foreign firms were not dumping (Krueger 1995; 33–50).

Heavy reliance on these forms of protection reversed some of the trade liberalization that had been previously achieved under the GATT. The United States and the EU negotiated VERs covering autos, steel, motorcycles, machine tools, and consumer electronics (Bhagwati 1988, 44). More broadly, the share of trade in manufactured goods among the advanced industrialized countries that was subject to nontariff barriers increased from 4 percent in 1974 to 17.4 percent in 1980 and then to 25 percent by the early 1990s (Greenaway 1983, 168; OECD 1997, 53). American and European auto producers were perhaps the most heavily protected of all industries, as VERs covered almost 50 percent of international trade of automobiles within the advanced industrialized countries by the mid-1980s (Gilpin 1987, 207). Antidumping and countervailing duty investigations also rose during this period. Between 1980 and 1992, the U.S. launched 345 countervailing duty and 540 antidumping investigations (Bhagwati 1988, 49; Krueger 1995, 40). In the EU, more than 260 such investigations were launched between 1980 and 1985.

Expanding membership. Membership in the World Trade Organization has increased greatly since the mid-1980s. More than 50 countries have joined the multilateral trade organization since 1985, increasing its total membership from about 90 to its current 144. Thus, slightly more than one-third of the current members are very recent entrants into the multilateral trade system. Moreover, an additional 27 countries have applied for

Table 2.6
New Members of the GATT/WTO, 1985–2002

Albania	2000	Lesotho	1998
Angola	1994	Liechtenstein	1994
Antigua and Barbuda	1987	Lithuania	2001
Bahrain	1993	Macao	1991
Botswana	1987	Mali	1993
Brunei Darussalam	1993	Mexico	1986
Bulgaria	1996	Moldova	2001
China	2001	Mongolia	1997
Costa Rica	1990	Morocco	1987
Croatia	2000	Mozambique	1992
Djibouti	1994	Namibia	1992
Dominica	1993	Oman	2000
Ecuador	1996	Panama	1997
El Salvador	1991	Papau New Guinea	1994
Estonia	1999	Paraguay	1994
Fiji	1993	Qatar	1994
Georgia	2000	Saint Kitts and Nevis	1994
Grenada	1994	Saint Lucia	1993
Guatemala	1991	Saint Vincent and the Grenadines	1993
Guinea	1994	Slovak Republic	1993
Guinea Bissau	1994	Slovenia	1994
Honduras	1994	Solomon Islands	1994
Hong Kong	1986	Swaziland, Kingdom of	1993
Jordan	2000	United Arab Emirates	1994
Kyrgyz Republic	1998	Venezuela	1990
Latvia	1999		

Source: World Trade Organization.

membership and are engaged in accession negotiations. Successful completion of these negotiations will bring the organization's membership to 171 countries. This explosion of new members is due in large part to two developments in the global economy. First, many developing countries' governments reoriented their trade policies beginning in the mid-1980s. As we will see in greater detail in Chapter 4, developing country governments were quite critical of the GATT throughout much of the postwar period. Moreover, between 1950 and 1980 developing countries participated little in the process of trade liberalization and pressed continually to supplant the GATT with trade institutions that directly addressed their perceived development goals. In the mid-1980s, however, developing countries began to adopt development strategies that placed a greater emphasis on international trade in the development process. As a consequence, many developing countries joined the GATT and WTO as trade became a more important element of their development strategies.

Second, the collapse of the Soviet empire at the end of the 1980s generated an entirely new slate of candidates for membership. The collapse of the Soviet bloc, and the consequent disintegration of the Soviet Union in the early 1990s, has been followed by radical political and economic reforms throughout the region. Newly-elected governments began to dismantle the Soviet style economic systems they had maintained

throughout the postwar period and began the process of creating market-based economies. As was the case in the developing countries, international trade was an important component of these economic reforms. In addition, these countries had to reorient their trade relationships fundamentally. Under the Soviet system, countries within the Soviet bloc traded extensively with each other and engaged in little trade with the rest of the world. With the collapse of the Soviet bloc, these trading relationships became less important and the need to develop trade relationships with Western Europe and the United States came to the fore. WTO membership thus became a critical component of the strategy that many governments adopted in making the transition to market-based economies. To date, eight countries in Eastern and Central Europe and the Former Soviet Union have joined the WTO since 1990. They join the four countries from this region that had joined the GATT much earlier (Czechoslovakia, Poland, Romania, and Hungary) but had played no role in the trade system.

Russia is conspicuously absent from the list of new WTO members. In fact, with China's entry into the WTO in late 2001, Russia became the only major power that is not a member of the World Trade Organization. Russia applied for membership in the GATT in 1993, but accession negotiations that began in 1995 have been delayed by developments in Russia and by the inability to agree on the terms governing Russia's entry into the organization. Russia has asked for longer than normal transition periods in order to protect uncompetitive industries and has been reluctant to alter some of its domestic trade laws, in particular those dealing with antidumping investigations and agricultural policies, to bring them into conformity with WTO rules. Moreover, segments of Russian society remain skeptical about the benefits Russia would gain from joining the WTO. Negotiations appeared to have gained momentum in the fall of 2001, with Russia, the EU, the United States, and WTO officials all indicating that Russian membership is a high priority. Given this commitment, some people, including WTO Director General Michael Moore, have suggested that Russia could be a member by as early as the summer of 2003.

The greatly expanded membership in the WTO will have an impact on how the WTO operates. Throughout the postwar period the advanced industrialized countries have dominated trade negotiations and as a consequence have been able to set negotiating agendas that reflect their interests. As a result, trade negotiations have focused on liberalizing trade in capital-intensive manufactured goods, and have largely excluded trade in labor-intensive manufacturing and agriculture, areas in which developing countries have a comparative advantage. Now that the developing and transitional countries comprise two-thirds of the WTO membership, they are likely to play a larger role in shaping the negotiating agenda to reflect their interests. This dynamic was evident in the WTO's Doha Ministerial Conference, which took place in November 2001 to set the agenda for the current round of trade negotiations (see Larson 2002). Developing countries played a much greater role in this conference than they had ever played before, prompting one EU participant to claim that the developing countries "came of age" at this conference. They "proved adept at building coalitions, formulating goals, and co-ordinating tactics" (De Jonquieres 2001). For the first time, developing countries' governments played a large role in organizing and running the conference, a role that included chairing many of the committees that established the final agreement. In addition, developing countries were able to resist EU pressure to include negotiations on investment rules and competition policy, insisting instead that before

new issues are brought into the WTO, the advanced industrialized countries must liberalize trade in agriculture and labor-intensive manufactured goods, areas in which market opening will yield significant export opportunities for developing countries. Whether the negotiations will produce an agreement that meets the interests of developing countries remains to be seen, but as the Brazilian ambassador to the United States remarked, successful negotiations will require the advanced industrialized countries to "recognize the new composition of forces in the WTO" (Dale 2001).

Regionalism. Regional trading arrangements have also proliferated during the last 15 years. **Regional trading arrangements** (RTAs) are trade agreements in which tariffs discriminate between members and nonmembers. RTAs come in two basic forms. In a **free trade area,** like the North American Free Trade Agreement, governments eliminate tariffs on other members' goods, but each member government retains independent tariffs on goods entering their market from nonmembers. In a **customs union,** like the EU, member governments eliminate all tariffs on intra-union trade and create a common tariff that is imposed on goods entering the union from nonmembers. Though inherently discriminatory, and therefore seemingly inconsistent with the MFN principle at the core of the GATT, GATT Article XXIV allows countries to form regional trading arrangements as long as the level of protection imposed by members against nonmembers is no higher than the level of protection applied by the countries prior to forming the arrangement.

Regionalism is not a fundamentally new development. The EU was created in 1957 and developing countries' governments created many RTAs during the 1960s. What has changed is the pace at which regional arrangements are being created. Of the 134 RTAs in active operation today, 90 were formed between 1995 and 2001. The EU is the largest and longest-lived RTA in existence. The EU currently has 15 members and is likely to admit 10 new members from East Central and Southern Europe by 2005. The most prominent of the recent creations include the North American Free Trade Agreement, created by the United States, Mexico, and Canada in 1993. MERCOSUR, one of the most prominent South American RTAs, was created by Argentina, Brazil, Paraguay, and Uruguay in 1991. Governments in East and Southeast Asia agreed to a free trade area in the late 1990s. Many other smaller RTAs exist in Latin America and the Caribbean, including the Andean Pact (Venezuela and Colombia) and the Caribbean Community and Common Market (Caricom) that incorporates many of the small Caribbean island nations. Governments in the Western Hemisphere are currently discussing a Free Trade Area of the Americas, which would expand NAFTA throughout Central and South America. Regional trading arrangements have become so prominent that about one-third of current world trade occurs within them (World Bank 2000).

During the last ten years, regionalism has thus emerged as a powerful force in the global economy. This can be attributed to two relatively recent developments in the world economy (see Frankel 1997). As we will see in greater detail in Chapter 4, developing country trade policies changed dramatically during the 1980s. Throughout most of the postwar period, developing countries restricted imports as part of their economic development strategies. Beginning in the mid-1980s, many developing countries began to liberalize trade in conjunction with a broader shift to market-oriented development strategies. In addition, East European countries began to liberalize trade and enter the global economy following the collapse of Communist rule in 1989. As a result of these two developments, the number of countries in the international system willing to enter

into trade liberalizing RTAs increased dramatically, and it is no surprise that the growth of RTAs has been fastest in the developing world and in post-Communist Europe.

While policy change in developing countries and the collapse of the Soviet bloc accounts for the larger number of states willing to undertake trade liberalization, it does not help us understand why they have chosen to liberalize trade through RTAs rather than do so exclusively through the WTO. Two principle motivations help account for the appeal of regional arrangements. First, governments may seek to enter a regional trading arrangement in order to gain more secure access to the market of a particularly important trading partner. In the U.S.-Canada free trade agreement concluded in the late 1980s, for example, Canada was motivated by a desire to gain secure access to the U.S. market—the most important destination for Canada's exports. The United States was increasingly using antidumping and countervailing duty investigations to protect American producers from Canadian imports. A free trade agreement with the United States, the Canadian government hoped, would give Canada "some degree of exemption" from these measures (Whalley 1998, 72–73). Second, governments may seek to enter a regional trading arrangement in order to increase their bargaining power in multilateral trade negotiations. Because an RTA creates a larger market, the value of a tariff concession offered by an RTA member in multilateral negotiations is increased. This might in turn increase the concessions that each member could gain from other trading partners in WTO negotiations.

This proliferation of regional trading arrangements could strengthen or weaken the multilateral trade system: the specific outcome depends upon whether RTAs have a trade liberalizing or a protectionist dynamic. On the one hand, RTAs may exert a gravitational force on countries that are not currently members. Countries that do not belong to a particular RTA, like the EU, but engage in a lot of trade with members of the RTA, have a strong incentive to seek membership. Over time, this gravitational force can attract so many additional members that what began as a regional RTA winds up as a global free trade area. In this optimistic scenario, RTAs are building blocks that lead eventually to global free trade. On the other hand, the creation of a large RTA in one region could encourage the formation of rival RTAs in other regions. In this scenario, the NAFTA could be seen as an American response to the EU, and the emerging free trade area in Pacific Asia could be seen as a response to regionalism in Europe and the Western Hemisphere. Once regional trading blocs have formed, each bloc might raise tariffs to limit trade with nonmembers. A tariff increase by one RTA could provoke retaliation by the others, leading to a rising spiral of protection that undermines global trade liberalization (Frankel 1997, 210).

It is impossible to predict which of these two outcomes will prevail in the real world. There is evidence that the positive dynamic is at work in the contemporary trade system. In the most recent expansion of the EU, Austria's application for membership placed pressure on other European governments outside of the EU who would be placed at a competitive disadvantage in the EU market. Sweden, Finland, and Norway responded by applying for membership in the EU in 1991 and 1992, and Iceland did the same in 1994. Others see this positive dynamic at work in the Western Hemisphere. Mexico's decision to seek a free trade agreement with the United States was at least partially motivated by concerns about the cost of being outside a U.S.-Canada Free Trade Area that had been negotiated in the late 1980s (Gruber 2000). The interest of many Latin American countries in a Free Trade

Area of the Americas is at least partially a consequence of Mexico's entry into the NAFTA (Baldwin 1995). There is also evidence consistent with protectionist dynamic. MERCOSUR, for example, or the emerging Asian FTA, might represent attempts by countries excluded from existing RTAs to create rival blocs. Moreover, the world does seem to be moving toward three RTAs: one in Europe, one in the Western Hemisphere, and one in Asia. Only time will tell whether these regional blocs will develop into discriminatory trading blocs that engage in tariff wars or if instead they will pave the way for global free trade.

How strong is the contemporary multilateral trade system? What do these developments portend for the future of the multilateral trade system? Unsurprisingly, scholars disagree. Some scholars suggest that these developments indicate that the multilateral trade system is weaker today than it was in the 1960s, and that it will continue to weaken in the future. These scholars argue that the decline in American economic power has reduced the American commitment to the multilateral trade system by changing its economic interests. Because American firms face much stiffer competition in the global economy, the United States can no longer afford to be an unconditional supporter of liberal international trade. Instead, the United States has become increasingly willing to act unilaterally and bilaterally in pursuit of its trade objectives, it has become more willing to close its markets to goods produced in the EU and Japan, and it has become more willing to consider regional arrangements such as NAFTA as an alternative to the global framework represented by the WTO. Moreover, the sense of common purpose among the United States, Japan, and the EU that was provided by the Cold War alliance against the Soviet Union has disappeared. Robert Gilpin, a political economist at Princeton University argues that "at the opening of the twenty-first century, all the elements that have supported an open global economy have weakened" (Gilpin 2000, 347). As a result, the EU, the United States, and Japan are now more likely to emphasize narrow domestic priorities rather than their shared interest in an open trading system (Gilpin 2000, 347).

Many other developments during the last 20 years suggest that the global trade system remains strong in spite of the strains just discussed. Governments have completed two bargaining rounds since 1970 and in 2001 embarked on a third. These bargaining rounds have strengthened the multilateral trade system in important ways. Tariffs have continued to fall, from the 9 percent average after the Kennedy Round to an average of 4 percent after the Uruguay Round. And as we discussed earlier in this chapter, governments have also created multilateral rules for new trade-related areas. The Tokyo Round brought rules governing antidumping, countervailing duties, and domestic safeguard investigations. The Uruguay Round brought rules to protect intellectual property, to liberalize international trade in services, to constrain government treatment of foreign direct investment, and it yielded some initial steps to liberalize trade in agriculture and in textiles and apparel. Moreover, during the Uruguay Round governments created the WTO and strengthened the system's dispute resolution mechanism.

The multilateral trade system has also been strengthened by a reorientation of trade policies in developing countries. As noted above, developing countries' governments were quite critical of the GATT throughout much of the postwar period. Moreover, between 1950 and 1980 developing countries participated little in the process of trade liberalization and pressed continually to supplant the GATT with trade institutions that directly addressed their perceived development goals. In the mid-1980s, however, developing countries began to adopt development strategies

that placed a greater emphasis on international trade in the development process. One consequence of this change has been the disappearance of developing country pressure for fundamental reforms of the multilateral trade system. In fact, most developing countries have become active participants in multilateral trade negotiations. While it would be an overstatement to claim that all developing countries have become enthusiastic supporters of all elements of the multilateral trade system, they no longer challenge the fundamental principles upon which the multilateral trade system is based. Thus, for the first time in its history, the multilateral trade system faces no pressures for fundamental reform from a large group of countries. These developments suggest that the multilateral trade system has not been weakened by the decline of American hegemony. "The institutions that took hold after World War II continue to provide governance now, and the economic interests and political consensus that lie behind them are more, not less, supportive of an open world economy today than during the Cold War" (Ikenberry 2000, 151).

On balance, then, is the multilateral trade system weaker today than it was at the height of American hegemony in the late 1950s and early 1960s? To answer this question it is useful to distinguish between trade policy conflicts within the framework established by the multilateral system, on the one hand, and conflicts about the multilateral trade system on the other. Conflict among the advanced industrialized countries typically occurs within the context established by the WTO. That is, conflicts usually involve disputes about compliance with WTO obligations and disagreements about whether sectors that have been excluded from the GATT/WTO process, like agriculture and services for example, should be incorporated and liberalized. These conflicts typically take place within the institutions established by the multilateral trade system and more often than not governments use the WTO to resolve them. Such conflicts are the essence of politics—independent actors with competing interests pursuing their objectives subject to the rules established by political institutions. Only rarely do the governments of the advanced industrialized countries engage in conflict over the institutions themselves. There are no conflicts about whether MFN should remain at the center of the system. There are no conflicts among the largest trading nations about whether market-based liberalism should be abandoned in favor of an alternative economic system. There are few conflicts among these same governments about inequities or illegitimacies in the WTO process. Instead, the world's largest trading nations all appear to believe that the international trade system represented by the WTO continues to offer the best way to organize world trade. The multilateral trade system will begin to weaken only when a powerful country challenges the core principles upon which it is based. Currently, no such challenge exists.

The Problem of Trade Cooperation

Why do governments need such an elaborate international framework in order to liberalize trade? If trade liberalization raises the standard of living, and if trade liberalization is something that most governments want to achieve (and the progressive

reduction of tariffs during the last 50 years suggests that it is), then why don't governments just liberalize trade? Why is it necessary to engage in complicated multilateral trade negotiations? Why must governments create an elaborate set of international rules to govern their activity and an international tribunal through which to enforce them? In short, why is the World Trade Organization necessary? In this section we will see that the WTO is necessary because even if we accept the claim that free trade benefits all countries, politics make it difficult to realize these benefits. The World Trade Organization helps governments solve these political problems and by doing so helps governments to realize the gains available from trade liberalization.

The Politics of Trade Liberalization

As we saw above, trade liberalization has occurred through a process of reciprocal trade agreements. Reciprocal agreements have been necessary because governments tend to stand the logic of trade theory on its head. Trade theory suggests that imports are good because they allow societies to consume things more cheaply. And while exports are not necessarily bad, they are the necessary price that societies must pay to import goods from other countries. From the perspective of trade theory, therefore, societies should seek to import as much as possible in exchange for as few exports as possible. Given this logic, unilateral trade liberalization, that is, eliminating tariffs and other barriers to imports without receiving reciprocal tariff reductions from other countries, is perfectly sensible. Governments often adopt the opposite logic, however. Governments tend to believe that exports are good and should therefore be expanded as much as possible, while imports are bad and are to be limited as much as possible. From this standpoint, unilateral trade liberalization makes no sense.

Why do governments invert the logic of trade theory? To understand this fully we must delve deeply into the domestic politics of trade policy, a topic we examine in greater detail in the next chapter. Here it is sufficient to note that the interests of domestic firms tend to be heavily represented in domestic trade politics, while the interests of consumers are often over-looked. As a result, governments have little reason to care about the gains consumers realize from imports and more reason to care about how imports and exports affect domestic industries. And not all domestic industries will gain from trade liberalization. Firms based in industries in which the country has a comparative advantage will gain from trade liberalization. Such firms will face little competition from imports and will have the opportunity to expand their sales in foreign markets. Firms in industries in which the country has a comparative disadvantage, however, suffer from trade liberalization. Opening to trade allows foreign firms to compete directly with domestic firms, and uncompetitive domestic firms will lose out in this competition with foreign firms. As a general rule, therefore, governments strive to pry open foreign markets so that their competitive industries can increase their exports while continuing to protect their less competitive industries from imports. In this political world, trade liberalization becomes possible only through international agreements that provide reciprocal tariff reductions.

As a direct consequence, reciprocal agreements have become the standard way through which trade is liberalized. In the early GATT bargaining rounds, for example, governments reduced tariffs by making reciprocal tariff reductions in manufacturing industries. Each government would present an "offer sheet" that listed the industries for which it was willing to reduce tariffs and the amount by which it was willing to reduce them. It would then try to get as many tariff reductions as it could from other countries in exchange for these tariff concessions. The objective in each bargaining round was to reach an overall agreement in which the value of the total tariff concessions each government granted equaled the value of the total tariff concessions each government received from all other GATT members (Jackson 1998, 143–144). Such reciprocity also underpinned the Uruguay Round agreement, even as the focus of negotiations shifted from tariffs to other trade barriers. Developing countries agreed to liberalize services and to rules governing intellectual property rights, two areas in which their industries are at a comparative disadvantage. In exchange, the advanced industrialized countries agreed to liberalize trade in textiles and agriculture, sectors in which developing countries hold a comparative advantage.

Of course, as we will see in greater detail in Chapter 3, domestic politics often make it difficult for governments to make the tradeoffs necessary to liberalize trade. Opening a heavily protected part of the economy to international competition will spark an adjustment process that will force some domestic firms out of business. If the protected industry is politically influential, the government will be reluctant to force it to accept these adjustments. In Western Europe, for example, farmers are well organized and politically influential. Liberalizing trade in agriculture therefore requires EU governments to act against the interests of a powerful domestic interest group, something that few governments are keen to do. In the Uruguay Round, European farmers barricaded roads and organized large protests in an attempt to block liberalization of trade in agriculture. EU governments responded to the farmers' opposition by digging in their heels and resisting U.S. pressure for liberalization. Moreover, European farmers enjoy much greater political influence than the firms that would benefit from access to new export markets. Therefore, EU governments cannot easily liberalize their agricultural markets in exchange for market access in other industries because the political support they lose from farmers will not necessarily be compensated for by increased support from the industries that gain in the agreement. Crafting reciprocal trade agreements, therefore, requires governments to balance political gains and losses as well as economic gains and losses.

The ability of governments to conclude the reciprocal trade agreements necessary to liberalize trade is frustrated by a second political problem: the enforcement problem. The **enforcement problem** refers to the fact that in the international state system governments cannot be certain that other governments will comply with the trade agreements that they conclude (Keohane 1984; Conybeare 1984; Oye 1986). As a result, governments will be reluctant to enter into trade agreements, even when they all recognize that they would benefit from doing so. While this might seem counter-intuitive, we can use a simple game theory model, called the prisoners' dilemma, to see how the enforcement problem can frustrate the efforts of governments to conclude mutually beneficial trade agreements. The **prisoners' dilemma** has been developed to highlight how people can have real difficulties in

achieving cooperation even in situations where all would clearly benefit from such cooperation.

Suppose that France and Denmark are using tariffs to protect their comparatively disadvantaged industries and that as a result, no trade in wine and cheese between the two countries takes place. Let's also suppose that the French and Danish governments both know that a reciprocal agreement that eliminated these tariffs would make them both better off. Would the French and Danish governments be able to conclude such an agreement? The prisoners' dilemma tells us that they will be unable to do so. In the prisoners' dilemma, France and Denmark each have two strategy choices: each can choose to open its market to the other's exports, which we will call *liberalize*, or each can choose to protect its domestic market, which we will call *protect*. Two governments with two strategy choices each generates the two-by-two matrix depicted in Figure 2.2. Each cell in this matrix corresponds to a strategy combination, and these strategy combinations produce outcomes. We can describe these outcomes starting in the top left cell and moving clockwise. One word about the notation we use before we proceed. It is conventional to list the strategy choice of the row player (the player who selects its strategy from the rows of the matrix) first and the strategy choice of the column player (the player who selects its strategy from the columns of the matrix) second. Thus, the strategy combination referred to as *"liberalize/protect"* means that the row player, which in this case is France, has chosen the strategy *liberalize* while the column player, which is Denmark, has chosen the strategy *protect*.

We can now describe the four outcomes in the prisoners' dilemma. If France chooses *liberalize* and Denmark chooses *liberalize* (*liberalize/liberalize*), then the two have agreed to eliminate tariffs on wine and cheese. France will begin to export wine to Denmark, and Denmark will begin to export cheese to France. If France chooses *liberalize* and Denmark chooses *protect* (*liberalize/protect*), then France has reduced tariffs on Danish cheese but Denmark retains its tariffs on French wine. As a result, Denmark will begin to export cheese to France, but France will remain unable to export wine to Denmark. If France chooses *protect* and Denmark chooses *protect* (*protect/protect*), both countries retain their tariffs and no trade takes place. Finally, if France chooses *protect* and Denmark chooses *liberalize* (*protect/liberalize*), then Denmark

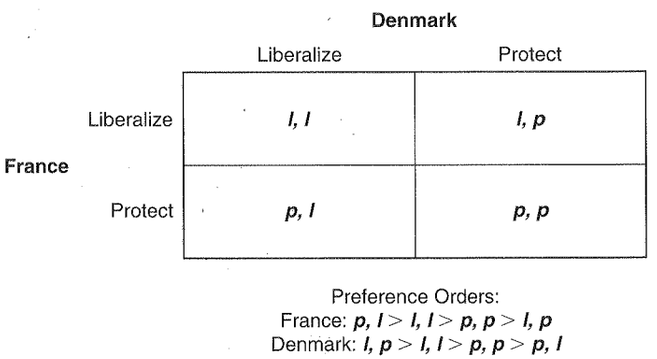

Figure 2.2 The Prisoners' Dilemma and Trade Liberalization.

has eliminated its tariff on French wine, but France retains its tariff on Danish cheese. France will begin to export wine to Denmark, but Denmark will remain unable to export cheese to France.

Now we must determine how each government ranks these four outcomes: which is their most, second most, third most, and least preferred outcome? France's most preferred outcome is *protect/liberalize,* where it protects and Denmark liberalizes. This outcome allows France to export wine to Denmark while continuing to protect French cheese producers from Danish competition. France's least preferred outcome is *liberalize/protect* because this outcome gives Denmark access to the French market without giving French exporters access to the Danish market in return. Where do the other two outcomes fit in? France prefers *liberalize/liberalize* to *protect/protect* because France gains from the resulting trade when both governments liberalize, but when both governments continue to protect their markets, France gains nothing. It should also be clear that France prefers both *liberalize/liberalize* and *protect/protect* less than *protect/liberalize,* because with *protect/liberalize* France gains access to the Danish market, as it does with *liberalize/liberalize,* but it does not have to give Denmark access to its market. Finally, France prefers *liberalize/liberalize* and *protect/protect* to *liberalize/protect,* because under *liberalize/protect* France is denied access to the Danish market, as it is in *protect/protect,* but it has opened its market to Denmark. Thus, we have a clear preference order for France *protect/liberalize* > *liberalize/liberalize* > *protect/protect* > *liberalize/protect* where the "greater than" sign means "is preferred to." In words, France's most preferred outcome is unreciprocated access to Denmark's market. Its second best outcome is reciprocal tariff reductions, which is in turn better than reciprocal protection. France's worst outcome is a unilateral tariff reduction.

The prisoners' dilemma is a symmetric game, which means that Denmark faces the exact same situation as France. Denmark's payoff order is therefore identical to France's, with one small difference arising from the notation we use. Like France, Denmark's most preferred outcome is the one in which it gets unreciprocated access to the other's market, but for Denmark this is the outcome *liberalize/protect.* Also like France, Denmark's least preferred outcome is the one in which it grants the other unreciprocated access to its market, which for Denmark is the outcome *protect/liberalize.* Thus, Denmark's payoff order is identical to the French payoff order, but the position of the most and least preferred outcomes are reversed: *liberalize/protect* > *liberalize/liberalize* > *protect/protect* > *protect/liberalize.*

We can now solve the prisoners' dilemma by determining what strategies France and Denmark will choose, and what outcome we should therefore expect, given their preference orders. In the prisoners' dilemma France and Denmark both have a dominant strategy—a single strategy that always returns a higher payoff than all other strategy choices. *Protect* is this dominant strategy. *Protect* dominates *liberalize* as a strategy choice because each government will always gain a higher payoff by playing *protect* than it will by playing *liberalize.* We can make this clear by working through France's best responses to Danish strategy choices. Suppose Denmark plays the strategy *liberalize.* If France plays *liberalize* in response, France receives its second most preferred outcome (*liberalize/liberalize*). If France plays *protect* in response, France receives its most preferred outcome (*protect/liberalize*). Thus, if Denmark plays *liberalize,* France's best response—the strategy that returns the highest payoff—is

protect. Now suppose that Denmark plays *protect.* If France responds with *liberalize,* it receives its least preferred outcome (*liberalize/protect*). If France responds with *protect,* however, it receives its second least-preferred outcome (*protect/protect*). Thus, if Denmark plays *protect,* France's best response is to play *protect. Protect,* therefore, "dominates" *liberalize* as a strategy choice; that is, *protect* provides France with a higher payoff than *liberalize* regardless of the strategy that Denmark plays. Because the prisoners' dilemma is symmetric, *protect* is also Denmark's dominant strategy. Because both governments have dominant strategies to play *protect* the game always yields one outcome: France and Denmark both play *protect* and the game produces the *protect/protect* outcome.

The *protect/protect* outcome has two important characteristics. First, this outcome is **Pareto sub-optimal.** Pareto optimality is a way to conceptualize societal welfare. An outcome is Pareto optimal when no single actor can be made better off without at the same time making another actor worse off. Pareto sub-optimal refers to outcomes in which it is possible for at least one actor to improve its position without any other actor being made worse off. In the prisoners' dilemma the *protect/protect* outcome is Pareto sub-optimal because both governments realize higher payoffs at *liberalize/liberalize* than they realize at *protect/protect.* Thus, rational behavior on the part of each individual government, each playing its dominant strategy *protect,* produces a sub-optimal collective outcome. France and Denmark are both poorer than they would be if they both liberalize trade.

Second, the *protect/protect* outcome is a **Nash equilibrium.** A Nash equilibrium is an outcome at which neither player has an incentive to change strategies unilaterally. If France changes its strategy from *protect* to *liberalize,* the outcome shifts to *liberalize/protect,* France's least preferred outcome. Thus, France has no incentive to change its strategy unilaterally. If Denmark changes its strategy from *protect* to *liberalize,* the outcome moves to *protect/liberalize,* Denmark's least preferred outcome. Thus, Denmark has no incentive to change its strategy unilaterally either. Putting these two points together reveals the prisoners' dilemma's central conclusion: even though France and Denmark know that they would gain from reciprocal tariff reductions, neither has an incentive to reduce tariffs. More broadly, the prisoners' dilemma suggests that even when all countries would clearly benefit from trade liberalization, political dynamics trap governments in a protectionist world.

Why are governments unable to conclude agreements that make them all better off? The problem arises because each fears getting the "sucker payoff." If France and Denmark agree to liberalize trade and then France complies with this agreement but Denmark does not, Denmark has played France for a sucker. France suffers the "costs" of rising imports without getting the "benefit" of increased exports. Indeed, the recognition that the other government has no incentive to comply with any trade agreement that is reached would prevent governments from concluding the agreement in the first place. The gains from trade liberalization could be achieved, of course, if governments could enforce international trade agreements. Governments could agree in advance to play *liberalize* strategies if they were confident that cheating would be caught and punished. Moreover, because cheating would be punished, both would comply with the agreement. The international system provides no enforcement mechanism, however. Whereas domestic political systems rely upon the police and the judicial system to enforce laws,

the international system does not have an authoritative and effective judicial system. Instead, the international system is anarchic, that is, it is a political system without an overarching political authority capable of enforcing the rules of the game.

Multilateral Institutions and Trade Cooperation

Against this backdrop we can now consider the WTO's role in the international trade system. As you may already have guessed, the WTO helps governments liberalize trade by helping them enforce reciprocal trade agreements. To understand how, we will first determine under what conditions cooperation can emerge in the prisoners' dilemma. Then we can examine how the World Trade Organization helps create these conditions.

While the prisoners' dilemma is generally pessimistic about the prospects for international trade cooperation, it turns out that cooperation in a prisoners' dilemma is not impossible. Cooperation can emerge if three specific conditions are met. First, cooperation can emerge in an **iterated prisoners' dilemma,** that is, in a game played repeatedly by the same set of actors (see Taylor 1976; Axelrod 1984; Keohane 1984; Oye 1986). Iteration changes the nature of the reward structure that governments face. In a one-shot play of the prisoners' dilemma, countries make a one-time choice and receive a one-time payoff. In an iterated game, however, governments make repeated choices and receive a stream of payoffs over time. As a result, if the two other necessary conditions are met, governments will prefer the stream of payments they receive over time through iterated play to the payoff they receive from cheating on an agreement. Iterating the game can therefore make it rational for a government to play the *liberalize* strategy.

Second, governments must use reciprocity strategies to enforce the *liberalize/liberalize* outcome. While many reciprocity strategies exist, the most well known is called **tit-for-tat** (Axelrod 1984). In tit-for-tat, each government plays the strategy that its partner played in the previous round of the game. Trade liberalization by one government in one round of play is met by trade liberalization from the other government in the next round. Should one government play *protect* in one round (or cheat on an existing trade agreement) the other government must play *protect* in the next round of play. Playing such tit-for-tat strategies allows governments to reward each other for cooperation and punish each other for cheating.

Third, governments must also care about the payoffs they will receive in future rounds of the game. If governments fully discount future payoffs, the iterated game essentially reverts back to a single play of the prisoners' dilemma; when it does, the threat of punishment in the next round of play can hardly be expected to promote cooperation in this round. But if governments care about the future and if they use a reciprocity strategy such as tit-for-tat, then cooperation in an iterated prisoners dilemma becomes rational; each government can realize a larger stream of payoffs by cooperating than it can realize by defecting.

International trade institutions provide the first two of these three necessary conditions. Trade institutions like the WTO help iterate the game by creating expectations of repeated interaction. The WTO iterates trade interaction between governments in a number of ways. Membership in the WTO has been relatively stable. While the number of countries that belong to the WTO has increased over time, very few countries have left the organization after joining. As a consequence, WTO members know that the governments with which they negotiate today will be the governments with which they negotiate tomorrow, next year, and on into the future. In addition, WTO members interact regularly within the World Trade Organization. As we saw above, governments have already concluded eight formal bargaining rounds and a ninth, the Millenium Round began in 2001. In addition to these formal rounds of negotiations, the WTO draws governments together for annual and semiannual reviews of national trade policies. By bringing the same set of governments together in a regularized pattern of interaction, the World Trade Organization iterates intergovernmental trade interactions.

The WTO also provides the information that governments need in order to use reciprocity strategies. In order to use a tit-for-tat strategy effectively, governments must know when their partners are complying with trade agreements and when they are cheating. The WTO makes this easier by collecting and disseminating information on its members' trade policies. Moreover, WTO rules provide clear standards against which governments' trade policies can be evaluated. As we saw earlier in this chapter, the WTO's most favored nation clause prohibits discriminatory practices except under a set of well-defined exceptions. To give another example, the WTO's rules governing domestic safeguards define the conditions that must be met in order for governments to temporarily opt out of commitments. These detailed rules increase transparency. **Transparency** means that it is easier for governments to determine whether a specific trade measure adopted by a particular government is or is not consistent with WTO rules. The high quality information and the transparency provided by the WTO allow governments to monitor the behavior of other WTO members. This in turn makes it easier for governments to use reciprocity strategies to enforce trade agreements.

The ability of governments to use the WTO to enforce trade agreements is most clearly evident in the WTO's dispute settlement mechanism. The dispute settlement mechanism follows a standard procedure that was agreed by all members of the WTO as part of the Uruguay Round. A dispute is initiated when a government brings a complaint about an alleged violation of WTO rules to the WTO Dispute Settlement Body (DSB), a body composed of all WTO member governments. The DSB initially encourages the governments involved in the dispute to try to resolve the conflict through direct consultations. If such consultations are unsuccessful, the DSB creates a formal panel to investigate the complaint. This panel is typically composed of three experts in trade law who are selected by the DSB in consultation with the governments that are involved in the dispute. The panel reviews the evidence in the case, meets with the parties to the dispute, and prepares a final report that it submits to the DSB. The DSB must accept the panel's final report unless all WTO members, including the government that initially brought the complaint, vote against its adoption. Once the DSB has accepted the report, both governments can appeal the decision. If the losing side appeals, the DSB creates an Appellate Body composed of three to five people drawn from a list of seven permanent members. The Appellate Body can uphold, reverse, or modify the panel's findings, conclusions, and recommendations. The appellate report is given to the DSB for approval, and as with the panel report, the DSB can reject the report only with the consent of all member governments. If at the end of this process it is determined that the disputed trade measure is inconsistent with WTO rules, the government must alter its policy to conform to the rule in

question or compensate the injured parties. The entire dispute settlement process, from initiation to appellate report, is supposed to take no longer than 15 months.

A recent case involving the European Union's banana import regime illustrates this dispute settlement mechanism in operation and highlights how governments use the system to enforce trade agreements.[1] The banana case began in 1993 when the European Union removed all tariffs on bananas imported from former French and British colonies in Africa, the Pacific, and the Caribbean while continuing to impose tariffs on bananas imported from other countries. By waiving tariffs on banana imports from some countries but not others, the EU began to discriminate against bananas produced in other countries. In the mid-1990s Ecuador, Guatemala, Honduras, Mexico, and the United States—all countries whose export interests were harmed by the new EU banana policy—claimed that this policy was inconsistent with a number of GATT rules. In other words, they accused the EU of cheating on its WTO obligations. Consultations in early 1996 failed to resolve the dispute, so the DSB established a panel that concluded that the EU could give preferential treatment to bananas from African, Caribbean, and Pacific countries, but that the specific arrangements it had used discriminated illegally against Latin American producers and the American firms, Chiquita and Dole (*Europe*, May 1999, 24B). The EU appealed the panel's findings, but the Appellate Body that reviewed the case largely upheld them. In September 1997 the DSB adopted the Appellate Body report and demanded that the EU implement WTO-consistent policies by January 1, 1999. Thus, the EU was found to be "cheating" on a trade agreement it had entered, and was required to bring the offending policies in line with these obligations.

The changes the EU made to its banana import regime in response to the WTO findings raised further concerns in the countries that had brought the original complaint. In August 1998, these countries requested further consultations with the EU to determine whether the new measures were consistent with WTO rules. Consultations were again unproductive, and in December 1998, Ecuador requested the original WTO panel to examine the new EU measures. The panel found that the new measures were not fully consistent with WTO rules. Thus, the EU had "cheated" in the first place by implementing a banana import regime inconsistent with its WTO obligations, and had "cheated" again when altering these policies in response to the ruling of the DSB. Recognizing that the EU was unlikely to comply with its WTO obligations unless it was costly not to do so, the United States then asked the WTO to allow it to suspend $520 million in tariff concessions it had previously granted to the EU. In essence, the United States was asking for permission to retaliate against the EU. The EU argued that the size of the proposed retaliation was disproportionate to the injury to American trade caused by the EU banana policy. WTO arbitration, initiated at the EU's request, agreed and authorized the United States to suspend only $191.4 million of previous tariff concessions. In response to the American retaliation, the EU once again altered its banana import regime, this time shifting 100,000 tons of the EU market that had previously been reserved for African, Caribbean, and Pacific producers to Latin American banana producers. In response, the United States suspended its sanctions (*The Financial Times* 12 April 2001, 14).

[1]This description draws heavily on WTO summaries available at http://www.wto.org/wto/dispute.

The banana case illustrates how governments can use tit-for-tat strategies to enforce trade agreements. An alleged defection by the EU prompted an impartial investigation by the WTO. This investigation indicated that EU policy violated WTO rules and when the EU failed to bring its policies into line with its obligations, the United States retaliated by withdrawing concessions it had made previously to the EU. In the language of the iterated prisoners' dilemma, the EU defected and the United States, playing a tit-for-tat strategy, defected in response. Moreover, American retaliation came only after the WTO had determined that it was justified and the scale of the retaliation was proportionate to the injury suffered. While the WTO's dispute resolution mechanism focuses our attention on a legalistic version of tit-for-tat, it allows us to see in a very detailed way how the WTO can promote trade cooperation by helping governments enforce trade agreements.

This discussion points us to one simple answer to the questions posed in the introduction to this section: governments need the WTO because without it they would find it extremely difficult to liberalize international trade. Domestic politics and international politics both stand in the way. Domestic politics, by inverting the logic of trade theory, make governments reluctant to liberalize trade unilaterally, and willing to do so only through reciprocal trade agreements. International politics, and particularly the absence of an over-arching authority in the international state system capable of enforcing international trade agreements, make governments reluctant to enter reciprocal trade agreements. Trade liberalization is unlikely to occur, therefore, unless governments can be assured that their partners will comply with the commitments they undertake. The World Trade Organization helps provide this assurance by allowing governments to monitor the behavior of their trade partners and enforce trade agreements.

Globalization and its Critics

The economic and political consequences of the multilateral trade system have been profound. The liberalization of trade has unleashed forces that are transforming the world economy. As barriers to trade have been dismantled, international competition has intensified. This has in turn set in motion processes that are creating international trade and production networks and forging a global division of labor. It is this transformation of the world economy that is often referred to as **globalization.** The political consequences have also been profound. The economic dynamics of globalization have been one of the most important forces driving the trade conflicts, new protectionism, and regionalism that we examined in the previous section. In addition, globalization has more recently generated a political backlash targeted at the multilateral trading system in general and the WTO in particular. We conclude our discussion of the multilateral trade system, therefore, with a focus on globalization and its critics.

The Globalizing World Economy

Economic globalization has resulted in part from economic dynamics unleashed by trade liberalization. These dynamics are driven by international trade flows and by the activities of multinational corporations (MNCs) in an increasingly open and deeply integrated

global economy. While trade flows and MNCs are both important components of globalization, in this section we focus on the impact of trade liberalization; we will look at the role of multinational corporations in detail in Chapter 5.

As governments have reduced tariffs and dismantled other barriers to international trade during the last 50 years, world trade has grown at historically unprecedented rates. Between 1950 and 1999 world trade grew at an average rate of 6 percent per year (Figure 2.3). What is perhaps more impressive than the simple growth of world trade, however, is the fact that international trade has consistently grown more rapidly than total world economic production. Figure 2.4 charts the annual rate of growth of world exports and the annual rate of world economic growth. Looking at the two trends together indicates that in almost every year since 1950, world trade has grown at a faster rate than world economic output. Thus, year after year a larger share of the world's economic output enters into international trade—each year more of the world's total economic production is produced in one country but consumed in another.

Trade openness is the standard measure of the importance of international trade to national economies. **Trade openness** measures each country's total trade (its imports plus its exports) as a percentage of its total domestic economic production (its gross domestic product or GDP). The statistics on trade openness since 1950 presented in Table 2.7 illustrate the rising importance of international trade to many regions of the world. In Western Europe, trade openness increased from 35 percent in the early postwar period to almost 50 percent by 1990. This means that half of the income of West European countries is either earned by selling domestic production in foreign markets or spent on goods imported from foreign producers. While North America (the United States and Canada) is less open to international trade than Western Europe, trade openness in these countries has also increased during the last 50 years. Developing countries display a different pattern. Many were already quite open in the early postwar period, and few became substantially more open during the postwar period. In fact, Africa and Latin America actually became less open to trade between 1948 and 1980. We will explore the reasons for this in Chapter 4. Note that these statistics on regional patterns of trade openness reinforce the central message of Figure 2.4; during the last 50 years trade has grown in importance to economic activity in many regions of the world.

While the volume of international trade has grown tremendously since 1947, the figures on trade openness suggest that not all countries have participated to the same

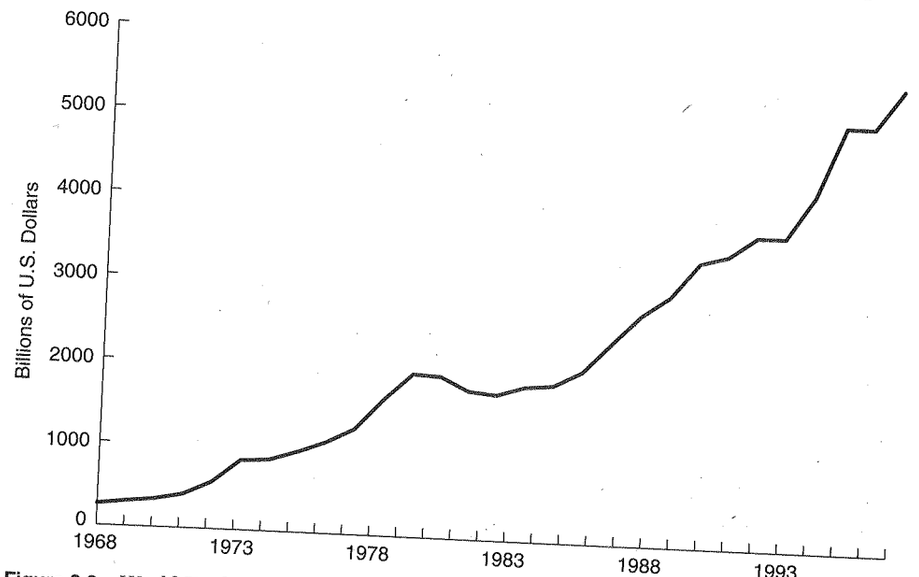

Figure 2.3 World Trade, 1968–1997.
Source: World Trade Organization.

Table 2.7
Trade Openness, 1948–1990
(Imports+Exports/GDP)

	1948	1958	1968	1979	1990
World	22	22	22	35	34
Western Europe	35	33	34	48	46
Eastern Europe*	25	25	40	40	41
North America	11	9	10	19	19
Asia	25	26	21	27	29
Latin America	30	30	21	27	28
Africa	50	58	37	56	53

*Estimated Figures
Source: Grimwade 2000, 13.

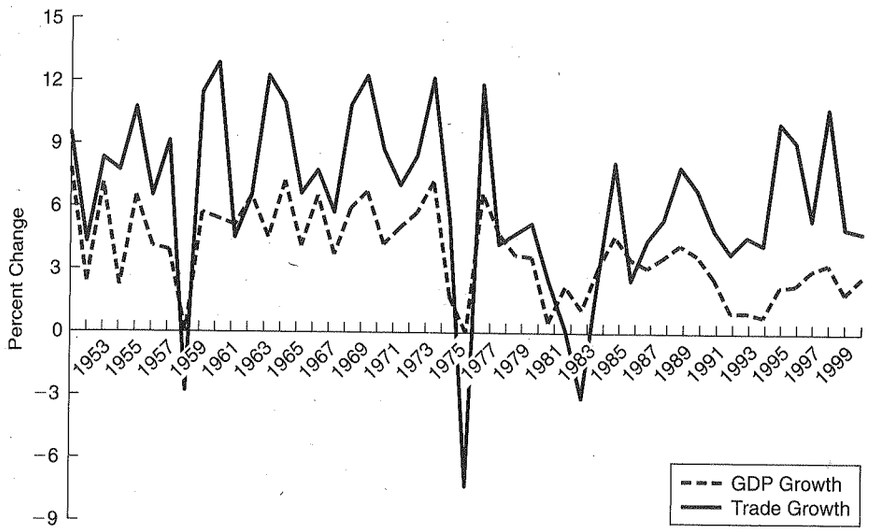

Figure 2.4 Growth of World Output and Trade.
Source: World Trade Organization.

degree. Table 2.8, which presents shares of world trade during the last 40 years broken down by geographic region, confirms this impression. The table illustrates three important points. First, international trade has been dominated by the advanced industrialized economies, which together account for about 70 percent of total world trade. Second, while developing countries account for only a small share of world trade, this share has grown during the last 40 years. In the early 1960s, developing countries accounted for only about one-fifth of world trade. This share has subsequently increased to about one-quarter of the total. Finally, while the developing countries' share of world trade has grown, six East Asian countries—Taiwan, Singapore, Hong Kong, South Korea, Malaysia, and Thailand—are responsible for most of this increase. Their share of world trade increased from 2.6 percent in 1953 to 10 percent in 1999. In contrast, Africa and Latin America saw their shares of world trade fall during this period. Countries in the former Soviet bloc have also seen their share of world trade fall sharply since the late 1980s, in large part because of the economic reform process that has been underway in this region. Thus, while world trade has grown steadily, and while the world as a whole has become more open to international trade, both developments have been heavily concentrated in a relatively small number of countries in Western Europe, North America, and Asia.

The liberalization and subsequent expansion of international trade has unleashed economic forces that have restructured the global economy. Trade theory tells us that countries open to international trade will specialize in goods that make intensive use of their abundant factors of production. In a fully open international economy, therefore, a **global division of labor** should emerge in which each country produces goods in which it has a comparative advantage and sheds industries in which it has a comparative disadvantage. Such a division of labor has begun to emerge in the global economy. Though this division is far from complete, it is possible to identify four emerging tiers.

- The advanced industrialized countries hold a comparative advantage in capital and human-capital intensive goods. Producers in the advanced industrialized countries lead the world in the production of knowledge-intensive products such as pharmaceuticals, computers and software, telecommunications equipment, commercial aircraft, and other research- and high-technology-intensive products.
- The Asian NICs, especially South Korea, Taiwan, Hong Kong, and Singapore, hold a comparative advantage in mature and relatively standardized capital-intensive goods such as semiconductors and other computer components, automobiles, and steel. These countries have not yet become an important source of product or process innovation.
- The second wave of NICs, including Indonesia, Malaysia, Thailand, Mexico, and Argentina, hold a comparative advantage in labor-intensive goods such as apparel, footwear, and the assembly of finished goods from components. These countries have not yet emerged as important international producers of capital-intensive goods, but are likely to make that transition relatively soon.
- Other developing countries hold comparative advantages in land-intensive primary commodities such as fuel, minerals, and agricultural products.

Table 2.8
Regional Shares of World Exports (percent of total world exports)

	1953	1963	1973	1983	1993	1999
North America	24.6	19.4	17.2	15.4	16.8	17.1
Western Europe	34.9	41.0	44.8	39.0	43.7	43.0
Former Soviet Bloc	6.0	8.2	11.0	8.9	2.9	3.9
Asia	13.2	12.6	15.0	19.1	26.3	25.5
Japan	1.5	3.5	6.4	8.0	10.0	7.7
Asian NICs	2.6	2.4	3.4	5.8	9.7	10.0
Latin America	10.5	7.0	4.7	5.8	4.4	5.4
Africa	6.5	5.7	4.8	4.4	2.5	2.0

Source: World Trade Organization 2000.

This global division of labor is not emerging spontaneously; firms have created it by beginning, ending, or relocating production in response to pressures exerted by international competition. An entrepreneur in Pakistan, for example, might recognize the opportunity to make a profit in the labor abundant apparel industry and start a business to realize these profits. Conversely, an apparel producer in North Carolina might recognize that he cannot compete against apparel produced in developing countries like Pakistan, and stop producing clothes in North Carolina. These independent decisions cause apparel production to shift out of the United States and into Pakistan. The relocation of production is also sometimes a consequence of production decisions taken within a single firm. An American auto firm such as Ford, for example, may recognize that it needs to reduce its production costs in order to compete against Japanese producers in the American market. To do so, Ford may build an auto assembly plant, a labor-intensive aspect of auto production, in Mexico, where labor is abundant and relatively cheap. Ford's decision may therefore cause some aspects of auto production to shift out of the United States to Mexico. The emerging global division of labor is the result of hundreds of thousands of such decisions taken by individuals and firms in response to the competitive challenges of the international economy.

In some respects the emerging division of labor is not a new phenomenon. A division of labor also characterized the nineteenth century international economy. European countries specialized in manufactured goods and what we now call the developing world specialized in raw materials. However, the contemporary division of labor differs from the late nineteenth century division of labor in two important ways. Today's division of labor is more diverse than that of the nineteenth century. To the basic nineteenth century division between manufacturing and raw materials, the contemporary system adds divisions within manufacturing activity. Today we see countries specializing in human capital-intensive manufacturing, other countries specializing in capital-intensive manufacturing, and still others specializing in labor-intensive manufacturing. In addition, during the nineteenth century, production remained national; production "was primarily organized within national economies . . . production, plant, and firm were essentially national phenomena" (Hobsbawm 1979, 313). In the contemporary international economy, production is increasingly an international phenomenon; the production of individual goods is being broken down and allocated to different regions of the globe. The personal computer is one example. The typical PC contains a microprocessor designed in the United States by Intel, Motorola, or Advanced Micro Devices (AMD). It contains a hard drive and memory chips that were likely produced in Taiwan or South Korea. The multiple components were likely assembled into a working PC in yet another location, perhaps in

Malaysia or Mexico. Thus, a personal computer, and many of the other products that we use daily, are no longer produced in a national economy. Instead, the production of many individual goods is organized globally.

A Closer Look

The Global Division of Labor in the Semiconductor Industry

The semiconductor industry illustrates the global division of labor that is emerging in the contemporary international economy. Semiconductors are the tiny chips used to create microprocessors and other integrated circuits. An integrated circuit can be thought of as a "collection of tiny interconnected switches etched onto a smaller sliver of silicon and encased in a hard plastic or ceramic package. These 'switches' control the flow of electronic currents in carefully controlled patterns" (The Semiconductor Industry Association 2002). Such devices power computers and almost all other electronic devices that we use. The semiconductor industry was one of the first industries to globalize, and it is in this industry that a clear global division of labor has become most apparent. The production of semiconductors involves a rather elaborate six-step process, and understanding this production process is central if we are to understand how the global division of labor in this industry has emerged and evolved. The first step in semiconductor production involves design, during which the precise location of each element and the connections between them is laid out. In the second stage the large silicon rods are produced and then sliced into individual wafers. In the third stage these silicon wafers are etched using a mask and photolithography. Etching transfers the design developed in the first stage to the wafer and deposits the chemicals that will provide the electronic circuitry. Each wafer will contain hundreds of small yet identical semiconductors. In the fourth stage, each individual chip on the larger wafer is tested electronically to determine whether the circuits are working properly. In the fifth stage the larger wafer is broken apart into individual chips and these chips are then incorporated into an integrated circuit or microprocessor. In the final stage, the chips are tested and packed for final shipment. Five of these six steps rely heavily upon sophisticated and expensive equipment and highly skilled technicians. Step five, in which the wafer is broken into chips that are then attached to integrated circuits, is a relatively more labor-intensive process.

American firms were the first to produce semiconductors and prior to the 1960s all of their production was done inside the United States (Dicken 1998, 373). As the industry grew more competitive in the early 1960s, however, many of these firms began creating production facilities in East Asia. Fairchild was the first firm to move part of its production overseas, creating a plant in Hong Kong in 1962. General Instruments followed in 1964, building a plant in Taiwan. Fairchild built a second plant in South Korea in 1964. As the decade progressed, American firms began constructing production facilities in northern Mexico, Singapore and Malaysia. Additional investments were made in the Philippines and Indonesia. By the early 1970s every major American producer of semiconductors had created overseas production facilities, with the majority of these plants based in East Asia. In creating these plants, American firms sought to take advantage of lower labor costs in East Asia for the most labor-intensive aspect of

Continued

chip production. As a consequence, the first three stages of production continued to be performed in plants located in the United States. Once the wafer had been tested to make sure the circuits were operating properly (stage 4), however, the wafers are packaged and shipped to plants in Asia. Workers in these plants break the larger wafers into individual chips, attach them to the integrated circuit, package them, and ship them back to the American plant for final testing.

The global division of labor in the semiconductor industry between labor-intensive and capital-intensive forms of production has not been static. Instead, the precise distribution of production responsibilities between the American firm and its East Asian affiliates has evolved as East Asian countries have gained technological experience. During the 1980s the American firms that had established operations in East Asia began transferring a larger share of the production process to these overseas plants. By the 1990s, a division of labor based on the distinction between "hard" and "soft" competencies had emerged (Gereffi 1996). East Asian firms developed strong capacities in the production of the silicon rods and in etching the wafers. Firms based in the United States increasingly shed some of the more capital-intensive production stages and began to specialize in the design and development of chips. As Dicken (1998, 374) notes, "a clear system of *intraregional specialization* has emerged, with higher-level functions being performed in the more advanced industrialized countries and the lower-level assembly functions being progressively relocated to later entrants." This division of labor is evident today in the structure of two leading American semiconductor firms. Most of Fairchild Semiconductor's design facilities are located in the United States, with operations in Maine, California, Utah, and Pennsylvania, although it has also opened design facilities in South Korea and Singapore. Its manufacturing facilities are distributed rather evenly between the United States and Asia, with plants in Maine, Utah, Pennsylvania, and overseas plants in South Korea and Singapore. All of its assembly operations are conducted overseas, however, in plants located in the Philippines, Malaysia, and China (www.fairchildsemi.com). AMD, short for Advanced Micro Devices, has an international profile quite similar to Fairchild. Design and the most capital-intensive stages of production are performed at facilities based in California, Texas, Germany, and Japan. Testing and assembly operations are performed in plants based in Singapore, Thailand, Malaysia, and China (www.amd.com). While these are only two firms, this structure is typical of most firms in the industry. And the global division of labor one finds in the semiconductor industry is also increasingly apparent in other industries, including computers and electronics more broadly, as well as the auto industry.

The liberalization of international trade has thus set in motion economic forces that are rapidly transforming the global economy. The elimination of trade barriers has intensified international economic competition. Firms' responses to the profit opportunities and the competitive challenges of this global market have shifted production away from countries where it is more costly to those countries where it can be done more efficiently. The progressive elimination of political barriers to international economic activity has been accompanied by a dramatic decrease in the cost of transportation and telecommunications (World Bank 1995). The cost of shipping goods by sea and by air has been cut in half since 1950. The cost of long-distance phone calls has fallen even more sharply. Whereas it cost about $250 to make a three-minute call from

New York to London in 1930, such a call now costs less than a dollar. Falling transport and telecommunications costs facilitates the creation of a global division of labor by making it cheaper to import and export intermediate inputs and to organize and manage production on a global scale.

As a result, economic activity has become increasingly internationalized, and these international activities are increasingly being woven into a deeply integrated web of trade and production relations. It is this phenomenon that has been labeled globalization. How far has globalization progressed? There is disagreement among those who study the world economy. Some argue that globalization has fundamentally transformed the world economy as a whole and national economies individually. Robert Reich (1992, 3), argues that "[w]e are living through a transformation that will rearrange the politics and economics of the coming century. There will be no national products or technologies, no national corporations, no national industries. There will no longer be national economies, at least as we have come to understand that concept." Others suggest that this transformation has already occurred. Business consultant and author Peter Drucker argues that "the talk today is of the 'changing world economy'. . . The world economy is not 'changing'; it has already changed—in its foundations and in its structure—and in all probability the change is irreversible (1986, 768).

Others are more skeptical about globalization. Robert Gilpin claims that "globalization is much more limited than many realize" (2001, 363). Skeptics point to the nineteenth century global economy to buttress their counter-arguments. In this first global economy, Gilpin argues, countries were more open to trade than they are today. And "although trade has grown enormously during the past half century, trade still accounts for a relatively small portion of most economies . . . [and] is still confined to a limited number of economic sectors. The principal competitors for most firms (with important exceptions in such areas as motor vehicles and electronics) are other national firms" (Gilpin 2001, 365). And even where globalization has progressed the furthest, in the "Triad" composed of Pacific Asia, the United States, and the EU, national barriers continue to impose substantial obstacles to the international flow of goods and services (Gilpin 2000, 295).

It may be useful to look for middle ground in this debate. Economic processes are fundamentally changing the world economy. At the same time, however, it is important to recognize that globalization is limited in geographic scope, involving primarily the countries of the Triad. Globalization is limited in industrial scope as well, with some industries, such as electronics, being much more globalized than other industries, such as steel. As Peter Dicken (1998, 5) observes, "although there are globa*lizing* forces at work we do not have a fully globa*lized* world economy. Globalization forces can be at work without this resulting in the all-encompassing end-state—the globalized economy—in which all unevenness and difference are ironed out, market forces are rampant and uncontrollable, and the nation-state merely passive and supine." In short, while it is premature to proclaim a fully globalized world economy, and while nothing that is created by human activity is ever irreversible, it is also misleading to claim that nothing has changed.

The Critics of Globalization and the World Trade Organization

The early 1990s saw the emergence of a political backlash against globalization that strengthened over the subsequent decade. This opposition has been most visible in a series of large protests, mostly peaceful but sometimes violent, staged at the annual meetings of the major international organizations that directly address aspects of the international economy. Behind the drama of public protests, however, the antiglobalization movement has articulated a number of criticisms of the global economy in general and of the WTO-centered trade system in particular. The critique is multi-faceted, and includes criticisms of international economic organizations like the WTO, the World Bank, and the

A Closer Look

The WTO and its Critics

The WTO has responded directly to some of its critics, particularly those it claims are misinformed. Here we look at a few specific criticisms put forth by the nonprofit organization, Global Exchange, and the WTO's point-by-point responses to these criticisms. The full exchange can be found by visiting the respective organization's web pages, the links to which are provided at the end of the chapter.

THE WTO ONLY SERVES THE INTERESTS OF MULTINATIONAL CORPORATIONS

GLOBAL EXCHANGE CRITICISM	*THE WTO RESPONSE*
1. The WTO is not a democratic, transparent institution, but its policies impact all aspects of society and the planet.	1. The WTO is as democratic as its member governments; and between the members it is ultra-democratic because decisions are taken by consensus—all members have to be persuaded.
2. The WTO rules are written by and for corporations with inside access to the negotiations. For example, the U.S. Trade Representative relies on its 17 "Industry Sector Advisory Committees" to provide input into trade negotiations.	2. The rules are written by member governments, no one else has access to the negotiations. However, governments, which are elected democratically by their citizens, do take into account the views of various groups in their societies. How they do that is up to them and their citizens.

THE WTO IS A STACKED COURT

GLOBAL EXCHANGE CRITICISM	*THE WTO RESPONSE*
1. The WTO's dispute panels, which rule on whether domestic laws are "barriers to trade," should be abolished.	1. Dispute panels rule on whether countries break agreements they have made with each other in the WTO—not on "whether domestic laws are barriers to trade."
2. Panels consist of three trade bureaucrats who are not screened for conflict of interest.	2. All three panelists are normally agreed by both sides in a dispute. In the minority of cases (15 out of almost 200 cases) when the two sides cannot agree, the WTO director-general selects the panelists.

Continued

3. In the tuna/dolphin case that Mexico filed against the United States, the United States was forced to repeal its law that barred tuna from being caught by mile-long nets that kill hundreds of thousands of dolphins each year.	3. The United States was not required to repeal its law. Instead, Washington negotiated treaties with relevant trading partners.

THE WTO TRAMPLES OVER LABOR AND HUMAN RIGHTS

GLOBAL EXCHANGE CRITICISM	*THE WTO RESPONSE*
1. The WTO has refused to address the impacts of free trade on labor rights, despite that fact that countries that actively enforce labor rights are disadvantaged by countries that consistently violate international labor conventions.	1. The "WTO" has not refused to address this issue. At their first ministerial meeting (Singapore 1996), WTO members reaffirmed their commitment to core labor standards. In addition, to suggest that developed countries are handicapped because they enforce labor standards ignores the fact that developed countries are highly successful in exporting—they have by far the largest share of export markets.
2. Many developing countries, such as Mexico, contend that labor standards constitute a "barrier to free trade" for countries whose competitive advantage in the global economy is cheap labor.	2. No one has argued in the WTO that "labor standards constitute a barrier to free trade."
3. . . . The WTO has ruled that it is: (1) illegal for a government to ban a product based on the way it is produced (i.e. with child labor); and (2) governments cannot take into account "non commercial values" such as human rights and the behavior of companies that do business with vicious dictatorships such as Burma when making purchasing decisions.	3. The WTO has never ruled on child labor because the issue has never come up for a ruling. Countries' efforts to deal with child labor problems have never been challenged in the WTO. Moreover, the WTO made no such ruling over trade with Myanmar (Burma).

THE WTO IS DESTROYING THE ENVIRONMENT

GLOBAL EXCHANGE CRITICISM	*THE WTO RESPONSE*
1. The WTO is being used by corporations to dismantle hard-won environmental protections, which are attacked as "barriers to trade." In 1993, the very first WTO panel ruled that a provision of the U.S. Clean Air Act, requiring both domestic and foreign producers alike to produce cleaner gasoline, was illegal.	1. The WTO panel ruled in 1996. It did not rule that the U.S. Clean Air Act was illegal. It ruled that the act should be applied equally to domestic and foreign producers alike, and should not be more lenient towards domestic producers.

Continued

2. Recently, the WTO declared illegal a provision of the Endangered Species Act that requires shrimp sold in the United States to be caught with an inexpensive device allowing endangered sea turtles to escape.	2. The "shrimp-turtle" panel and the appeals body stated clearly that the United States can pursue the protection of endangered turtles. They did not rule that the provision of the Endangered Species Act is illegal. They ruled, among other things, that the U.S. government was discriminating against Asian suppliers and in favor of Caribbean suppliers.

THE WTO IS KILLING PEOPLE

GLOBAL EXCHANGE CRITICISM	*THE WTO RESPONSE*
1. The WTO's fierce defense of intellectual property rights—patents, copyrights, and trademarks—comes at the expense of health and human lives.	1. The need to protect health and human life is built into the WTO agreement on intellectual property rights.
2. The organization's support for pharmaceutical companies against governments seeking to protect their people's health has had serious implications for places like sub-Saharan Africa, where 80 percent of the world's new AIDS cases are found.	2. The WTO cannot support pharmaceutical companies against governments because the WTO is run only by governments, and decisions in favor of or against a member government are reached only by consensus among those governments.

THE WTO UNDERMINES NATIONAL SOVEREIGNTY

GLOBAL EXCHANGE CRITICISM	*THE WTO RESPONSE*
1. By creating a supranational court system that has the power to levy big fines on countries to force them to comply with its rulings, the WTO has essentially replaced national governments with an unaccountable, corporate-backed government.	1. The WTO dispute settlement system's rulings are based on agreements that all parties in a dispute have agreed to. The sanctions are not imposed by the WTO, but by the country winning the case.
2. For the past nine years, the European Union has banned beef raised with artificial growth hormones. The WTO recently ruled that this public health law is a barrier to trade and should be abolished. The EU has to roll back its public health protections or pay stiff penalties.	2. The WTO did not say the law should be abolished. The ruling said the ban (not the law) violated WTO agreements that the EU itself negotiated and signed. The EU had the option of providing sufficient evidence of health risk to support the ban, or removing the ban. It chose to supply the evidence, but within the agreed time-limit it was unable to do so and U.S. sanctions were imposed. The EU still says it will supply the evidence. Meanwhile, the ban has not been lifted. No one has been forced to do anything.

Continued

3. Under the WTO, governments can no longer act in the public interest.	3. This is completely false. The agreements include countless provisions allowing governments to take public interest into account. The agreements are also the result of negotiations in which all governments pursued what they saw as the interests of their public. If their view of public interest changes, they are completely free to seek to amend the agreements.

International Monetary Fund, efforts to link international trade to the environment and to labor standards, and proposals to safeguard the rights of indigenous peoples and achieve gender equality. What binds the many organizations and individuals that count themselves among this antiglobalization movement is opposition to a global economy that they believe prioritizes corporate and commercial interests over other concerns. As one scholar has written, "there is . . . an overarching umbrella uniting the backlash: opposition to corporate control of the global economy" (Broad 2002, 3). Here we look at two issues that have been at the center of the backlash against the international trade system: the relationship between trade and labor; the relationship between trade and the environment.

Labor unions and the WTO. Labor unions in the United States and Western Europe have been highly critical of globalization. Unions have argued that globalization has had three negative consequences for people employed in manufacturing industries in the advanced industrialized countries. First, labor unions argue that globalization eliminates high-paying manufacturing jobs. For example, a study by the Economic Policy Institute, a think tank with links to American labor unions, estimates that trade between the United States and the rest of the world has eliminated as many as 1.9 million "actual and potential" manufacturing jobs in the American economy (Scott 2001). And even though the American economy created more jobs during the 1990s than were lost, labor unions argue that the high-paying manufacturing jobs that have been lost to globalization have been replaced by jobs in the service sector (Public Citizen 1998). Critics of globalization assert that these jobs pay substantially lower wages than the manufacturing jobs that are lost. According to one study, workers who lose their jobs to import competition find new jobs that pay, on average, 13 percent less than the jobs they have lost (Mishel et al. 2001, 24).

Second, labor groups argue that globalization places downward pressure on wages among those workers that retain manufacturing jobs. The deepening of globalization since the late 1970s has been paralleled by a widening income gap between low- and high-skill workers. In the United States, high-skill workers (traditionally defined as workers who hold a college degree) earned about 50 percent more than low-skill workers (traditionally defined as workers with no more than a high school education) in the late 1970s. This gap has since widened substantially, so that by 1996, high-skill workers were earning 70 percent more than low-skill workers (Scheve and Slaugher 2001). Many people have concluded that because globalization and the widening income disparity have occurred simultaneously, the former must be the cause of the latter. Downward pressures are particularly evident in wage negotiations, the AFL-CIO and others argue, when corporations can threaten to shut down a plant and move jobs to

Mexico or Asia unless workers moderate their wage demands (Destler and Balint 1998, 17). Labor unions report that such practices are widespread, as does some broader evidence. A survey conducted by the Wall Street Journal in 1992, for example, found that about one-quarter of 500 American corporate executives said that they would be "willing" or "somewhat willing" to use the threat to move to Mexico as a bargaining chip in wage negotiations (Tonelson 2000, 47). In addition, greater international competition has forced American firms to cut costs to remain competitive, and one way they have responded is by slowing the growth of their labor costs.

Third, labor organizations argue that globalization weakens labor unions and undermines labor standards in the advanced industrialized countries. Some studies have reported that American corporations regularly use the threat of moving production overseas to stem union organizing drives in their factories in the United States (Bronfenbrenner 1997). In addition, corporations operating in developing countries are outside the reach of American labor regulations. Consequently, they have the opportunity to "exploit workers with impunity in ways that U.S. laws would not permit" (Destler and Balint 1998, 17). The savings provided by low wages, long hours, and unsafe working conditions in developing countries in turn provide an unfair advantage in global markets to which advanced industrialized countries must respond by relaxing labor regulations at home. The result is a race to the bottom dynamic in labor standards. The AFL-CIO nicely summarizes what it believes to be globalization's impact on labor: the main consequence of globalization "has been to strengthen the clout and bargaining power of multinational corporations, to limit the scope of governments to regulate in the public interest, and to force workers into more direct competition with each other—reinforcing the downward pressure on their living standards, while assuring them fewer rights and protections" (2001).

In response to these concerns, organized labor has pursued a reform agenda that contains both negative and positive components. The negative aspect focuses on preventing further trade liberalization (Destler and Balint 1999). In the United States, the AFL-CIO has been one the most vocal critics of the NAFTA and one of the most strident opponents of further liberalization within the WTO and of the proposed Free Trade Area of the Americas. Labor's positive agenda focuses on linking a set of core labor standards to trade in the WTO and in regional trading arrangements. These core labor standards include the freedom of association, the right to collective bargaining, the abolition of forced labor, prevention of discrimination in employment, and a minimum age for employment (see Table 2.9). The International Confederation of Free Trade Unions (ICFTU), which represents 127 million workers in 136 countries, has led the push to incorporate labor standards into the WTO. The International Labor Organization (ILO) has already adopted many of the labor standards advocated by labor unions in the 1998 Declaration on Fundamental Principles and Rights at Work. The central weakness of the ILO, according to the ICFTU, is the lack of an enforcement mechanism. "The ILO's conventions protecting against unacceptable working conditions are voluntary. Even when governments accept particular conventions, there is no sanction to guarantee adherence. It keeps the profile of workers' issues on the agenda, but has no teeth to protect workers" (O'Brien et al. 2000, 77). Thus, the effort to bring core labor standards into the WTO arises in part from a desire to use the WTO's dispute settlement mechanism, and its threat of trade sanctions, to enforce global compliance with core labor standards (O'Brien 2000, 87–88).

Table 2.9
Core Labor Standards

Freedom of Association and Protection of the Right to Organize, 1948 (No. 87)

Article 2: Workers and employers, without distinction whatsoever, shall have the right to establish and, subject only to the rules of the organisation concerned, to join organisations of their own choosing without previous authorisation.

Article 3: Workers' and employers' organisations shall have the right to draw up their constitutions and rules, to elect their representatives in full freedom, to organize their administration and activities and to formulate their programmes.

Right to Organize and Collective Bargaining Convention, 1949 (No. 98)

Article 1

1. Workers shall enjoy adequate protection against acts of anti-union discrimination in respect of their employment.
2. Such protection shall apply more particularly in respect of acts calculated to—

(a) make the employment of a worker subject to the condition that he shall not join a union or shall relinquish trade union membership;

(b) cause the dismissal of or otherwise prejudice a worker by reason of union membership or because of participation in union activities outside working hours or, with the consent of the employer, within working hours.

Article 2

1. Workers' and employers' organisations shall enjoy adequate protection against any acts of interference by each other or each other's agents or members in their establishment, functioning or administration.
2. In particular, acts which are designed to promote the establishment of workers' organisations under the domination of employers or employers' organisations, or to support workers' organisations by financial or other means, with the object of placing such organisations under the control of employers or employers' organisations, shall be deemed to constitute acts of interference within the meaning of this Article.

Article 4

Measures appropriate to national conditions shall be taken, where necessary, to encourage and promote the full development and utilisation of machinery for voluntary negotiation between employers or employers' organisations and workers' organisations, with a view to the regulation of terms and conditions of employment by means of collective agreements.

Forced Labour Convention, 1930 (No. 29)

Article 1

Each Member of the International Labour Organisation which ratifies this Convention undertakes to suppress the use of forced or compulsory labour in all its forms within the shortest possible period.

Article 2

For the purposes of this Convention the term forced or compulsory labour shall mean all work or service which is exacted from any person under the menace of any penalty and for which the said person has not offered himself voluntarily.

Abolition of Forced Labour Convention, 1957 (No. 105)

Article 1

Each Member of the International Labour Organisation which ratifies this Convention undertakes to suppress and not to make use of any form of forced or compulsory labour—

continued

(a) as a means of political coercion or education or as a punishment for holding or expressing political views or views ideologically opposed to the established political, social or economic system;

(b) as a method of mobilising and using labour for purposes of economic development;

(c) as a means of labour discipline;

(d) as a punishment for having participated in strikes;

(e) as a means of racial, social, national or religious discrimination.

Equal Remuneration Convention, 1951 (No. 100)

Article 2

Each Member shall, by means appropriate to the methods in operation for determining rates of remuneration, promote and, in so far as is consistent with such methods, ensure the application to all workers of the principle of equal remuneration for men and women workers for work of equal value.

Minimum Age Convention, 1973 (No. 138)

Article 1

Each Member for which this Convention is in force undertakes to pursue a national policy designed to ensure the effective abolition of child labour and to raise progressively the minimum age for admission to employment or work to a level consistent with the fullest physical and mental development of young persons.

Source: International Labor Organization.
http://www.ilo.org/public/english/standards/norm/whatare/fundam/index.htm

American labor unions have been pursuing identical objectives for the Free Trade Area of the Americas. The AFL-CIO did not support the NAFTA, and in an attempt to gain their support the Clinton Administration incorporated a labor side agreement into the trade agreement. The North American Agreement on Labor Cooperation (NAALC) was created to provide trade adjustment assistance and the Commission for Labor Cooperation was created to investigate complaints about the treatment of labor in the member countries. American labor unions have been extremely disappointed with the operation of the NAALC. Concerned that the FTAA is being modeled too closely on the NAFTA, the AFL-CIO is seeking to push negotiations on to what they call a "new progressive model" of trade policy. This "progressive model" includes enforceable workers' rights, the protection of migrant workers, the ability to protect producers against import surges, and a "transparent, inclusive, and democratic process" for the negotiation and implementation of the agreement (AFL-CIO 2001). Thus, in both the multilateral trade system and regional free trade agreements, organized labor in the advanced industrialized world is attempting to link labor standards to trade liberalization.

Organized labor's efforts to link trade to core labor standards in the WTO and in regional trade arrangements have been criticized. Some opponents of the linkage between labor standards and international trade assert that globalization has not been the most important cause of the slow wage growth in the advanced industrialized countries. We will defer considering the causes of the widening income disparities until Chapters 3 and 5. Here we can note that low-skill workers have lost jobs and are facing lower wages as a result of globalization. However, it appears that globalization has not been the most important cause of the widening income gap. Most evidence suggests that domestic technological change has been far more important. Technological change allows businesses

to use technology to perform many of the tasks that used to be performed by low-skill workers. Think, for example, of the increased use of computerized robotics in many manufacturing industries, or the prominence of cash machines in the American economy. In both cases, jobs previously performed by people (basic assembly operations and bank tellers) are now performed by computerized machines. As a result, the demand for low-skill labor in the United States and other advanced industrialized countries has fallen, and falling demand has been associated with falling wages (see Graham 2000).

Many developing countries' governments also have criticized organized labor's effort to bring labor standards into the WTO. Many of these governments see the proposed linkage between labor standards and trade as simple protectionism. As Martin Khor, the director of the Third World Network and a prominent critic of many other aspects of globalization, has argued, "developing countries fear that the objectives of the northern and the international trade unions, and of the developed country governments that back [the push for core labor standards] are mainly protectionist in nature, that they want to protect jobs in the North by reducing the low-cost incentive that attracts global corporations to the developing countries" (Khor 1999). Developing countries' governments argue that the low wages paid to workers in their countries should not be viewed as a form of "exploitation," but is instead a result of the low standard of living in developing countries. In other words, low wages represent the legitimate comparative advantage held by developing countries. Linking trade to core labor standards within the WTO would enable advanced industrialized countries to adopt trade restrictions against developing countries if the WTO dispute settlement mechanism found them to be failing to comply with these core standards. Such a result would, in effect, punish developing countries for capitalizing on their comparative advantage.

It is unlikely that labor standards will be brought into the WTO anytime in the near future, in large part because of resistance from developing countries. Whether labor issues should be brought into the WTO was considered and decided in the WTO's First Ministerial Conference, held in Singapore in December 1996 (see O'Brien et al. 2002, 82–92). Largely as a result of developing country pressure, the conference concluded that "the International Labor Organization is the competent body to set and deal with [labor] standards . . . We reject the use of labour standards for protectionist purposes, and agree that the comparative advantage of countries, particularly low-wage developing countries, must in no way be put into question." When the Clinton Administration attempted to bring labor into the WTO once more at the Seattle Ministerial Conference in December 1999 by proposing the creation of a WTO working group on labor, developing countries governments refused. In fact, at Seattle the developing countries refused to consent to any agenda for the current round of trade negotiations that included labor standards. It was this refusal, in conjunction with Clinton's insistence of the inclusion of labor standards on the agenda, that caused the Seattle Ministerial Conference to fail to produce an agenda for negotiations. Consequently, the November 2001 "Doha Declaration," which established the agenda for the current WTO negotiations, says only, "We reaffirm our declaration made at the Singapore Ministerial Conference regarding internationally recognized core labour standards. We take note of work under way in the International Labour Organization (ILO) on the social dimension of globalization." The relationship between trade and labor, as well as the proper forum within which to examine this relationship, will remain controversial topics.

The environmental movement and the WTO. Environmental nongovernmental organizations, or ENGOs, argue that the multilateral trade system hampers governments' efforts to protect the environment. Some ENGOs claim that liberal international trade and environmental protection are inherently incompatible. Trade encourages economic growth, and economic growth generates greater demand for resources, more consumption, and higher levels of pollution. For these ENGOs, the only way to safeguard the environment is to roll back globalization (see Destler and Balint 1999; Esty 1994). Most ENGOs are not inherently opposed to trade, however, but do believe that the multilateral trade system undermines environmental regulations. Environmental groups argue that regulations are undermined in part by a "race to the bottom" competitive dynamic. Developing countries typically maintain less stringent environmental regulations than the advanced industrialized countries. As a consequence, environmental groups argue, corporations move production out of heavily regulated countries and into the less regulated developing countries in order to escape the cost of regulation. The problem is not simply that corporations shift their operations to countries with lax environmental standards—governments in the advanced industrialized countries must attract and maintain corporations, and to do so they must relax environmental regulations. As a consequence, environmental regulations established in the advanced industrialized countries during the last 30 years are being weakened. While a compelling argument, there is little systematic evidence that corporations have been shifting production to developing countries in order to escape stringent environmental regulations in the advanced industrialized countries. The cost of complying with environmental regulations is usually too small to induce a firm to shift production to "pollution havens" in the developing world (see Anderson 1999; Low 1992).

More problematic is the recognition that international trade rules can make it difficult for governments to use national and international regulations to achieve environmental objectives. To understand why, we need first to look closely at a few specific GATT rules. We can then examine how these rules can complicate governments' efforts to use environmental regulations. GATT Articles I and III require governments to accord equal treatment to "like products," regardless of where they are produced. Historically, the main criterion for determining whether two goods are like products has been their commercial substitutability. That is, can the two products be substituted for each other in the market? Consider, for example, two memory chips produced by different manufacturers. Suppose that both memory chips contain the same amount of memory, that both are produced to the same technical standards, and that both can be placed into a memory expansion slot in a personal computer. Under the market substitutability test, therefore, the two memory chips are like products. Environmental groups argue that market substitutability is an inadequate test for determining like products, and would like to see the criteria for doing so extended to include process and production methods. **Process and production methods,** or **PPMs,** refer to the precise way in which a product is made. Different production processes can have vastly different environmental consequences. In the semiconductor industry, for example, the manufacturing process has relied heavily upon chemicals that contribute to the depletion of the earth's ozone layer. While governments in many countries have forced firms to phase out the use of such ozone depleting chemicals, governments in some countries have not. Suppose that one of the two memory chips in our example is produced through a process that relies on

ozone-depleting substances, while the other does not. Is it right to consider these two chips as like products, even though one production process is more environmentally friendly than the other? Environmental groups argue that it is not right, and therefore that PPMs should be taken into account when determining whether two goods are like products. If the WTO would do so, then governments could discriminate against goods produced with PPMs that harm the environment.

WTO rules allow governments sometimes to take PPMs into account when deciding whether or not two goods are like products. Trade law distinguishes between two kinds of PPMs: product-related PPMs and non-product-related PPMs. A **product-related PPM** arises when distinct production methods produce similar goods that are not substitutes in the market. Consider, for example, two apples, one grown organically without the use of pesticides, and one grown conventionally with the use of pesticides (United Nations Environment Program 2000, 42). Although both products are apples, customs agents in an importing country and consumers will probably treat these two apples differently. Customs agents will try to evaluate how much pesticide remains on the skin of the conventionally grown apple, and they will try to evaluate whether the organically grown apple contains insects or other pests that could be brought into the country. Consumers may peel the skin off the conventionally grown apple, but eat the skin on the organic apple. Thus, the different PPMs result in very different apples that will be treated very differently. WTO rules allow governments to discriminate between these two kinds of apples. The Japanese government, for example, could allow the import of conventionally grown apples from the United States but restrict the import of organically grown apples from Australia without violating the MFN clause of the GATT. Alternatively, it could allow Japanese farmers to grow organic apples but prohibit the import of organic apples without violating the national treatment clause of the GATT. In contrast, a **non-product-related PPM** arises when different production methods do not affect the characteristics of the final good. Our earlier example of the two semiconductor chips is one example of a non-product-related PPM. Or consider as another example two rolls of newsprint, one produced from 100 percent virgin fiber and one produced from 50 percent recycled fiber. While these are very different PPMs, as long as the two rolls of newsprint are essentially the same (perhaps a newspaper printed on one is indistinguishable from a newspaper printed on the other), then the two are considered like products (United Nations Environment Program 2000, 42). As such, a government cannot discriminate against the 100 percent virgin fiber in favor of the paper with 50 percent recycled content.

These rules can limit the ability of a government to use national regulations in order to achieve an environmental objective. Two recent trade disputes involving American environmental regulations help illustrate how they can do so. The first case involved an American decision to ban imports of tuna from Mexico, Venezuela, and Vanuatu. This dispute arose because United States regulations required the American tuna fleet to reduce the number of dolphins killed during tuna fishing. As a consequence, between 1960 and 1990 the number of dolphins killed by the American tuna fleet fell by 90 percent from a high of about 500,000 per year (Vogel 2000, 353). Fishing fleets based in Mexico, Venezuela, and Vanuatu continued to kill dolphins at a much higher rate, however, and much of the tuna caught by these fleets was exported to the American market. The United States then banned tuna imports from these countries, hoping that the ban would encourage these governments to adopt regulations to protect dolphins. The Mexican government filed a complaint with the GATT, arguing that the U.S. trade restriction represented a non-product-related PPM. The United States was prohibiting the import of a like product (tuna imported from Mexico was identical to tuna caught by the American fleet) because of the production process used in Mexico. The GATT dispute panel ruled in favor of Mexico, stating that while a country could impose whatever regulation it wanted within its own borders (as long as the regulation did not discriminate between domestic and foreign producers), it could not attempt to regulate the production methods used in other countries. Thus, the United States could not attempt to regulate how the Mexican fleet harvested tuna, and it could not make access to the American market contingent upon the adoption of dolphin-friendly techniques. Environmental groups claimed that this case reflected an antienvironment bias at the center of the GATT. As the Sierra Club stated, "Meeting in a closed room in Geneva . . . three unelected trade experts . . . conspired to kill flipper" (Vogel 2000, 353).

The second case involved the use of turtle excluding devices, known as TEDs, on shrimp nets. This dispute originated in a law passed by the U.S. Congress in 1989 that required American shrimpers to use TEDs to prevent sea turtles from becoming entangled in shrimp nets. The United States then extended this regulation to foreign shrimpers in 1995. As a result, shrimp harvested in countries that did not require TEDs could not be sold in the United States. As in the tuna-dolphin case, the United States was restricting imports based on a non-product-related PPM. In October 1996, India, Pakistan, Malaysia, and Thailand, all of which were affected by the American regulation, initiated a dispute within the WTO. These governments argued that GATT rules prohibit the United States from restricting access to the U.S. market simply because their fleets used a different method to harvest shrimp. The initial WTO dispute panel ruled against the United States, as did the appellate body when the United States appealed. Some environmental groups argued that the decision in this case, like the decision in the previous tuna-dolphin case, reflects a willingness by the WTO to overturn environmental regulations in order to promote international trade. Charles Clarke of the World Wildlife Fund stated that the decision "denies individual countries the right to restrict trade even when species, in this case sea turtles, are endangered and the complainant countries have signed international environmental agreements to protect them" (Zaracostas 1998).

While these two decisions seem to indicate that WTO rules are antienvironment, the GATT does explicitly allow governments to restrict trade in order to achieve environmental objectives. GATT Article XX(b) allows governments to restrict trade when doing so is "necessary to protect human, animal, or plant life or health. Article XX(g) allows governments to use trade restrictions "relating to the conservation of exhaustible natural resources. . . ." The United States invoked Article XX(g) in the TEDs case, arguing that its ban on imported shrimp was legal because it represented an attempt to conserve an exhaustible natural resource. Moreover, the WTO Appellate Panel agreed with the American position, arguing that governments could use non-product-related PPMs as a justification for restricting trade in order to achieve an environmental objective. However, governments cannot restrict trade in any fashion. Instead, trade restrictions imposed under Article XX(b) and (g) must meet the conditions spelled out in the article's introductory paragraph (known as the *chapeau*). This paragraph states that trade restrictions

adopted under Article XX cannot be "applied in a manner which would constitute a means of arbitrary and unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade . . ." In other words, even when restricting trade to protect the environment governments must adhere to the principle of nondiscrimination. The chapeau was the critical factor in the Appellate Panel's decision in the TEDs case. The Appellate Panel ruled that even though the trade restriction was consistent with Article XX, the way the United States had applied it was not. The United States provided Caribbean nations with financial and technical assistance, as well as an extended transition period to help shrimpers in these countries adopt TEDs. The United States provided no such assistance to the Asian countries. As such, the U.S. ban discriminated between WTO members. For this reason, the U.S. trade restriction was found to be inconsistent with WTO rules.

While it is hard to characterize WTO rules as strongly pro-environment, one does see an emerging sensitivity by the WTO to the need to accommodate governments' environmental goals when interpreting trade rules. In addition, in 1995 the WTO created a **Committee on Trade and the Environment** (CTE). The CTE's mandate is "to identify the relationship between trade measures and environmental measures in order to promote sustainable development" and "to make appropriate recommendations on whether any modifications of the provisions of the multilateral trading system are required, compatible with the open, equitable and nondiscriminatory nature of the system." Since its creation, the CTE has examined a number of issues, including the relationship between the WTO and international environmental agreements, the feasibility of requiring environmental evaluations of trade agreements, the environmental impact of production subsidies, particularly in agricultural production and energy use, and other issues. NGOs argue that these steps do not do enough to balance trade and the environment. Environmental groups have pressed for increased openness and accountability in the WTO decision-making process. They want the WTO to collaborate with environmental institutions such as the United Nations Environment Program, the United Nations Development Program, and the secretariats of multilateral environmental agreements (see e.g., Coalition Report to the World Trade Organization 1999). ENGOs would also like to participate in the WTO decision-making process, including the dispute settlement mechanism.

ENGOs have also pressured governments to reconcile international trade rules with multilateral environmental agreements. A **multilateral environmental agreement** (MEA) is an international agreement between three or more governments dedicated to the achievement of a specific environmental objective (see Table 2.10). Potential conflict between MEAs and international trade rules arises because several MEAs contain trade restrictions that may violate WTO rules. Some MEAs encourage governments to restrict trade with nonmembers, thereby potentially violating the WTO's most-favored-nation clause. Other MEAs encourage governments to adopt different standards toward domestic and imported goods, thereby potentially violating the WTO's rule of national treatment. Many call upon governments to use trade sanctions to enforce the agreement, thereby raising the possibility of a violation of the most favored nation clause. The Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES), for example, requires signatory governments to prohibit or restrict trade in endangered species. Suppose a government belongs to the

Table 2.10
Multilateral Environmental Agreements

More than 200 MEAs have been signed to date. Only 20 MEAs regulate trade or contain trade provisions. Here are three of these agreements, the trade provisions contained in each, and the potential conflict with GATT rules.

Agreement	Trade Provisions
Convention for the Protection of the Ozone Layer (Montreal Protocol)	• Requires governments to apply stricter trade provisions to non-parties than to parties in potential conflict with Article I. • Regulates PPMs in potential conflict with Article III. • Allows trade sanctions to enforce the agreement, in potential violation of GATT Article I.
Convention on International Trade in Endangered Species of Wild Fauna and Flora	• Requires governments to apply stricter trade provisions to non-parties than to parties in potential conflict with Article I. • Requires licensing arrangements in potential conflict with GATT Article XI. • Allows trade sanctions to enforce the agreement in potential violation of GATT Article I.
Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal (Basel Convention)	• Requires governments to apply stricter trade provisions to non-parties than to parties in potential conflict with Article I. • Requires licensing arrangements in potential conflict with GATT Article XI. • Allows trade sanctions to enforce the agreement in potential violation of GATT Article I.

WTO but has not signed the CITES. Suppose further that producers in this country export products made in part from an endangered species or made through a process that kills the endangered species. Unable to export these goods to a WTO member country that has signed the CITES, the government in the exporting country might then initiate a dispute in the WTO. WTO rules might then require a lifting of the import ban enacted under CITES. Many ENGOs argue that to prevent such outcomes, any trade restriction applied in connection with an MEA should be fully consistent with WTO rules and beyond review by WTO dispute panels (see e.g. World Wildlife Fund 1999). It should be stressed, however, that to date not a single WTO dispute has been based on trade provisions contained in an MEA.

In short, the relationship between trade, trade rules, and the environment raises a complex set of issues that have moved towards the center of the discussion about the international trade system during the last 15 years. These issues will be the subject of continued controversy and ongoing negotiations within the international trade system.

More broadly, the antiglobalization movement appears to be tapping into wider public concern about the consequences of globalization. The American public is uneasy about American participation in the global economy. Public opinion polls tracking the

attitudes of American citizens toward international trade regularly indicate that a majority of Americans worry that international trade is eliminating jobs and lowering wages in the United States. For example, a May 1999 poll found that 52 percent of those interviewed believed that trade would "hurt the average American because businesses will rely more on cheap labor from other countries and U.S. jobs will be lost" (Scheve and Slaughter 2001, 22). Moreover, in one poll conducted every year since 1982, two-thirds of the respondents regularly prefer a protectionist trade policy that protects jobs to a liberal trade policy that allows for greater consumer benefits (Scheve and Slaughter 2001, 23). Eroding public support for the multilateral trade system among the voting public must eventually translate into diminished support for the system by democratically elected governments in the United States, Europe, and Japan. This apparent erosion of public support represents the largest challenge to the contemporary system.

Conclusion

The historically unprecedented growth of international trade since World War II has occurred as a result of the interaction between power, interests, and international institutions. Hegemonic power played a critical role in the creation of the postwar trade system. The dominant position of the United States following the Second World War created a strong American interest in an open and nondiscriminatory international trade system. Under U.S. leadership, the advanced industrialized countries created a multilateral trade system centered upon the GATT to promote trade liberalization. This institutional framework helped governments solve the enforcement problem at the center of international politics and by doing so enabled governments to engage in repeated rounds of trade negotiations. Governments have used these negotiations to progressively reduce barriers to trade in manufactured goods and to create new rules governing other aspects of international economic activity, including trade in services and intellectual property rights. And even though American interests have changed as a result of its diminished hegemony, this institutional framework continues to enjoy strong support from the world's largest trading nations.

The growth of international trade made possible by the multilateral trade system has transformed national economies and the global economy. The elimination of barriers to trade promoted the progressive development of a global division of labor and a tightly integrated network of economic relationships among the United States, the EU, Japan, and the Asian and Latin American NICs. Economic production is increasingly being broken down into its distinct components and distributed across the world according to the logic of comparative advantage. The emergence of a global division of labor is necessarily disruptive to the societies experiencing these changes, particularly in the advanced industrialized countries where high-paying, low-, and semi-skilled manufacturing jobs are shifting to Asia and Latin America. This economic disruption has in turn generated a backlash against globalization. Critics of globalization question the priority accorded to economic interests over other interests such as the environment and workers' rights, and they claim that the WTO is undermining democracy. While such claims may be exaggerated, they do suggest that there are clear limits to societal support for an international economic system that continually threatens established social arrangements. Only time will tell whether and how the multilateral trade system will be transformed by this opposition.

Key Terms

Absolute Advantage
Antidumping
Committee on Trade and the Environment
Common Agricultural Policy (CAP)
Comparative Advantage
Countervailing Duty
Customs Union
Dispute Settlement Mechanism
Domestic Safeguards
Enforcement Problem
Factor Endowments
Free Trade Area
General Agreement on Tariffs and Trade (GATT)
Global Division of Labor
Globalization
Hecksher-Ohlin Model
Hegemony
Industrial Policy
Intellectual Property
International Trade Organization (ITO)
Iterated Prisoners' Dilemma
Market-Based Liberalism
Multilateral Environmental Agreement (MEA)
Nash Equilibrium
New Protectionism
Nondiscrimination/Most Favored Nation
Non-product-related PPM
Nontariff Barriers
Pareto Sub-Optimal
Prisoners' Dilemma
Process and Production Methods (PPMs)
Product-Related PPM
Reciprocal Trade Agreements Act
Reciprocity
Regional Trading Arrangements (RTAs)
Service
Tariffs
Tit-for-Tat
Trade Openness
Transparency
Voluntary Export Restraints
World Trade Organization (WTO)

Web Links

You can visit the World Trade Organization at *http://www.WTO.org*.

The EU maintains a website dedicated to its trade policy at *http://europa.eu.int/comm/trade/*.

Japan maintains websites dedicated to international trade at The Ministry of Foreign Affairs: *http://www.mofa.go.jp/policy/economy/wto/index.html*.

Ministry of Economy, Trade, and Industry (METI): *http://www.meti.go.jp/english/index.html*.

The United States Trade Representative maintains websites dedicated to the WTO and other multilateral trade at *http://www.ustr.gov/wto/index.shtml*.

Government information on NAFTA can be found at the following sites:

Canada: *http://www.dfait-maeci.gc.ca/nafta-alena/menu-e.asp*.
Mexico: *http://www.naftaworks.org/*. This site is maintained by the Mexican embassy in Washington, D.C.
The United States: *http://www.ustr.gov/regions/whemisphere/nafta.shtml*.

A critical perspective on the WTO, NAFTA, and globalization more generally can be found at The Global Trade Watch homepage: *http://www.citizen.org/trade/*.

The International Labor Organization is a good source of information about international labor standards: *http://www.ilo.org/public/english/standards/norm/whatare/index.htm*.

The Exchange Between the WTO and Global Exchange can be found at the two following sites:

Global Exchange Criticisms:
http://www.globalexchange.org/economy/rulemakers/topTenReasons.html.

The World Trade Organization's Response:
http://www.wto.org/english/thewto_e/minist_e/ min99_e/english/misinf_e/01multi_e.htm.

Suggestions for Further Reading

For a readable historical account of the development of the theory of comparative advantage and of those theories that have challenged the central claim of this theory see Douglas Irwin, *Against the Tide: an Intellectual History of Free Trade* (Princeton: Princeton University Press, 1996). For an approach that emphasizes the intuition of the theory of comparative advantage and downplays explicit theory see Russell D. Roberts, *The Choice: A Fable of Free Trade and Protectionism* (Upper Saddle River, NJ: Prentice Hall, 1994).

For a detailed discussion of the origins and development of the rules governing international trade see John H. Jackson, *The World Trading System: Law and Policy of International Economic Relations* (Cambridge: MIT Press, 1997)

Unfortunately, there is no single book that provides a good overview of the GATT bargaining rounds. Detailed treatments of the political dynamics of the last three rounds of negotiations can be found in Ernest H. Preeg, *Traders and Diplomats: An Analysis of the Kennedy Round of Negotiations under the General Agreement on Tariffs and Trade* (Washington, D.C.: the Brookings Institution, 1995); Gilbert R. Winham, *International Trade and the Tokyo Round Negotiation* (Princeton: Princeton University Press, 1986); and Ernest H. Preeg, *Traders in a Brave New World: The Uruguay Round and the Future of the International Trading System* (Chicago: University of Chicago Press, 1995).

The most elaborate and detailed critique of the World Trade Organization has been written by Lori Wallach and Michelle Sforza, *Whose Trade Organization? Corporate Globalization and the Erosion of Democracy* (Washington, D.C.: Public Citizen, 2000). A more academic account of the emergence of the antiglobalization movement can be found in Susan A. Aaronson, *Taking Trade to the Streets: The Lost History of Public Efforts to Shape Globalization* (Ann Arbor: University of Michigan Press, 2001).

CHAPTER 3

The Domestic Politics of Trade Policy

Governments in the advanced industrialized countries have progressively opened their markets to imports through the multilateral trade system. Yet, even as tariffs have fallen these same governments have continued to protect specific domestic producers from foreign competition. While the United States, the European Union, and Japan were negotiating tariff reductions through the Uruguay Round, for example, the United States and the European Union were also negotiating bilateral agreements with Japan to limit the number of automobiles Japanese producers could export to the American and European markets. The contrast between multilateral trade liberalization on the one hand and unilateral or negotiated protection on the other is not unique to the auto sector. Indeed, throughout the past 30 years industrialized governments have simultaneously pushed for multilateral tariff reductions that open domestic markets to imports and for unilateral, bilateral, and multilateral measures that protect specific domestic producers from foreign competition. This chapter explores the domestic politics of trade policy to understand why governments have combined liberalization with protection.

Our exploration of domestic trade politics is organized around three central questions. First, to what extent and in what industries do governments in the advanced industrialized countries continue to rely on protection? As we will see, the pattern of liberalization and protection is not random. Advanced industrialized countries have been most willing to liberalize trade in capital-intensive manufacturing, and least willing to liberalize trade in labor-intensive manufacturing, in agriculture, and in high-technology industries. Second, what are the economic consequences of this protection? Standard economic theory suggests that in most instances protection reduces national welfare. More recent studies suggest that protection under certain circumstances can raise national welfare in high technology industries. Finally, how do we explain the pattern of protection and liberalization that we observe? Why have governments in the advanced industrialized countries been willing to liberalize trade in capital intensive manufacturing, but unwilling to do so in the other sectors? Answering this question requires us to focus on how interests and institutions shape the domestic politics of trade policy.

This chapter presents two different approaches to the domestic politics of trade policy. A society-centered approach asserts that patterns of protection and liberalization reflect politicians' responses to the demands made by domestic interest groups. A state-centered approach asserts that these patterns reflect efforts by autonomous states to enhance the nation's position in the international system. While the two approaches are often seen as alternative explanations, this chapter argues that the two fit together to help us make sense of different parts of the domestic politics of trade policy. The society-centered approach helps explain why governments in the advanced industrialized countries have been willing to liberalize trade in capital-intensive manufactured goods, but have been unwilling to liberalize trade in labor-intensive sectors and in agriculture. The state-centered approach helps explain why governments have intervened in their respective domestic economies to protect and promote high technology industries. Both approaches highlight how interests and institutions interact to shape trade policy.

Protection and its Consequences

We begin this chapter by taking a closer look at protectionism in the advanced industrialized countries. Two central questions guide us. First, we want to know whether it is possible to identify a common underlying pattern of liberalization and protectionism in the United States, in the EU, and in Japan. That is, even though these three political actors are different in many respects, do they maintain similar tariff structures? If so, can we identify a simple explanation that accounts for this similarity? In order to answer this question we look at which industries are heavily protected and which are not in each of the three economies and then highlight the commonalities that are apparent. Second, how does protectionism affect the creation and distribution of income within these societies? We explore this question using standard tariff analysis and evidence drawn from the United States.

The Structure of Protection in the Advanced Industrialized Countries

Governments in the advanced industrialized countries continue to use tariffs and nontariff barriers to protect some domestic producers from competition with cheaper imports. How much protection remains? Table 3.1 provides a summary of industrialized countries' tariff rates, calculated both by the currency value of imports and by the type of good imported. About one-third of all imports by value enter duty free, and more than 90 percent of all imports by value enter with tariff rates less than 10 percent. The picture changes somewhat when we shift from import value to import category, which

Table 3.1
MFN Tariff Rates in Advanced Industrialized Countries

	By Value	By Product Category
Duty Free	33%	14%
Low Tariffs (below 10%)	61%	68%
High Tariffs (above 10%)	6%	18%

Source: Finger and Olechowski 1987, 40.

A Closer Look

Trade Policy Instruments

Tariffs: A tariff is a tax imposed by the government on goods entering the country from abroad. This tax raises the price of the foreign good in the domestic market of the country imposing the tariff. While tariffs distort international trade, most economists believe that tariffs are the least distortionary of all trade barriers.

Quotas: A quota is a numerical cap that limits the number of goods that are imported. Because quotas restrict the number of foreign goods available for purchase in the domestic market below the amount demanded by domestic residents, they allow foreign producers to charge a higher price for each unit sold. This price difference is often called a quota rent. The GATT (Article XI) prohibits quotas.

Voluntary Export Restraints (VERs): VERs are quota-based forms of protection. They differ from quotas in two ways. First, they are created and administered by at least two countries—the importer and the exporter. Second, rather than the importing country imposing a quota on the number of foreign goods it will allow into the market (a practice that is illegal under the WTO), the exporting country limits the number of goods it exports to the importing country. Under an agreement reached during the Uruguay Round, all existing VERs were to be phased out, and new ones are prohibited.

Administered Protection: Administered protection refers most often to tariffs that are raised as a result of an administrative process initiated by a national government in response to two specific practices that are prohibited under the rules of the WTO.

Anti-Dumping: a government can raise tariffs to protect a domestic industry if it can prove that a foreign firm in the same industry is selling its goods at a price that is below "normal value." Normal value has traditionally been defined as the price the good sells for in the market of the exporting country. In such cases, the government can raise the tariff to offset the dumping margin.

Countervailing Duty: a government can raise the tariff to protect a domestic industry if it can prove that a foreign government has provided an export subsidy to one of its firms. What precisely constitutes an export subsidy remains a source of controversy in the multilateral trade system, with some governments arguing for a broad definition that includes production subsidies and others calling for a narrower definition that excludes such support. When an export subsidy is being used, the government in the importing country can raise tariffs to offset the subsidy.

In both cases, a higher tariff offsets the advantage gained through what have been generally recognized to be "unfair" trade practices. Before raising tariffs in response to dumping or subsidies, however, the national government must investigate whether dumping has occurred or an export subsidy has been provided. In addition, the government must determine that dumping or the subsidy has in fact injured domestic producers. Only then are they allowed to raise tariffs to counter the effects of these policies.

Nontariff Barriers (NTBs): Nontariff barriers cover a broad array of government policies and practices. Essentially, any barrier to trade that is not a tariff, such as a quota or a VER, fits into this category. Yet the term NTB is often used to describe government regulations and practices that create barriers to trade, either intentionally or accidentally. Health and safety regulations, environmental regulations, product standards, and government procurement practices, all of which can be enacted for public policy reasons can also restrict international trade. An EU policy banning imports of hormone-treated

Continued

beef, for example, while perhaps justifiable on the basis of public health concerns, also restricts the ability of American cattle ranchers that use such hormones to export to the EU market. NTBs also include practices that have obvious protectionist intentions. French policy once required that all factories producing pharmaceuticals for sale in France be inspected by French officials, yet the relevant French inspectors were not allowed to travel abroad (Jackson 1998, 383). This practice obviously restricted the ability of foreign pharmaceutical firms to sell their products in France. As quotas have been eliminated and tariffs reduced, these nontariff barriers have emerged as one of the most important remaining obstacles to international trade and have thus become an increasingly important issue in the WTO.

measures the type of good being imported. This alternative measure reveals that almost 20 percent of industries are protected by tariff rates above 10 percent, while just over 80 percent of industries are protected with tariffs of 10 percent or less. Thus, about 6 percent of industrialized country trade by value and almost 20 percent of industrialized country trade by category is protected by tariff rates greater than 10 percent. In general, therefore, while the tariffs that industrialized countries impose on imports from other WTO members are quite low, they have not been eliminated.

What industries continue to receive tariff protection and which have been more fully liberalized? Protection in the United States, the European Union (EU), and Japan tends to be concentrated in labor-intensive manufacturing industries, in agriculture, and in high-technology industries. Table 3.2 lists 11 of the most heavily protected American industries. With three exceptions, (ball bearings, frozen orange juice concentrate, and polyethylene resins), the production of each of these goods relies heavily on low-skill labor, a result that will take on particular significance when we discuss the politics of trade policy in the next section. A similar pattern of tariff protection is evident in the EU (Table 3.3). EU industries protected by tariffs higher than 10 percent include textiles and apparel, footwear, paper products, glassware, radio and television sets, motor vehicles, and microprocessors. EU high tariff sectors thus share some of the characteristics of American high-tariff sectors, namely that

Table 3.2
High Tariff Sectors in the United States

Product Category	Tariff Rate
Ball Bearings	11.0%
Canned Tuna	12.5%
Ceramic Articles	11.0%
Ceramic Tiles	19.0%
Frozen Concentrated Orange Juice	30.0%
Glassware	11.0%
Luggage	16.5%
Polyethylene Resins	12.0%
Rubber Footwear	20.0%
Womens' Footwear, except athletic	10.0%
Womens' Handbags	13.5%

Source: Hufbauer and Elliot 1994, 5.

Table 3.3
High Tariff Sectors in the European Union

Product Category	Tariff Rate
Apparel	14%
Footwear	20%
Textiles	25%
Paper Products	12.5%
Radio and Television Sets	15%
Electrical Machinery	15%
Motor Vehicles	22%
Glassware	12.5%

Source: WTO 1995.

many of these items are produced with low-skill labor. EU tariffs also protect one sector that we do not see in the American case, electrical machinery, with a particular focus on microprocessors. The United States and the EU have also protected domestic industries with voluntary export restraints and other nontariff barriers. These measures have been concentrated in agricultural products, in the labor-intensive textile and apparel industry, and in the steel and auto industries.

Japanese protection displays a pattern quite similar to what we see in the United States and the EU. In contrast to the United States and the EU, however, Japan relies little on tariffs to protect domestic industries. According to the WTO, only three Japanese manufacturing industries are protected with tariffs higher than 10 percent, and only 12 manufacturing sectors receive tariff-based protection between 5 and 10 percent. Most protection in Japan is provided through nontariff barriers to trade, and once these are taken into account the structure of Japanese protection looks very much like the structure we see in the EU (Sazanami et al. 1995). Agriculture is the most heavily protected sector in Japan, with NTBs providing protection equivalent to a tariff of 272.5 percent. Rice producers are shielded most heavily, receiving protection equivalent to a 737 percent tariff. Japan also protects labor-intensive manufacturing sectors, particularly in footwear and apparel (WTO 1998b; Sazanami et al. 1995). Finally, Japan protects a number of high technology industries, which on average receive nontariff forms of protection equivalent to tariffs of 140 percent. The most heavily protected high tech industries include telecommunications (tariff equivalent of 236.5%), semiconductors (tariff equivalent of 106.6%), and computers (tariff equivalent of 75.8%).

This brief survey suggests a fairly clear and common pattern of protectionism and liberalization across the advanced industrialized countries. Governments in the United States, the EU, and Japan, have been least willing to liberalize trade in labor-intensive manufacturing industries, in agriculture, and in high-technology industries. Textiles and apparel remain heavily protected in all three economies. In addition, agriculture is heavily protected in the EU and Japan, and, though somewhat less heavily, in the United States. Finally, EU governments and Japan have protected high-technology industries, particularly information technology industries, fairly heavily. Advanced industrialized country governments have been most willing to liberalize trade in capital-intensive manufacturing industries. With the important exceptions of steel and automobiles, capital-intensive industries are largely absent from our lists of heavily protected industries in the United States,

the EU, and Japan. In general, therefore, governments in advanced industrialized countries have liberalized trade most in industries in which their producers hold a comparative advantage—capital-intensive manufacturing—and have liberalized trade least in industries in which their producers are at a comparative disadvantage: labor-intensive manufacturing for all, and agriculture and some high-technology industries for the EU and Japan.

The Economic Consequences of Protection

What are the domestic economic consequences of such protection? Standard economic theory highlights two such consequences. Protection has *distributional consequences,* as it transfers income away from consumers to producers and the government. Protection also has *aggregate welfare consequences,* as it makes societies poorer than they would be in the absence of trade protection. We turn our attention to these consequences, looking first at the standard economic model of tariffs to understand how protection transfers income and reduces social welfare in theory. We then examine some evidence about the size of the transfers and welfare losses that result from trade protection in the United States.

The economic effects of tariffs. Standard tariff analysis is presented in a **comparative statics** framework. The analyst uses a simple supply and demand framework to describe the domestic market for a particular product in two different worlds, one in which the market is not protected by a tariff and one in which a tariff is applied. Comparing the two outcomes yields conclusions about the effect of the tariff on the economy. We adopt this approach here, comparing an open and a protected market in order to see how a tariff affects domestic production, domestic consumption, imports, and aggregate social welfare.

The domestic market for a single good is presented in Figure 3.1. While it does not matter what good we focus on, to make the discussion less abstract we will focus on the market for polo shirts, the kind sold by major retailers like The Gap. The horizontal axis in Figure 3.1 represents quantity, that is, the number of polo shirts demanded by domestic consumers and supplied by domestic apparel manufacturers. The vertical axis represents the price of polo shirts. The figure also provides demand and supply curves. The demand curve, the downward sloping line labeled d, tells us the total number of polo shirts that domestic consumers will want to buy at every price. This curve has a negative slope because consumers will want to buy more polo shirts as the price of these shirts falls. The supply curve, the upward sloping line labeled s, tells us the total number of polo shirts that domestic producers will want to supply at every price. The supply curve has a positive slope because domestic producers will want to sell more shirts as the price they receive for these shirts rises.

Introductory economics tells us that the number of polo shirts that will be produced and consumed, as well as the price for which they will sell, will be determined by the intersection of the supply and demand curves. Therefore, the quantity of polo shirts produced is Q in Figure 3.1, and these shirts should sell at price p. While this conclusion is technically correct, international trade changes how the domestic price for an internationally traded good like polo shirts is determined. In an open economy, domestic prices for internationally traded goods are determined by the interaction between world demand and world supply rather than by the interaction between national supply and national demand. Moreover, because most national economies are small in relation to the world economy, each national economy's individual demand for and supply of goods will not affect total world demand or total world supply. Therefore, domestic producers and domestic consumers of polo shirts (and all other internationally traded goods) have no influence on the price of the goods sold in the domestic market. This logic is identical to that of individual producers and consumers operating in a perfectly competitive market, where each individual is a "price taker." Rather than focus on an individual in the domestic market, here we focus on a national economy in the global economy. And, just as no individual in a perfectly competitive market is a large enough producer or consumer to alter prices in that market, no single country is a large enough producer or consumer of polo shirts to affect the world price of polo shirts. Thus, domestic producers and consumers of polo shirts are "world price takers." The world price, which is depicted in Figure 3.1 as p^w, is taken as a given by domestic producers and consumers.

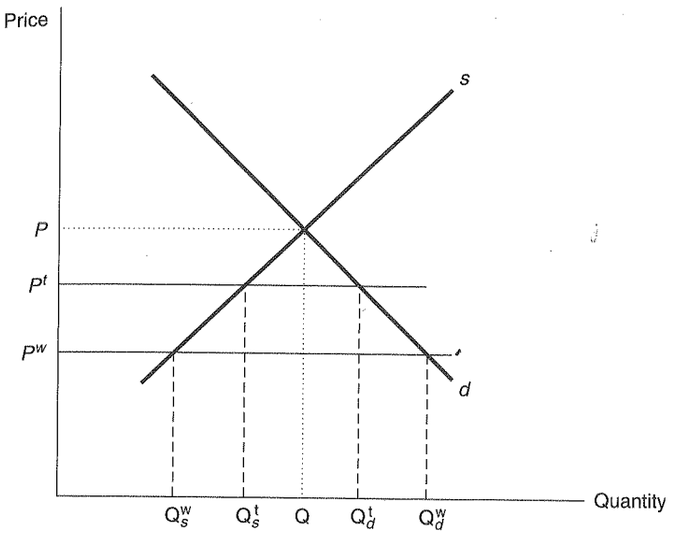

Figure 3.1 The Economic Effects of Tariffs.

Given the world price, how many polo shirts will domestic producers want to sell and how many shirts will domestic consumers want to buy? Domestic producers are willing to supply polo shirts up to the amount Q^w_s, the point at which the world price line intersects the domestic supply curve. Domestic consumers are willing to buy polo shirts up to the amount Q^w_d, the point at which the world price intersects the domestic demand curve. At the world price, therefore, domestic consumers want to buy more polo shirts than domestic producers are willing to supply. In the absence of international trade, this demand for polo shirts in excess of domestic supply would cause the price of polo shirts to rise. As prices rose, domestic production would increase, and the interaction between price increases and expanding domestic production would lead to equilibrium price and quantity levels where the domestic demand and supply curves intersect. Because the economy does engage in international trade, however, we know that the domestic price cannot rise

as a result of the excess demand for polo shirts. Instead, the domestic price remains at p^w and domestic producers continue to produce at Q_s^w Domestic demand for polo shirts in excess of domestic production, an amount equal to $(Q_d^w - Q_s^w)$, is satisfied by imports.

Suppose now that the government imposes a tariff. This tariff is a tax that the government adds to the world price, thereby raising the domestic price of polo shirts. In Figure 3.1 this effect is illustrated by the shift from the world price p^w to the higher price p^t. Now notice what has happened to domestic supply, domestic demand, and imports as a result of the increase in the domestic price for polo shirts caused by the tariff. Domestic producers are now willing to supply more polo shirts, and domestic production therefore expands from Q_s^w to Q_s^t (the point where the new domestic price (p^t) intersects the supply curve). Because the price for shirts has risen, consumers want to buy fewer of them, so the demand for polo shirts falls from Q_d^w to Q_d^t (the point where the new domestic price (p^t) intersects the demand curve). Finally, because domestic supply increases while domestic demand falls, imports of polo shirts fall from the amount equal to $(Q_d^w - Q_s^w)$ to the amount equal to $(Q_d^t - Q_s^t)$. Thus, relative to the free trade world, the imposition of a tariff has increased domestic supply while reducing both domestic demand and imports.

To evaluate how tariffs affect social welfare we need to introduce two concepts: consumer surplus and producer surplus. Producer and consumer surplus are aggregate measures of utility for society's producers and consumers. Consider **consumer surplus** first. If you look at the demand curve in Figure 3.2 it should be clear that a few people (those represented by the top left portion of the demand curve) would be willing to pay a high price to buy polo shirts. Yet, these people are actually able to purchase polo shirts at the much lower market price. The difference between what these people would have been willing to pay and the market price that they actually did pay provides them a surplus. Consumer surplus aggregates all of these individual consumer gains, and total consumer surplus is equal to the area below the demand curve and above the price line. **Producer surplus** is the analogous concept on the supply side. It is clear that some producers would be willing to supply a limited number of polo shirts for a relatively low

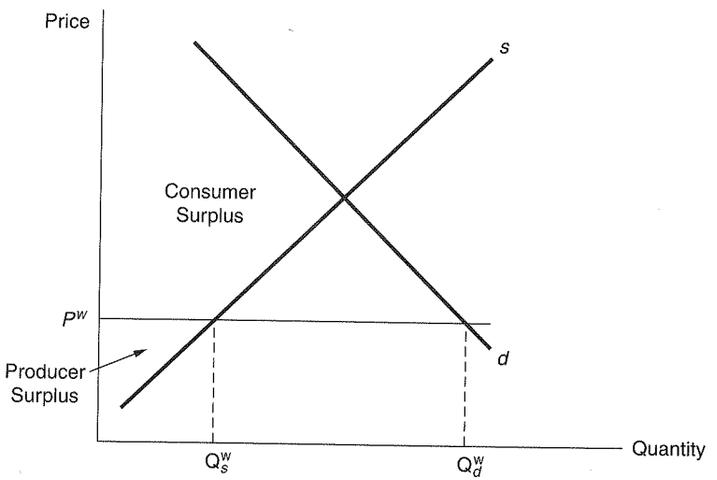

Figure 3.2 Consumer and Producer Surplus.

price (those represented by the lower left portion of the supply curve). Yet, when these same producers do sell the polo shirts they produce, they receive the much higher market price. The difference between how much each producer would have been willing to receive to produce polo shirts and what they actually do receive in the market represents that producer's surplus. Producer surplus aggregates all of these individual producer gains and is equal to the area above the supply curve and below the price line.

Producer and consumer surplus allow us to evaluate the welfare consequences of tariff-based protection with greater precision. Look first at how the tariff affects consumer surplus (Figure 3.3). When the government imposes a tariff, the area under the demand curve and above the price level is reduced by the amount labeled *A*, *B*, *C*, and *D*. The tariff reduces consumer surplus. Since we know that consumer surplus measures consumer welfare in the economy, we know that consumers have been made worse off by the tariff. Conversely, the tariff increases producer surplus. Because the tariff raises the price producers get from selling their shirts, the tariff increases the area above the supply curve and below the price line by the amount equal to the area labeled *A*. Since we know that producer surplus is a measure of producer welfare, we know that producers have been made better off by the tariff. Thus, the first consequence of a tariff is a transfer of welfare from consumers to producers.

What happens to the rest of the consumer surplus lost from the tariff? We have accounted for *A*, the transfer from consumers to domestic producers, but we have not yet examined what happens to the areas labeled *B*, *C*, and *D*. A portion of this lost consumer surplus, the area labeled *C*, is transferred to the government as tariff revenue. The total amount of this transfer is equal to the size of the tariff times the number of polo shirts being imported. This leaves the regions labeled *B* and *D*. These regions represent **efficiency losses:** the losses of consumer surplus that are not offset by an increase in

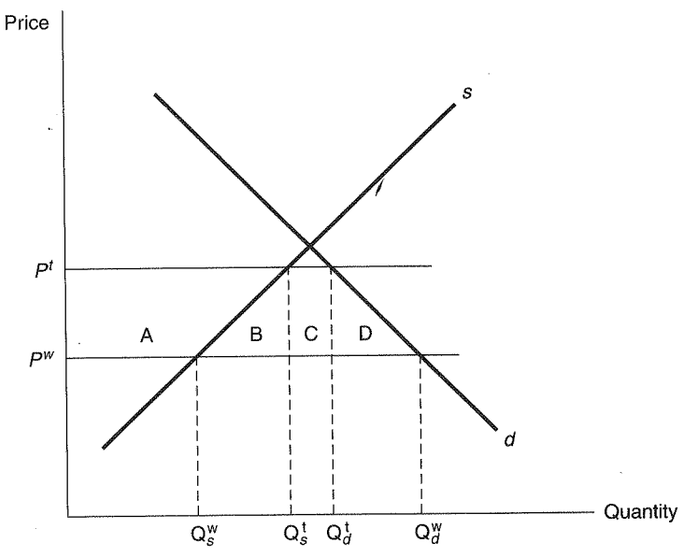

Figure 3.3 The Welfare Consequences of Tariffs.

producer surplus or government tariff revenue. Efficiency losses take two forms. The triangle labeled *D* is called a **consumption distortion** loss. It arises because the tariff causes domestic consumers to buy too few polo shirts given their preferences and the world price for these shirts. The triangle labeled *B* is called a **production distortion** loss. It arises because the tariff causes domestic producers to produce too many polo shirts, given domestic production costs and the world price (Krugman and Obstfeld 1991). These losses are the social welfare losses that give protectionism a bad name.

The case of the United States. How large are the income transfers and efficiency losses of protection in practice? We can get a sense of their magnitude by looking at the distributional and efficiency consequences of tariffs and nontariff barriers in the United States (see Table 3.4).[1] Let's examine the scale of redistribution from consumers to producers first. Lost consumer surplus in the 11 most heavily protected sectors in the American economy amounts to almost $2.3 billion. While the magnitude varies across sectors, from $376 million in women's footwear to $64 million in the ball bearing industry, consumers are made worse off by the imposition of tariffs in every

Table 3.4
The Costs of Protection in the United States (Millions of Dollars)

Product Category	Loss of Consumer Surplus (A+B+C+D)	Gain in Producer Surplus (A)	Tariff Revenue or Quota Rents (C)	Deadweight Loss (B+D)
Tariffs				
Ball Bearings	64	13	50	1
Canned Tuna	309	127	172	10
Ceramic Articles	102	18	81	2
Ceramic Tiles	139	45	92	2
Frozen Concentrated Orange Juice	281	101	145	35
Glassware	266	162	95	9
Luggage	211	16	169	26
Polyethylene Resins	176	95	60	20
Rubber Footwear	208	55	141	12
Women's Footwear, except athletic	376	70	295	11
Women's Handbags	148	16	119	13
Total	2,280	718	1,419	141
Voluntary Export Restraints				
Apparel	21,158	9,901	8,956	2,301
Textiles	3,274	1,749	1,345	181
Machine Tools	542	157	350	35
Total	24,974	11,807	10,651	2,517

Source: Hufbauer and Elliot 1994.

[1]While the discussion here focuses on the United States, similar studies of the costs of protection in Japan and the EU can be found in Sazanami et al. 1995 and Messerlin 1999.

instance. Producers capture about one-third of these consumer losses ($718 million). And while producer gains also vary in magnitude, from $162 million for glassware producers to $13 million for ball bearing producers, producers always realize some increase in income as a result of protection. Identical consequences are evident in the sectors protected by voluntary export restraints. VERs governing trade in apparels reduce consumer surplus by more than $21 billion and increase producer surplus by almost $10 billion. The three most important VERs reduce consumer surplus by almost $25 billion and raise producer surplus by almost $12 billion.

As we expect, American producers gain by less than the full amount lost by American consumers. Part of this difference is transferred from consumers to other agents. For all of the industries protected by tariffs, about $1.4 billion of the consumer loss is transferred to the government in the form of tariff revenue. In sectors protected by VERs, a portion of consumer losses is transferred to foreign producers as a quota rent. A **quota rent** is an above market return created by the imposition of a quota on imports. A quota rent arises because a VER, or any other import quota, restricts the number of foreign goods that can be sold in the domestic market below the level that domestic consumers want to buy. With supply held below demand, foreign producers can charge a higher price for each good they sell in the domestic market. Suppose, for example, that during the 1980s American consumers wanted to buy 4 million Japanese cars at the market price. The VER that the United States negotiated with Japan, however, allowed Japanese auto producers to export only 2.3 million cars to the American market. Because the VER kept the number of Japanese cars supplied to the American market substantially below the number Americans wanted to buy, the price for each Japanese car sold in the U.S. market was higher than it would have been in the absence of the VER. The quota rent is the difference between the high price Japanese auto producers received for each car with the VER and the lower price they would have received in the absence of the VER. Such quota rents can be quite large. In the apparel industry, which has been heavily protected with a quota-based international agreement, quota rents total almost $9 billion per year. Here, total transfers from American consumers to the U.S. government as tariff revenue and to foreign producers as quota rents amount to about $12 billion.

Finally, the U.S. economy suffers efficiency losses from protection. Table 3.4 suggests that the magnitude of these efficiency losses is moderate but still significant. Efficiency losses are largest in frozen orange juice concentrate industry and smallest in ball bearings, but in each sector they are positive. In total, American society is deprived of more than $2.5 billion as a direct result of protection in these 14 sectors of the American economy. Are these efficiency losses substantial? The answer to this question depends upon the context we use to evaluate them. Efficiency losses that result from protection are small as a percentage of total American income, amounting to much less than one percent of American GNP per year. This amount may seem even smaller if we apportion it equally across all the people that participate in the American economy—only about $13 per person, per year. Paying such a low price to protect American workers' jobs in these industries may seem quite reasonable. Yet, we get a different picture if we consider how much it costs American consumers and American society as a whole to save a single job. Every job that protection saves costs American consumers $170,000 per year, an amount that is about six times the average annual income for the typical manufacturing worker. This cost does fall substantially to

$54,000 per job if we consider only the efficiency losses rather than the total loss of consumer surplus. But even this lower figure is almost twice as high as the average annual income of manufacturing workers (Hufbauer and Elliott 1994, 11). Seen in this context, the costs of protection are rather high.

In general, therefore, economic theory and evidence drawn from the United States suggest that protection has two economic consequences. First, protection transfers income from consumers to producers. While the scale of this transfer in the United States varies, producers realize income gains while consumers realize income losses in every industry where protection is used. Second, society as a whole loses from protection. A portion of the income lost by consumers is not transferred to other groups in society, but simply disappears. Exceptions exist, of course, and we will examine the most important one below. Still, the general point remains: protectionism makes societies worse off than they could be otherwise.

A Society-centered Approach to Trade Policy

Protectionism is costly; it renders consumers and society worse off than they would be if tariffs and nontariff barriers were dismantled. Why then have governments liberalized trade in some industries but continued to protect others? A society-centered approach argues that the answer lies in the interaction between societal trade policy preferences and political institutions. Consider, for example, recent congressional votes on fast track legislation in the United States. Under **fast track,** Congress grants the executive the authority to negotiate international trade agreements. Under this arrangement Congress must approve (by simple majority) any trade agreement that the executive concludes before the agreement enters into law. And it must do so within 90 days. In voting on trade agreements, however, Congress cannot propose amendments; it must vote the agreement up or down in the form it is presented to them. Fast track authority greatly affects the ability of the United States to negotiate trade agreements with other governments. With fast track authority, the president can engage in constructive bargaining in the WTO and conduct meaningful negotiations on the Free Trade Area of the Americas. Without fast track authority, America's trade partners will conclude that Congress will pick apart any trade deal that may be reached, and they will be understandably reluctant to conclude any agreements with the United States. Fast track authority is therefore central to additional trade liberalization. Prior to the mid-1990s, Congress had regularly granted the authority to negotiate trade agreements to every president. Most recently Congress had granted this authority to President George H.W. Bush in connection with the Uruguay Round and the NAFTA. Fast track authority expired in 1994, however, and the Clinton Administration sought renewal in 1997 in order to pursue the Free Trade Area of the Americas and a new WTO round. Clinton's effort was unsuccessful, however. In 1997, fast track legislation was never put to a vote because it did not have enough votes to pass; in 1998 the legislation came to a vote but was defeated decisively as 240 representatives voted against and only 180 voted in favor. The House finally passed fast track legislation in December 2001 by the slimmest possible margin, with 215 voting in favor and 214 voting against.

A society-centered approach suggests that there are two important and interesting questions to ask about fast track legislation. First, what factors determine the votes by individual legislators on fast track authority, or on any other trade legislation for that matter? To answer this question we could start with a simple party politics hypothesis. We might expect Democrats to vote one way on trade legislation and the Republicans to vote the other way. Whichever party holds a majority in the House will then win the legislative battle over trade policy. In the 1998 fast track vote, for example, 151 Republicans voted for fast track while 171 Democrats voted against. In 2001, 194 Republicans voted for fast track while 189 Democrats voted against. There does seem to be considerable evidence, therefore, that the Republicans support trade liberalization while the Democrats oppose it. Yet, the power of an explanation based solely on political parties fades once we look more deeply. On the one hand, a large number of legislators voted across party lines. Twenty-nine Democrats voted in favor of, while 70 Republicans voted against fast track in 1997. A narrow focus on parties doesn't help us account for these votes. On the other hand, and more importantly, a focus on parties doesn't really help us explain trade votes. True, we observe that Democrats often vote against trade liberalization while Republicans often vote in favor, but what we really want to know is why these voting patterns exist. That is, why did so many Republicans vote for fast track while so many Democrats voted against? To answer this question we need to look beyond legislators' party affiliations and examine the societal interests that they represent. As we will see, the Democrats who voted against fast track typically represented societal groups that are harmed by international trade, while the Republicans that voted for fast track typically represented groups that gain from international trade. As a first step toward understanding how domestic politics shape trade policy, therefore, we must understand which societal groups win and which lose from trade liberalization, and then use this knowledge to illustrate how the economic characteristics of the constituents that legislators represent shape their votes on trade legislation.

The second question a society-centered approach asks is how do political institutions transform these societal interests into trade policy? Political institutions set the rules governing who has access to the political system and they determine how and where government decisions on trade policy are made. By doing so they exert a powerful influence on trade policy outcomes. Consider, for example, the impact of fast track legislation on American trade policy. To appreciate the impact we must know three things about the American political system. First, the U.S. Constitution assigns to Congress the authority to make trade policy. Second, for reasons we examine in detail below, the nature of legislative politics is such that when Congress determines tariff rates the result is often a higher level of protectionism than any individual legislator desires. Finally, and again for reasons we explore below, the president has incentives to adopt a relatively liberal trade policy. Thus, congressional control will produce a relatively protectionist trade policy, while executive control will produce a relatively liberal trade policy. Given these few details it is not hard to see that fast track has a profound impact on American trade policy. Fast track transfers the authority to make trade policy from a protectionist Congress to a trade-liberalizing executive. The United States therefore pursues a more liberal trade policy with fast track authority than it would without fast track. Thus, different political institutions, in this instance different rules about whether Congress or the president makes trade policy,

can generate very different trade policies. To understand how societal interests shape trade policy, therefore, we must examine how the specific political institutions in place transform these interests into actual policies.

In short, a society-centered approach argues that trade policy emerges from the interaction between societal interests and political institutions. We develop this approach in this section, looking first at each component individually and then examining how they interact to shape trade policy. We look first at how international trade affects the fortunes of economic groups within society and, by doing so, creates interest group demands for trade liberalization or protection. This provides a solid understanding of the source and content of societal preferences over trade policy. Second, we examine some of the ways in which political institutions shape how these societal preferences are brought into the political system and transformed into trade policies. Finally, we bring these components together to examine how the interaction between interests and institutions have shaped American trade policy during the last 100 years.

Trade Policy Preferences

At one level we can think of the domestic politics of trade as competition between societal groups, some of which want the government to liberalize trade while others prefer to be protected from trade. We could conceptualize contemporary American trade politics, for example, as competition between labor unions on the one hand, which oppose fast track authority and further liberalization, and American businesses on the other, many of which have supported fast track and additional liberalization. In order to understand why different groups in society hold different trade policy preferences we need to examine the distributional consequences of international trade. For even though trade raises national welfare, not everyone benefits from trade. For some groups, international trade brings rising incomes, while for others international trade causes incomes to fall. The groups that gain from trade have a preference for liberalization while those that lose have a preference for protection.

Economists have developed two different models to show how the distributional consequences of international trade shape the trade policy preferences held by societal groups. Both models agree that the losers from international trade prefer protection while the winners from international trade prefer liberalization. The two models differ, however, in the assumptions they make about how easy it is for workers and business owners to move from one industry to another in response to the changes in the profitability of particular domestic industries generated by international trade. These different assumptions generate two different portraits of trade policy preferences, one that emphasizes competition between labor and capital, and one that emphasizes competition between industries. We examine both models, focusing first on the model that emphasizes labor-capital competition and then turning our attention to the model that emphasizes competition between industries.

Factor incomes and class conflict. Our first model, called the **factor model,** argues that the domestic politics of trade policy are characterized by competition between labor and capital. Each group has a distinct trade policy preference because international trade has a differential effect on their incomes: in the advanced industrialized countries, trade reduces the income of labor and raises the income of capital. To

understand the factor model, we need to examine how and why international trade has this differentiated effect on the incomes of labor and capital.

We learned in Chapter 2 that cross-national differences in factor endowments give rise to different factor prices that provide the basis for mutually beneficial trade. What we did not cover is the fact that international trade in turn affects factor prices. International trade will exert pressures that lead eventually to a phenomenon called **factor price equalization** (Stolper and Samuelson 1941). Factor price equalization means simply that the price of the factors of production in all economies that are open to international trade will be the same. Thus, if it costs $4 an hour to hire a worker in the United States, it will cost $4 an hour to hire a worker in Mexico. International trade causes factor price equalization through a two-step process. First, trade forces the prices of internationally traded goods to equalize. We can understand why by returning to our polo shirt example from the previous section. The availability of low-cost polo shirts produced in a developing country will cause consumers in the advanced industrialized country to shift their purchases away from domestic shirts to the cheaper imports. As consumers shift to the less expensive imported shirts, shirt producers in advanced industrialized countries must reduce their prices in order to remain competitive. In the developing country, the increased demand for shirts generated by exports to the advanced industrialized country causes the price of their shirts to rise. These price changes will stop only when the price of shirts is the same in both countries. The convergence of goods prices will then exert pressure on factor prices. The price of a polo shirt, or any good for that matter, reflects the cost of the factors of production used in the manufacturing process. Thus, unless firms can raise **productivity,** that is, unless they can increase the number of polo shirts their workers can produce in a given amount of time, advanced industrialized country producers can reduce the price they charge for polo shirts and still make a profit only by reducing the amount they pay their workers. Conversely, the higher price that producers in developing countries now receive for polo shirts allows them to pay higher wages to the workers they employ.

It should be fairly clear that factor prices correspond directly with factor incomes. A factor price is simply the amount a producer pays to employ a factor of production for a specific amount of time. The price of labor is the wage paid to workers; the price of capital is the interest rate paid to capitalists. And while wages and interest rates are costs for the producer who hires labor and capital to manufacture goods, these payments are obviously income for workers and capitalists. Because international trade changes the amount a producer must pay to hire labor or capital, it must also alter the incomes earned by workers and capitalists. We can say something quite specific about whose incomes will rise and whose incomes will fall as a result of international trade. A society's scarce factors are priced higher at home than in countries where they are abundant. The income of the scarce factor must fall, therefore, as a consequence of factor price equalization. A society's abundant factor is priced lower at home than in countries where it is scarce. The income of the abundant factor must rise, therefore, as a consequence of factor price equalization. In general, the factor price equalization driven by international trade raises the income of society's abundant factor and lowers the income of society's scarce factor.

The trade policy preferences of specific societal interest groups follow directly from these income effects of international trade. The scarce factor, whose income falls as a result of trade, will want to minimize the amount of trade the domestic economy engages in. This group will therefore prefer trade policies that protect the domestic market from

imports. The abundant factor, whose income rises as a result of trade, will want to maximize the amount of trade the domestic economy engages in. This group will therefore prefer trade policies that promote trade liberalization. In the United States and other advanced industrialized countries, the factor model predicts that owners of capital will prefer liberal trade policies while workers will prefer protectionist trade policies. In developing countries, the factor model predicts that labor will prefer liberal trade policies while owners of capital will prefer protection. It suggests, therefore, that because the distributional consequences of international trade fall along factor lines, trade politics will be characterized by conflict between labor and business (or capital).

Class conflict and the politics of globalization. The factor model provides insight into how economic interests are driving the political debate over globalization. It leads us to expect American workers and the organizations that represent them to prefer trade protection to trade liberalization. Indeed, we see these preferences in the political debate over globalization. The AFL-CIO, a federation of 64 labor unions representing a total of 13 million American workers, has been among the most prominent critics of globalization. While the AFL-CIO does not consider itself protectionist, it played a leading role in organizing the protest against the WTO in Seattle in December 1999. In addition, it has fought consistently during the 1990s to prevent congressional passage of fast track authority. Conversely, the factor model leads us to expect American business to prefer trade liberalization to trade protection and thus to support globalization. These business preferences are also evident in the contemporary political debate over globalization. The Business Roundtable, a business association that brings together the chief executives of the largest American corporations, strongly supports globalization. It has been an active lobbyist for fast track authority, it supports the proposed FTAA, and it was a strong proponent of China's entry into the World Trade Organization. The National Association of Manufacturers, which represents about 14,000 American manufacturing firms, also supports multilateral and regional trade liberalization. Thus, in the United States the pattern of interest group preferences regarding trade liberalization and, more generally, globalization, is consistent with the factor model. The scarce factor, American labor, tends to oppose trade liberalization while the abundant factor, American capital, tends to support trade liberalization. While we will add nuance to this broad approach below, it helps us conceptualize how the economic dynamics of international trade drive political conflict over trade liberalization and globalization.

Specific factors and sectoral conflict. Our second model, called the **specific factors model,** characterizes the domestic politics of trade policy as a competition between industries rather than as a competition between labor and capital. In this model, the distributional consequences of international trade affect industries rather than factors. That is, the labor and capital employed in some industries both gain from trade, while the labor and capital employed in other industries both lose from trade. To understand the specific factors model, we need to examine why the distributional consequences of international trade might fall on industries rather than on the factors of production.

The key difference between the specific factors model and the factor model lies in the assumptions each makes about factor mobility. **Factor mobility** refers to the ease with which labor and capital can move from one industry to another in response to the changes

in relative prices caused by international trade. The factor model assumes a high degree of factor mobility, that is, it assumes that labor and capital can move easily out of one industry and into another. Suppose for example that some capital is currently being used to produce apparel in North Carolina and that the return to capital in the American apparel industry begins to fall as a result of increased imports from developing countries. The factor model assumes that this capital can quickly be shifted from apparel production to another industry, such as semiconductors, where the return on capital is high and rising.

In contrast, the specific factors model assumes that factors cannot be easily reallocated from one industry to another in response to changes in relative prices. Instead, capital is tied to, or specific to, the sector in which it is currently employed and cannot be easily or quickly moved to another use. Capital employed in apparel production is essentially stuck in this industry, at least in the short run. Nor can labor move easily from one industry to another. Workers often have industry-specific skills that do not always transfer easily from one sector to another. A worker who has spent 15 years as a welder in an auto plant cannot easily transfer these skills to the production of pharmaceuticals or semiconductors. In addition, the geography of industry location often means that quitting a job in one industry and taking a job in another requires workers to physically relocate. Shifting from apparel production to automobile production might require a worker to move from the south, where much of the apparel production takes place, to the midwest where the bulk of car manufacturing takes place. Logistical obstacles to physical relocation can be insurmountable. What if a worker cannot sell his house because the decline of the local industry has contributed to a more general economic decline in his community? Complex social and psychological factors also intervene. How easy is it for people to abandon the network of social relations that they have developed over the course of many years? The combination of specific skills, logistical problems, and attachments to an established community mean that labor cannot always move from one industry to another in response to economic changes caused by international trade.

When factors are specific to a particular industry, international trade will affect the incomes of all factors employed in a given industry in the same way. Consider the American apparel industry. As producers in developing countries begin to export their products to the American market, the price of clothing begins to fall in the United States. We know already, based on the factor model, that rising imports from developing country producers will place downward pressure on wages paid to American workers in this labor-intensive industry. The specific factors model tells us that these imports will also place downward pressure on the returns to capital employed in American apparel production. As long as the capital employed in apparel production cannot easily be shifted to the production of some other good, then the owners of this capital will see their incomes fall as a result of international trade. Thus, in addition to the falling wages for apparel workers that we saw in our discussion of the factor model, international trade in the apparel industry will reduce the profit earned by the owner of the apparel plant, that is, trade will reduce the return to capital employed in apparel production. Labor and capital employed in the apparel industry both lose from international trade. Conversely, consider the American pharmaceutical industry, which is highly competitive in the global pharmaceutical market. The return to capital invested in U.S. pharmaceutical production will rise as foreign markets open to U.S. exports. Moreover, because pharmaceutical companies are exporting, there is upward rather

than downward pressure on the wages earned by the workers they employ. Capital and labor employed in the American pharmaceutical industry therefore both gain from international trade. The specific factors model tells us that international trade will cause the incomes of labor and capital employed in the same sector to rise and fall together.

We can identify the industries that will gain from international trade and those that will lose. Labor and capital employed in industries that rely intensively on the society's abundant factor will both gain from trade. As a group, these industries are usually referred to as the **export-oriented sector.** In the advanced industrialized countries, this predicts that labor and capital employed in capital intensive and high technology industries both gain from international trade. The owners of plants that produce semiconductors or pharmaceuticals and the workers employed in these plants will both realize rising incomes as a result of trade. Labor and capital employed in sectors that rely most heavily upon society's scarce factor both lose from trade. As a group, these industries are usually referred to as the **import-competing sector.** In the advanced industrialized countries, this predicts that the owners of the capital employed in labor-intensive sectors such as apparel and footwear and the workers they employ will both experience falling incomes as a result of international trade. In contrast to the class conflict suggested by the factor model, the specific factors model characterizes trade politics as common interests among classes and competition between the import-competing and export-oriented sectors.

A recent case illustrates the pattern of trade policy preferences highlighted by the specific factors model. A worldwide slowdown in economic growth following the 1997 Asian financial crisis triggered a flood of steel imports into the United States.[2] The American price of steel fell by about 20 percent between 1997 and late 1999 and this intense import competition reduced the profitability of American steel companies. Six American steel companies declared bankruptcy in 1999 and approximately 10,000 jobs in the industry were lost. Steel workers and the steel companies united in pursuit of government policies to protect them from these imports under the umbrella of a coalition called "Stand Up For Steel." The steel companies applied for trade protection under American antidumping laws, while the steel workers' union, the United Steel Workers of America, lobbied Congress for more comprehensive government action to support the industry. International trade hurt both capital and labor employed in the American steel industry, and both responded by seeking protection from imports.

Sectoral conflict and the politics of globalization. The specific factors model also adds nuance to our understanding of the political debate over globalization. Whereas the factor model suggests that the debate over globalization pits labor against capital, the specific factors model suggests that this political debate often pits capital and labor in import competing industries against capital and labor in export oriented industries. We might expect therefore that both UNITE (the Union of Needletrades, Industrial and Textile Employees), the principle union in the American apparel industry, and the American Textile Manufacturers Institute, a business association representing American textile firms, would oppose globalization. Indeed, this is what we find. UNITE has been a vocal opponent of NAFTA, of the Free Trade Area of the Americas, and of fast

[2]Based on material available at the websites of the United Steel Workers of America (http://www.uswa.org) and the Steel Manufacturers Association (http://www.steelnet.org).

Table 3.5
Two Models of Interest Group Competition Over Trade Policy

	The Factor Model	The Specific Factors Model
The Principal Actors	Factors of Production or Classes	Industries or Sectors
How Mobile are Factors of Production?	Perfectly Mobile Across Sectors of the Economy	Immobile Across Sectors of the Economy
Who Wins and Who Loses from International Trade?	*Winner:* Abundant Factor—capital in the advanced industrialized countries. *Loser:* Scarce Factor—labor in the advanced industrialized countries.	*Winner:* Labor and Capital Employed in Export-Oriented Industries. *Loser:* Labor and Capital Employed in Import-Competing Sectors.
Central Dimension of Competition Over Trade Policy	Protectionist Labor *Versus* Liberalizing Capital	Protectionist Import-Competing Industries *Versus* Liberalizing Export-Oriented Industries

track authority. For its part, the American Textile Manufacturers Institute has not been critical of all trade agreements, but it has opposed free trade agreements with South Korea and Singapore, has been very critical of the American decision to grant China permanent normal trade status, and does not support further opening of the U.S. market to foreign textiles through multilateral trade negotiations (AMTI 2001). In general, labor and capital employed in textile and apparel are both skeptical of globalization.

Conversely, the specific factors model predicts that capital and labor employed in export-oriented industries will both support globalization. Among firms based in export-oriented sectors of the American economy, such support is relatively easy to document. A coalition of business associations representing American high-tech firms—including the Consumer Electronics Association, Electronic Industries Alliance, Information Technology Industry Council, MultiMedia Telecommunications Association, and The Semiconductor Industry Association—has supported fast track authority, the approval of normal trade relations with China, NAFTA, and the FTAA. It is more difficult to document the attitudes toward globalization held by workers employed in these industries, in large part because these workers are not organized to the same extent as low and medium skill workers in manufacturing industries. However, workers in high-tech industries are predominantly high skilled, and on average, high-skilled workers are more supportive of trade liberalization than low-skill workers (Scheve and Slaughter 2001). While this is indirect evidence, it is consistent with the prediction of the specific factors model that both labor and capital employed in American high technology industries will support globalization.

Overall, both of the society-centered models we have explored here argue that the trade policy preferences held by domestic interest groups are determined by the distributional consequences of international trade. Trade raises the incomes of some groups and

lowers the income of others. Those who gain from trade prefer trade liberalization, while those who lose prefer protectionism. We can conceptualize the resulting patterns of trade policy preferences according to our two models (see Table 3.5). The factor model states that the distributional consequences of international trade fall along factor lines and give rise to conflict between labor and capital. The specific factors model states that the distributional consequences of trade fall along sector lines and give rise to conflict between import competing and export oriented industries. In both cases, the domestic politics of trade policy are driven by competition between the winners and losers from international trade.

The Collective Action Problem and Trade Policy Demands

The trade policy preferences held by domestic interest groups are not transformed automatically into political demands for trade policies. Individual preferences must be aggregated and collective action in pursuit of trade policy must be organized. Not all groups with a common interest in trade policy will be able to organize for collective action. This might seem counter-intuitive. If people are rational, and if international trade affects incomes in predictable ways, then why wouldn't people who share a common interest join forces to lobby the political system for their desired trade policy? Groups don't always lobby because of the collective action problem (Olson 1965). The **collective action problem** refers to the fact that "rational, self-interested individuals will not act to achieve their common or group interests. . . . Even if all of the individuals in a large group are rational and self-interested, and would gain if, as a group, they acted to achieve their common interest or objective, they will still not voluntarily act to achieve that common or group interest" (Olson 1965, 2). In the context of trade policy, this means that even though all consumers benefit from free trade, or all workers and firms engaged in a particular industry would benefit from a particular trade policy, they will not necessarily be able to act as a group to achieve their preferred trade policy outcome.

The collective action problem arises from a phenomenon called free riding. **Free riding** describes situations in which an individual relies on others to bear the costs of a program from which he or she derives benefits (Sandler 1992, 17). My experience with public radio offers a very good example. My local public radio station uses voluntary contributions from its listeners and businesses to finance 87 percent of its budget. Without these voluntary contributions, the station would be forced to go off the air. As a regular listener to many programs on this station, I benefit immensely from the station's existence and my life would be greatly diminished were the station forced off the air. Yet, in spite of the fact that I do benefit, I have never made a financial contribution to the station. Instead, I rely upon others to pay for the station's operations. In other words, I free ride on the contributions made by others. Free riding takes place because in any large group with a common objective, be that the continued existence of the public radio station or trade liberalization, all group members will realize benefits once the common objective has been achieved, but the contribution toward this goal made by each individual member of the group is too small to affect the final outcome. In my case, I recognize that whether I contribute $100 to the radio station or not is unlikely to determine whether the station continues to operate or is shut down.

To take a more meaningful example, consider consumers and trade policy. As a group, the 200 million or so consumers that live in the United States would all gain

from free trade. These 200 million people thus have a common interest in seeing the U.S. government implement a trade policy based on the principle of unilateral trade liberalization. The problem, however, is that consumers will have to lobby the government in order to achieve this goal. Such lobbying is costly—money is required to create an organization, to pay for a lobbyist, and to contribute to politicians' campaigns, and time must be dedicated to fundraising and organization. No individual consumer has an incentive to pay these costs. Instead, most consumers will perform the following very simple calculation: my contribution to this campaign will make no perceptible difference to the group's ability to achieve the final outcome. Moreover, I will realize the benefits of free trade if the group is successful regardless of whether I have contributed or not. Therefore, I will let other consumers spend their money and time, that is, I will free ride on the efforts of other consumers. Because all consumers have the same incentive to free ride, no one contributes time and money, no one lobbies, and consumer interests fail to influence trade policy. Thus, even though consumers share a common goal, the collective action problem prevents them from exerting pressure on politicians to achieve this goal. And what is true for consumers is true for all groups with a common interest. The incentive to free ride on the contribution of others makes collective action in pursuit of a common goal very difficult.

The severity of the collective action problem that a group faces depends upon the size of the group. In large groups, each contribution is very small, relative to the total contribution, and as a result each individual will have less of an impact on the ability of the group to achieve its objective. In large groups, therefore, the incentive to free ride faced by each individual is very strong and large groups face very severe collective action problems. In small groups, each contribution is large relative to the total contribution, and each contribution will therefore be more likely to affect the group's ability to achieve its common goal. As a result, the incentive to free ride and the collective action problem is somewhat weaker (though not altogether absent) in small groups. This simple logic of group size tells us a lot about why consumers have not been a powerful force in the domestic politics of trade policy. Because all consumers face a strong incentive to free ride, contributions to a "Consumers for Free Trade" interest group are substantially less than the underlying common interest in free trade would seem to dictate. Producers, in contrast, can more easily overcome the collective action problem because most industries are composed of a relatively small number of firms. Producer groups can thus lobby the government much more effectively in pursuit of their desired trade policy. This logic helps us understand why producers' interests dominate trade politics while consumer interests are often neglected.

The collective action problem also helps us answer a puzzle we encountered in Chapter 2: why have governments rarely liberalized trade unilaterally but have been willing to do so through reciprocal trade agreements? We see that in the absence of reciprocal trade agreements, import-competing industries can overcome the collective action problem and influence trade policy while groups hurt by protection cannot. A tariff provides benefits to the few firms based in the protected industry. A higher tariff on steel, for example, benefits only steel producers and their workers but imposes costs on the very large group of consumers and firms outside the protected industry. It harms those who use steel as an input in other production processes such

as automakers, and it harms all consumers who buy finished goods containing steel. The benefits of protection, therefore, are concentrated on a small group that can easily overcome the collective action problem, while the costs of this protection are imposed on a large and heterogeneous group that cannot overcome the collective action problem. In the absence of reciprocal trade agreements, therefore, domestic trade politics are dominated by import-competing industries and demands for protection. Liberalizing trade will be difficult in this political environment.

Reciprocal trade agreements pave the way for trade liberalization by enabling export-oriented industries to overcome the collective action problem (see Bailey et al. 1997; Gilligan 1997; Milner 1991). By opening foreign markets to domestic exports, reciprocal trade agreements transform the large and heterogeneous pro-liberalization interests into smaller groups of export-oriented industries that can overcome the collective action problem and lobby for trade liberalization. This transformation occurs because reciprocal trade agreements provide large benefits in the form of access to foreign markets to small groups of export-oriented firms. Reducing foreign tariffs on microprocessors for personal computers, for example, provides substantial gains to the three American firms that dominate this industry (Intel, Advanced Micro Devices (AMD), and Motorola). These three firms will solve the collective action problem they face rather easily and lobby for trade liberalization at home in exchange for the removal of foreign barriers to their exports. Thus, whereas only protectionist interests mobilize when the government pursues unilateral trade policy, both protectionists and liberalizers mobilize when the government pursues a reciprocal trade policy. This change in the balance of political pressure makes trade liberalization possible.

Political Institutions and Trade Politics

Societal interests are not transformed directly into trade policies. Instead, societal interests are brought into the political arena and transformed into policy outcomes through a highly institutionalized political process. Political institutions, the rules governing political activity, have a powerful influence on trade politics because they determine the structure of interest representation and the location of decision making authority. Consider first the impact of competitive elections, which many would suggest is the defining characteristic of democracy, on the representation of societal interests. Elections create powerful incentives for politicians to represent the economic interests of their constituents. Electoral success requires politicians to respond to the demands made by those members of society who keep them in office. Yet, even though electoral politics create incentives for politicians to represent constituent interests in all democracies, the specific rules governing elections can shape how these interests are represented in the political system—that is, whether trade politics will revolve around sector- or factor-based competition. Consider, for example, the impact of an electoral system based on single-member districts. Under this system the nation is divided into mutually exclusive electoral districts, and one person is elected to represent each district. Consequently, political representation is explicitly tied to geography. In order to maintain political office in this system, representatives must make policies that satisfy the demands of the constituents in their districts. District residents will typically be employed in only a few industries. The wages paid in these industries will in turn play a large role in supporting the rest of the local economy—the retail and other service oriented businesses that provide jobs for many other people in the community. The fortunes of a

district's largest industries in turn will shape the electoral fortunes of the politicians representing them. If the representative supports policies that raise incomes in the industries in her district, she is likely to be rewarded with campaign contributions and votes. If the representative supports policies that reduce incomes in these industries, she is likely to be punished as business owners and workers support other candidates. In a single-member district electoral system, therefore, national trade politics will be characterized by competition between industries because political representation is directly linked to specific territorial districts with unique economic characteristics.

The 1998 vote on fast track legislation in the House of Representatives provides plenty of evidence that U.S. legislators do in fact vote their district's economic interest (see Baldwin and Magee 2000). The typical representative that voted against fast track legislation represented a district dominated by import-competing industries. A low percentage of the residents in his district had been to college, and most were therefore employed in low-skill jobs. The manufactured goods produced in the districts were generally low-skill labor intensive goods, and thus not competitive in world markets. The typical opponent of fast track legislation therefore represented a district that was likely to be harmed by additional trade liberalization. Robin Hayes, for example, who represents the 8th District in North Carolina, voted against fast track in 1998 because textiles and apparel firms provide about 40 percent of the jobs in the district. Conversely, the typical representative who voted for fast track represented a district that was dominated by export-oriented industries. The typical worker in this district had a college education and was therefore employed in a high skilled job. Firms in the district were engaged in physical and human capital-intensive production and were therefore highly competitive in world markets. The typical supporter of fast track, therefore, represented a district that was likely to gain from trade liberalization. Jim DeMint, for example, who represents the 4th District in South Carolina, voted for fast track in 2001 in large part because his district is home to a large number of highly competitive, export-oriented producers such as BMW, Michelin, Hitachi, General Electric, and Lockheed Martin.

In contrast, proportional representation electoral systems are more likely to give rise to trade coalitions organized around factoral rather than sectoral lines. Under proportional representation, legislators are selected from party lists in correspondence with the share of the vote each party gains in a national election. In such systems political representation is not explicitly linked to geography. Consequently, we might expect national trade politics to revolve around class- or factor-based coalitions, particularly in countries where political parties have developed close ties to class-based organizations. In Western Europe, for example, Socialist and Social Democrat parties have had historical links with national labor unions while parties of the right have had close ties to business associations. Because politicians do not need to maintain the support of geographically specific constituents, they need not emphasize the interests of specific industries. Because politicians often need to appeal to nation-wide class-based constituents, politicians will often need to emphasize the interests of specific classes in order to maintain power. Thus, in democracies with proportional representation we might expect trade politics to be characterized by class-based or factor-based competition rather than by sectoral competition. Different electoral systems, therefore, are likely to create different kinds of trade politics. Systems based on single member districts will give rise to sector-based competition, while systems based on proportional representation will give rise to factor-based competition.

Elected officials bring the interests they represent into the political system, and this system in turn influences how these competing demands are aggregated and transformed into trade policies. The political system determines where decision-making authority lies and who has access to key decision makers. Consequently, different political systems will give rise to different trade policy processes. Consider the contrast between a presidential and a parliamentary system. The American presidential system divides power between the executive branch and the legislature. The U.S. Constitution gives Congress sole authority over trade policy. In the United States, therefore, trade policy is powerfully influenced by legislative politics. Congressional decisions emerge from the aggregated votes of hundreds of legislators, each representing a specific geographic territory. Electoral rules, therefore, encourage legislators to emphasize the narrow sectoral interests of their districts. The sectoral orientation of interest representation is further strengthened by weak political parties, which means that the party leadership cannot easily compel party members to vote the party's position, and by the fact that Congress is very open to lobbying by private interest groups. The result is a trade politics process in which narrow interests receive lots of representation while broader interests are under-represented.

This institutional framework has two important consequences for American trade policy. First, congressional dominance makes the direction of American trade policy unpredictable and somewhat unstable. Such instability is evident in American history. Tariffs regularly rose and fell between 1846 and 1930 in response to changes in the majority party in Congress. When the Democrats, who at that time represented the interests of Southern export-oriented agriculture, held a majority of seats they would pass legislation that reduced tariffs; when the Republicans, who were then representing the interests of Northeastern import-competing manufacturers, held a majority, they would pass legislation that raised tariffs (Bailey, Goldstein, and Weingast 1997). It is also evident in recent trade legislation; Congress voted against fast track authority in 1998 and then approved the measure in 2001. Second, congressional dominance constrains the ability of the executive to participate in international trade negotiations. The recent history of fast track legislation highlights this effect quite clearly. The president cannot easily pursue WTO or regional trade negotiations without fast track authority, yet Congress has struggled to provide a large and stable coalition in support of fast track legislation. Fast track did pass the House in 2001, but there is no assurance that Congress will ratify any trade agreement concluded in current WTO negotiations. In the American presidential system, therefore, the legislature and narrow industry interests exert a powerful influence on trade policy.

Now consider trade politics in a parliamentary democracy like Japan. In parliamentary democracies the executive and legislative branches are fused. The executive dominates policymaking and the legislature plays little role. In the Japanese system, executive branch dominance has enabled three executive agencies to play the leading role in formulating and implementing postwar trade policy. The most important has been the **Ministry of Economy, Trade, and Industry** (METI) (until quite recently, METI was called the Ministry for International Trade and Industry, or MITI). METI's primary responsibility has been the formulation and implementation of industrial policy, or what the Japanese have called "administrative guidance." Because trade policy has been a critical component of Japanese industrial policy, METI created an International Trade Policy Bureau that has responsibility for multilateral and bilateral trade negotiations. In conducting international trade negotiations, the International Trade Policy Bureau attempts to ensure that the trade concessions that Japan gains and grants in the WTO and other trade negotiations are consistent with their industrial policy objectives. The Ministry of Foreign Affairs has primary responsibility for conducting international negotiations, and it has created international trade bureaus to facilitate trade negotiations. The Ministry of Foreign Affairs thus duplicates many of METI's trade responsibilities, and as a consequence, the two ministries are frequently involved in jurisdictional conflict (Higashi 1983, 42). Finally, the Ministry of Agriculture, Forestry, and Fisheries (MAFF) has responsibility for international trade and international trade agreements involving products that fall under its domain.

This political structure has two consequences for Japanese trade policy. First, the government can pursue a consistent and stable trade policy under the leadership of executive branch agencies. In contrast with the United States, the executive is not greatly constrained by the legislature. Second, the role of executive branch agencies in formulating trade policy makes it difficult for groups that are not close to the ruling party, the Liberal Democrats, to gain access to decision makers. METI, for example, interacts most heavily with export-oriented industries, and consequently its policies favor export-oriented producers over import-competing industries (Okimoto 1988, 310). The MAFF maintains close contact with Japanese agricultural and fishing interests. It sees its primary task as protecting the incomes of Japanese citizens engaged in import-competing agricultural production (Okimoto 1988, 310). The contrast with the American system is again quite stark. Whereas interest groups can gain access to key decision makers in the United States by lobbying Congress, access to decision makers in the Japanese system is much more restrictive. Japanese labor organizations have a hard time gaining access to the decision-making arena, as do many import-competing manufacturing industries. In a parliamentary democracy like Japan, therefore, the executive is insulated from competing interest group pressures and consequently has the ability to pursue a consistent and coherent trade policy.

We could look at other differences in political institutions. We might consider, for example, how trade politics in a multi-party coalition government in a parliamentary system, such as one finds in many West European countries, would differ from trade politics in a single party government like Japan. While such a comparison could be interesting, it would only reinforce the more fundamental point: the specific political institutions in place in a society exert a powerful influence over how societal interests are brought into the political arena and transformed into trade policy. In order to understand the domestic politics of trade policy, it is necessary to examine the pattern of societal trade policy demands and the specific political institutions through which these competing demands are transformed into policy outcomes. Doing so often entails undertaking a detailed, fine-grained analysis of the interplay between interests and institutions within a specific political system.

Interests and Institutions in American Trade Politics

The United States provides an excellent lens through which to examine how societal interests and political institutions interact to shape trade policy. The case provides a fascinating

A Closer Look

Trade Politics in the European Union

National governments do not fully control trade policy in the EU. Instead, the European Union's founding document, the Treaty of Rome, gives the European Commission the authority to determine EU trade policy toward nonmembers. Because it is a customs union, the EU imposes a common external tariff on imports entering the union from outside. In WTO negotiations, therefore, the EU negotiates as a single actor, and it is the European Commission that conducts these negotiations on behalf of all of the member governments. The ability of the EU Commission to exercise its authority over trade policy is limited, however, by the political and institutional relationships within which it operates (see Hayes 1993, 15; Schuknecht 1992, 37; Johnson 1998; Meunier and Nikolaidis 1999; Nugent 1994). Of particular importance in this regard is the Council of Ministers, the EU's principal decision-making body. In the context of trade policy, the Council of Ministers is composed of the trade ministers of each of the EU member governments, and these trade ministers set the parameters within which the Commission must operate as it negotiates in the WTO or in other international arenas. The process works in the following manner. The Commission develops a general set of recommendations for a proposed round of multilateral negotiations. In developing these recommendations it works closely with the "Article 113 Committee," which is an EU committee composed of national civil servants, usually the national trade ministers' top aides (Gray 1985). The Commission's recommendations are then submitted to the Council of Ministers for approval. Often such approval is accompanied by strict limits on the ability of the Commission to make concessions that extend beyond the agreed recommendation. As a consequence, when the Commission is faced with the need to make a large concession to achieve one of its objectives in the WTO, it will usually have to go back to the Council of Ministers to gain the approval of national governments. Thus, even though the EU Commission has legal authority over trade policy, it exercises this authority under the close scrutiny of the EU's member governments.

The trade policy objectives that EU member governments instruct the Commission to pursue reflect the demands placed upon these national governments by domestic interest groups. While it is impossible to trace such demands in each of the 15-member countries, we can sketch out the basic pattern of demands that are present in the EU. As in the United States and Japan, export-oriented industries in capital-intensive manufacturing and services have lobbied for multilateral trade liberalization. But there have been important exceptions as mature capital-intensive manufacturing industries such as steel and automobiles have grown increasingly protectionist in the face of international competition. As in the United States and Japan, internationally traded services, particularly financial services based in London and Frankfurt, have lobbied for liberalization of trade in services since the early 1980s. Again in parallel with the United States and Japan, politically influential import-competing manufacturers have lobbied for protection and against multilateral liberalization. European-based textile and apparel industries have been the most important opponents of liberalization, as they have been in the U.S. and increasingly in Japan. European firms in high technology sectors have also been at a disadvantage internationally, and have therefore been ambivalent about liberalization. Finally, European agriculture is not competitive internationally, and EU farmers have lobbied consistently for protection. As a consequence, European agriculture is heavily protected from foreign competition. Overall, EU trade policies reflect a pattern of societal group interests quite similar to what we see in Japan: capital-intensive manufacturing and service industries promote liberalization, while labor-intensive manufacturing industries, high-technology sectors, and agriculture promote protection.

Continued

example of how a coalition of export-oriented interests determined to pursue a liberal trade policy in the context of political institutions biased toward protectionism created new political institutions that made trade liberalization possible. It also highlights how the contemporary congressional debate over fast track authority has implications that extend well beyond the terms under which the United States participates in the current WTO negotiations or can conclude a free trade agreement with Latin American countries.

A coalition of export-oriented interests has provided the political support for postwar trade liberalization. This coalition first came to power in 1932 under the banner of the Democratic Party. The New Deal realignment of the American political party system of the early 1930s brought capital-intensive manufacturing, export-oriented agriculture, and organized labor (most of which was based in capital-intensive manufacturing) together in support of Franklin D. Roosevelt's bid for the presidency (see Ferguson 1984; Frieden 1988). In the 1932 elections, the Democrats captured the White House and gained majorities in the House and Senate. This coalition, and the societal groups they represented, had a clear interest in trade liberalization. There was little chance, however, that they could rely upon Congress to achieve this objective. Indeed, at the onset of the Great Depression in 1930, Congress had passed the very protectionist **Smoot-Hawley Act,** which raised the average tariff to an historic high of almost 60 percent (Pastor 1980, 77–78). The problem that the pro-liberalizing coalition faced extended beyond Smoot-Hawley, and resided in the protectionist bias at the core of congressional tariff politics. We saw above that in the absence of reciprocal trade agreements industries that benefit from protection have a stronger incentive to organize and lobby than do groups that benefit from low tariffs. Legislators thus faced interest group pressure for protection and little countervailing pressure. Moreover, the dynamics of legislative politics worked in such a way that any effort to protect a single industry would be transformed into legislation that protected lots of industries. Suppose that a representative from Pennsylvania introduced legislation that proposed to raise tariffs on steel. A higher tariff on steel would benefit steel producers based in a few congressional districts, but it would also impose costs on all of the districts that did not have steel producers but were instead consumers of steel. Consequently, in order to get representatives from, say, Michigan (where the auto industry is very important and a large consumer of steel) to vote for a high tariff on steel, the representative from Pennsylvania would have to support a high tariff on automobiles. The initial legislation is thus transformed into a bill that raises tariffs on steel and cars. Other legislators will now ask for higher tariffs for industries in their districts as the price for their support for this bill. The legislation is again amended to add the higher tariffs on these goods. This dynamic, a process that has been called **logrolling,** produces a final tariff bill that raises tariffs on a much larger number of items than any individual legislator desires. This is precisely what happened in the Smoot-Hawley Act. The initial legislation proposed only a moderate increase of tariffs on farm products. Once it entered Congress, however, legislators from farm districts dominated by small farmers facing

competition from imported potatoes, cream, butter, and eggs joined forces with legislators from districts dominated by labor-intensive manufacturers of such items as shoes, watches, apparel, gloves, and some luxury goods. The bill was amended more than a thousand times in the Senate, and the resulting bill raised tariffs on almost 20,000 items in the American tariff schedule (Pastor 1980, 78; Eichengreen 1989b).

Legislators cannot easily escape this logrolling dynamic. While each may want to limit the amount of protection granted to industries outside his district, each also recognizes that a refusal to support protection for industries in other districts will cause other legislators to refuse to support protection for industries in his district. As one senator stated in the debate over Smoot Hawley Act, "I will not vote for a tariff upon the products of another State if the Senators from that State vote against protecting the industries of any State" (quoted in Pastor 1980, 80). Cordell Hull, a staunch proponent of free trade who had represented Tennessee in the House and then the Senate before becoming Roosevelt's Secretary of State, recognized that Congress greatly limited the prospects for durable trade liberalization. "It would have been folly to go to Congress and ask that Smoot-Hawley be repealed or its rates reduced . . . This [approach had] . . . always resulted in higher tariffs because the special interests enriched by the tariffs went to their respective congressmen and insisted on higher rates" (quoted in Destler 1986, 13). Durable trade liberalization could be achieved only by institutional reform that took the tariff out of congressional politics. Thus, while Smoot-Hawley was unique in the level of protection it provided, the dynamic that produced this legislation was not. It would be difficult to pursue lasting trade liberalization through Congress because congressional logrolling would always be more likely to generate protection than trade liberalization.

The desire to pursue trade liberalization coupled with the need to take the tariff out of congressional politics to do so led to institutional reform through which tariff-setting authority was shifted from Congress to the executive. The executive was more likely than Congress to pursue a liberal trade policy for two reasons. First, the president represents a national constituency rather than a single district. Because individual legislators represent a single district, they can gain the benefit of protection for producers based in their districts and impose the costs of protection on people and businesses living outside their district. The president, whose constituency extends into every district, has nowhere to push the costs of protection. Instead, the president must weigh the benefits gained by one district from a higher tariff against the costs that such tariffs impose on other districts. As a consequence, trade policy set by the president is likely to be less protectionist than trade policy set by legislators. Second, the executive can negotiate reciprocal tariff agreements with foreign governments. As we saw above, such reciprocal agreements create an incentive for export-oriented interests to lobby in support of trade liberalization, thereby altering the balance of interest group pressure in a direction that favors liberalization. The executive is thus more likely than Congress to pursue a liberal trade policy and in doing so, will be better able to attract the political support that liberalization requires.

The Roosevelt Administration proposed such a shift of authority in 1933 and Congress responded by passing the **Reciprocal Trade Agreements Act** (RTAA) of 1934. Under this legislation Congress allowed the executive to reduce tariffs by as much as 50 percent in exchange for equivalent concessions from foreign governments. Why would a Congress so intent on raising tariffs in 1930 pass legislation that authorized

the executive to lower tariffs only four years later? Students of American trade policy have suggested a number of explanations for this reversal. Some have argued that Congress passed the RTAA because it recognized that it was producing bad trade policy (Destler 1994; Lohman and O'Halloran 1994). As foreign governments raised tariffs on American exports in retaliation to the Smoot-Hawley Act, and as the American and world economies fell deeper into depression it became clear that high tariffs were not solving the economic crisis. Aware that they could not escape the political logic that led to protectionism, Congress delegated authority to the executive "to protect themselves from the direct one-sided pressure from producer interests that had led them to make bad law" (Destler 1994, 14). Others argue that the liberal emphasis of the RTAA resulted from shifting party majorities in Congress (Pastor 1980). The Republican Party, which throughout the nineteenth and early twentieth centuries was the party of protection, held a majority of seats in Congress in 1930 and used it to pass the protectionist Smoot-Hawley Act. The Republicans lost the majority to the Democrats in both the House and Senate in the 1932 elections, however. Democrats used this majority to pass trade-liberalizing legislation. The Smoot-Hawley Act and the RTAA simply represented a continuation of a longer historical pattern in which Republican majorities raised protection and Democrat majorities lowered it.

Still others highlight the importance of the RTAA itself (Bailey, Goldstein, and Weingast 1997). These students argue that even though the Democrats enjoyed a congressional majority after 1932, they did not have enough votes to reduce American tariffs unilaterally. Many Democrats at the time argued that unilateral tariff reductions would generate a flood of imports, and consequently support for legislation that proposed unilateral reductions would be "politically dangerous" (Bailey, Goldstein, and Weingast 1997, 317). Yet, by linking reductions of American tariffs to the opening of foreign markets to American exporters, the RTAA created a large congressional coalition in support of trade liberalization. "It [was] easier to build majority support for reductions (and harder to form a coalition to negate an agreement) when tariffs [were] coupled with changes in access to foreign markets" (Bailey, Goldstein, and Weingast 1997, 318). The logic behind this claim should be familiar by now: reciprocal reductions created an incentive for export-oriented firms to lobby their representatives on behalf of trade liberalization. This in turn balanced the interest group pressures that legislators faced. While each of these explanations highlights a different reason for the passage of the RTAA, all agree that the RTAA represented a fundamentally important change in the institutional framework governing American trade politics. By delegating authority for trade policy to the executive, Congress removed tariffs from a legislative process that made sustained liberalization difficult. This institutional change has had a lasting impact on American trade politics. The basic approach initiated in 1934 remains at the center of U.S. trade politics, as current wrangling over fast track legislation indicates (see Table 3.6). As a result, Congress has not voted on a comprehensive tariff act since 1930. Instead, U.S. tariffs have been changed through GATT negotiations and through administrative procedures that we look at below. In short, postwar trade liberalization was made possible through the interaction between the interests of export-oriented producers and institutional change that reduced congressional influence over tariffs.

In delegating trade policy authority, Congress has not given the executive a completely free hand. Instead, Congress has continued to influence trade policy by setting the parameters within which the executive operates (see O'Halloran 1994). In part,

Table 3.6
Important American Trade Legislation, 1934–2002

Legislation	President
1934 Reciprocal Trade Agreements Act	Roosevelt
1937 RTAA Extension	Roosevelt
1940 RTAA Extension	Roosevelt
1943 RTAA Extension	Roosevelt
1945 RTAA Extension	Roosevelt
1948 RTAA Extension	Truman
1949 RTAA Extension	Truman
1951 RTAA Extension	Truman
1953 RTAA Extension	Eisenhower
1954 RTAA Extension	Eisenhower
1955 RTAA Extension	Eisenhower
1958 RTAA Extension	Eisenhower
1962 Trade Expansion Act	Kennedy
1974 Trade Act	Nixon
1979 Trade Agreements Act	Carter
1984 Trade and Tariff Act	Reagan
1988 Omnibus Trade Act	Reagan
2001 Trade Policy Authority Act	Bush

this has been achieved by writing explicit constraints on executive action into the legislation delegating authority and in part by delegating authority only for short periods of time. The 1934 RTAA, for example, authorized the president to reduce American tariffs only by 50 percent, and even this authority expired after three years. Subsequent extensions adopted essentially the same approach. In addition, in a practice that began with the 1974 Trade Act, Congress now requires all trade agreements negotiated under this delegated authority to be ratified by Congress under the fast track procedure. Congress instituted fast track in 1974 because the GATT's Tokyo Round included a number of issues that would require changes to American trade law. Of particular concern were negotiations on antidumping and countervailing duty investigations. Congress was unwilling to give prior consent to any changes to American laws that might emerge from the Tokyo Round. At the same time, however, it could not easily establish parameters within which the executive would have to negotiate. The solution that Congress adopted was to provide the executive with the authority to negotiate, but to require Senate approval of the resulting agreement. The need to secure congressional approval of the trade agreements that the executive concludes ensures that congressional concerns are taken into account during the negotiating process.

Congress also created a new agency inside the Executive Office of the President, called the **United States Trade Representative** (USTR), to lead and coordinate American trade policy. During the early postwar period the State Department took the lead in GATT negotiations. By the late 1950s, however, Congress was becoming concerned that the State Department was not the best representative of American commercial interests. Too often, the congressional leadership argued, State Department officials approached trade negotiations from the context of America's broader

foreign policy objectives. As a consequence, the State Department was too often willing to achieve these broader objectives by sacrificing the interests of American industries, in essence opening American markets to imports without gaining equivalent access to foreign markets. To ensure that American commercial interests were well served in GATT negotiations, Congress created a new agency called the Special Trade Representative (STR), as part of the 1962 Trade Expansion Act. The STR was to be the "chief representative of the United States during trade negotiations" and it was to coordinate the positions of various executive branch agencies for these negotiations. In addition, Congress required the STR to seek advice from industry, agriculture, and labor during trade negotiations. During the 1970s Congress made the USTR a statutory unit of the Executive Office and gave it its current name. Today, the USTR sets and administers U.S. trade policy, is the nation's chief trade negotiator, and represents the United States in the WTO and other international trade organizations. Through all of these mechanisms, Congress has maintained a considerable degree of influence over how the executive uses the trade policy authority that Congress delegates.

Congress has not been entirely unresponsive to the interests of import-competing industries. Congress established a rule-based system of administered protection to handle demands for protection from individual industries (see Goldstein 1986). Industries can seek protection through two different administrative channels. First, an industry can pursue protection through the "escape clause" included in American trade legislation (Sections 201 and 204 of the 1974 Trade Act) and embodied in Article XIX of the GATT. Article XIX of the GATT states that governments can provide protection if "any product is being imported . . . in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers." To gain import protection under this remedy, the industry must file a case with the **United States International Trade Commission** (ITC), an independent and nonpartisan quasi-judicial federal agency that provides trade expertise to Congress and the executive. The ITC then conducts an investigation in order to determine whether imports are causing substantial damage to the industry in question. If the ITC determines that imports are causing substantial harm to the industry, it recommends to the executive that relief be granted. The executive then decides whether or not to provide such relief. When President George W. Bush raised tariffs on imported steel in the spring of 2002, for example, he did so on the basis of an ITC investigation undertaken during 2001 under Section 201 of the 1974 Trade Act. Second, a firm can apply for protection in cases of "unfair trade," which are cases in which a foreign firm is dumping goods in the American market or a foreign government is subsidizing the production or export of a good. Petitions for relief from unfair trade go through a two-stage administrative process. In the first stage the Commerce Department determines whether foreign firms are dumping or a foreign government is providing subsidies. If Commerce finds evidence of such practices the case then goes to the ITC, which determines whether dumping or subsidies are a cause of substantial injury to the domestic industry. If the ITC and the Commerce Department both reach positive findings, then the tariff will be raised to offset the margin of dumping or the subsidy. This system of administered protection allows industry demands for protection to be handled on a case-by-case basis within a system guided by legal rules and administrative procedures.

In short, desiring liberalization but facing a legislative process that made this difficult to achieve, politicians representing export-oriented interests created political institutions that reduced the role played by Congress in making American trade policy. The interaction between societal interests and these institutional arrangements created a political system within which trade liberalization could be lastingly achieved. This institutional framework allowed the United States to participate in GATT, and through the GATT process the United States progressively reduced barriers to trade. It is unlikely that the United States would have been able to pursue a trade policy that was as durably liberal in the absence of this institutional change. The executive could have participated in GATT negotiations without delegated authority. But the need to submit the resulting agreements to Congress, and the ability of Congress to amend these agreements, would have greatly reduced the chances that multilateral negotiations would succeed. Thus, the creation of institutions that limited the role played by Congress in trade policy has been a critically important aspect of postwar liberalization. Equally important was the process established for handling industry demands for protection. Individual demands for protection could not simply be ignored, because the affected industries might then build a legislative coalition that reversed the liberal emphasis of American trade policy. The system of administered protection allowed demands for protection to be handled on a case-by-case basis. This in turn allowed protectionist pressure to be diverted away from the legislature, where congressional dynamics could generate broader protectionist legislation, to administrative agencies immune to such dynamics.

This historical context makes it clear that the contemporary congressional debate over fast track authority has implications that extend beyond the terms under which the United States participates in the current round of WTO negotiations. This debate suggests that congressional support for the institutions that have made postwar liberalization possible is weakening. At the base of this weakening support lie some important changes in the interests of many American industries. As postwar reconstruction was completed in Europe and Japan, as American tariffs have been reduced, and as competitive manufacturing industries emerged in East Asia and Latin America, American industry began to confront a much more competitive economic environment. For many industries, tougher competition implied costly adjustment. As a consequence, some economic groups that had supported trade liberalization in the early postwar period became advocates of protectionism. Perhaps chief among these groups is organized labor. Since the early 1970s the AFL-CIO has grown more critical of the pro-liberalization stance of American trade policy and has in many instances advocated a more protectionist policy. Mature capital-intensive manufacturing industries such as the auto and steel industries also have become less supportive of trade liberalization. Such industries have repeatedly, and often with considerable success, sought protection from foreign competition during the last 25 years. It is not surprising that these two groups would become wary of liberalization. Most labor unions represent workers employed in mature capital-intensive manufacturing industries like the auto and steel industries, and these industries have seen the comparative advantage they enjoyed in the years immediately following World War II gradually erode. Their change from export-oriented industries to import-competing industries has been accompanied by a change in their trade policy preferences.

As we would expect, Congress has been responsive to growing demands for protection. Indeed, current reluctance to approve fast track authority is only one in a series of decisions that highlight the growth of protectionist sentiment in Congress. During the 1970s Congress loosened the guidelines governing administered protection (Destler 1995, Chapter 6). These changes reduced the threshold for determining whether an industry is injured from imports from the prior standard that imports be the major cause of injury to the much less stringent requirement that imports be a "substantial cause of injury or threat thereof" (Destler 1995, 143). Congress also granted the ITC greater independence, greatly reduced the time frame within which petitions for relief had to be decided, and transferred authority for investigating antidumping and countervailing duty petitions from the Treasury Department to the Commerce Department, which it was believed would be more receptive to demands for protection (Destler 1995, 150). These changes made it easier for industries to get a positive finding, and therefore, made it more likely that firms facing import competition would petition for relief. As a result, petitions for relief, and the amount of relief provided, both rose sharply in the wake of these legislated reforms (See Destler 1995, Chapter 6). And as we saw in Chapter 2, during the 1980s and early 1990s Congress began to pressure the executive branch to adopt a more aggressive policy toward countries engaging in what it believed to be "unfair" trade practices through Section 301 of American trade law.

Current congressional reluctance to support fast track legislation is thus the most recent manifestation of a 25 year trend of growing protectionist sentiment in Congress and growing congressional assertiveness in American trade policy. These changes in congressional trade politics in turn reflect changes in the balance of power among the industry groups that legislators represent. They suggest a growing influence for groups in import-competing industries and a weakening of influence for export-oriented industries. The outcome of this political competition will in turn shape the future direction of American trade policy in part by shaping the institutions through which American trade policy is made. Congressional support for fast track legislation will safeguard the pro-liberalization orientation of American trade policy and allow the executive to pursue additional liberalization in multilateral and regional negotiations. Defeat of fast track will make international negotiations extremely difficult, if not altogether impossible, and may in fact herald the transition back to the old system in which Congress fully dominated trade policy. Such developments would almost surely bring greater protection.

Weaknesses of a Society-centered Approach

While a society-centered approach helps us understand how the interaction between societal interests and political institutions shapes trade policies, it does have weaknesses. Let us now turn to the three most significant weaknesses. First, a society-centered approach does not explain trade policy outcomes. It tells us that trade politics will be characterized by conflict between the winners and losers from international trade, and it does a fine job telling us who the winners and losers will be. It does not help us predict or explain which of these groups will win the political battle. Presumably, a country's trade policy will embody the preferences of the most powerful interest

groups. To explain trade policy outcomes, therefore, we need to be able to evaluate the relative power of the competing groups. The society-centered approach provides little guidance about how to measure this balance of power. The temptation is to look at trade policy outcomes and deduce that the most powerful groups are those whose preferences are reflected in this policy. Yet, looking at outcomes renders this approach tautological; we assume that the preferences of powerful groups are embodied in trade policy, and then infer the power of individual groups from the content of trade policy. Thus, the society-centered approach is better at explaining why trade politics is characterized by competition between societal groups than at telling us why one group outperforms another in this competition for influence.

Second, the implicit claim at the center of this approach that politicians have no independent trade policy objectives and play no autonomous role in trade politics is probably misleading. Politicians are not simply passive recorders of interest group pressures. As Ikenberry et al. (1988, 8) note, politicians and political institutions "can play a critical role in shaping the manner and the extent to which social forces can exert influence" on trade policy. Politicians do have independent trade policy objectives and the constellation of interest groups that politicians confront is not fixed. Indeed, politicians can actively attempt to shape the configuration of interest group pressures that they face. They can, for example, mobilize latent interest groups that have a preference for liberalization or protection by helping them overcome their collective action problem. By doing so, politicians can create coalitions of interest groups that support their own trade policy objectives. Political institutions also affect the extent to which societal groups can influence policy. In some countries, political institutions insulate politicians from interest group pressures, thereby allowing politicians to pursue their trade policy objectives independent of interest group demands. We will examine this in greater detail when we look at the state-centered approach in the next section.

Finally, the society-centered approach developed here does not address the motivations of noneconomic actors in trade politics. Societal interest groups other than firms, business associations, and labor unions do attempt to influence trade policy. In the United States, for example, environmental groups have played a prominent role in trade politics, shaping the specific content of the North American Free Trade Agreement and attempting to shape the negotiating agenda of the Millennium Round. Human rights groups have also become active participants in American trade politics. This has been particularly important in America's relationship with China. Human rights groups have consistently sought to deny Chinese producers access to the U.S. market in order to encourage the Chinese government to show greater respect for human rights. The assumption that trade politics are driven by the reactions of interest groups to the impact of international trade on their incomes provides little insight into the motivations of noneconomic groups. The society-centered approach tells us nothing about why groups that focus on the environment or human rights spend resources attempting to influence trade policy. Nor does it provide any basis with which to make sense of such groups' trade policy preferences. In the past, such a weakness could perhaps be neglected because noneconomic groups played only a small role in trade politics. The contemporary backlash against globalization suggests, however, that these groups must increasingly be incorporated into society-centered models of trade politics.

A State-centered Approach to Trade Policy

A state-centered approach assumes that trade policy, as well as economic policy more broadly conceived, is set by the state in pursuit of the national interest. The state occupies a privileged position in any country; it defines the rules within which others act, it alone has the authority to make definitive decisions about these rules, and it alone has the coercive capacity necessary to extract resources from society and to allocate them in line with its economic objectives. The state-centered approach argues that states use this power to intervene in the economy in pursuit of objectives that are determined independent from domestic interest groups' narrow self-interested concerns. The state-centered approach therefore depicts a process of economic policy-making in which protection and liberalization reflect the interests and power of the state. We examine the state-centered approach with a specific focus on government intervention designed to promote national economic development. We look first at the broader economic justification for protectionism aimed at creating internationally competitive industries, and then narrow our focus to the use of such measures by the advanced industrialized countries in high technology industries. In the concluding section we look briefly at the weaknesses of this approach.

States and Industrial Policy

A state-centered approach assumes that governments and government bureaucracies can operate independently of interest group pressures. As a consequence, trade and economic policies do not necessarily reflect the interests of societal pressure groups, but instead embody the goals of state policymakers. The ability to formulate and implement policy independent from societal group demands allows the state to pursue objectives that enhance national welfare, however that may be defined, rather than raise the income of specific interest groups. This approach argues that states use their capacity for autonomous action to intervene in the domestic economy in order to promote the development of industries that will make a positive contribution to national economic development and to discourage those industries deemed less likely to make a positive contribution. As we will see below, governments in many of the advanced industrialized countries have used such policies in some form during the postwar period, and some authors attribute Japan's postwar economic success to such policies.

The intellectual justification for state intervention in the economy rests on the claim that targeted government intervention can create internationally competitive industries. Historically, this justification has been provided by the infant industry case for protection. The **infant industry case for protection** applies to cases in which a country's newly-created firms (infants, so to speak) could not *initially* compete against foreign producers in an established industry, but would be able to do so eventually if they were given time to mature. The infant industry case for protection rests on a presumed disjuncture between the social and private returns from manufacturing (Balassa and Associates 1971, 93). While manufacturing activity yields high social returns (that is, it provides large benefits to society as a whole), the short-term private returns (the profits realized by the person or firm making the investment) are at best uncertain and at worst negative. This disjuncture between the social and private returns can arise

because a new firm that might be profitable in the long run might operate at a loss in the short run because it cannot produce goods at a cost that is competitive with established firms. Over time, however, the new firm will gain experience that will enable it to reduce its cost of production and become competitive with older established firms.

The logic of the infant industry case for protection applies most directly to **late industrializers**—countries that are trying to develop manufacturing industries in competition with established manufacturing industries in other countries. This term obviously describes most developing countries in the contemporary international economic system. But it once described many of today's advanced industrialized countries, including the United States, as they attempted to develop manufacturing industries in the face of dominant British manufacturing power in the nineteenth century. It also describes modern Japan and the continental European states, all of which were trying to develop advanced manufacturing industries in the face of American competitive advantages in these sectors during the twentieth century. Protecting domestic firms in such cases can enable them to overcome their initial competitive disadvantages by allowing them to gain experience by producing for the domestic market (we will look more closely at why protection might facilitate the development of competitive industries in the next section). Once domestic firms become competitive in world markets, protection can be eliminated.

The infant industry argument for protection is not universally accepted. Critics charge that a tariff or another form of protection is probably not the best response to the central problem the firm confronts. If a firm will be profitable in the long run, but must operate at a loss in the short run, the firm should be able to borrow from private capital markets to cover its short run losses. Such borrowing would obviate the need for trade protection, because the firm could sell its goods at the same price as the established firm and use the borrowed funds to cover its losses until it begins to reduce its production costs. If capital markets are not sufficiently developed to allow infant industries to borrow the necessary funds, the government can do more to raise social welfare by improving the capital market to make such lending possible than by imposing a tariff to protect the infant industry (Baldwin 1969). While this criticism questions the use of protection to promote industry development, it does not challenge the central claim of the infant industry argument, namely that firms that can be competitive in the long run might need some form of government assistance in the short run.

Industrial policy takes the infant industry argument one step further by suggesting that governments can create internationally competitive industries through a combination of protection and subsidies. The term **industrial policy** refers to an assortment of policies including tax policy, government subsidies, traditional protectionism, and government procurement practices. By using such policies, the state channels resources away from some actors and industries and directs them toward those actors and industries that it wishes to promote. The use of such policies is typically based on long-term economic development objectives defined in terms of boosting economic growth, improving productivity, and enhancing international competitiveness. The specific goals often are determined by explicit comparisons to other countries' economic achievements (Wade 1990, 25–26). In postwar Japan, for example, the explicit goal of Japanese industrial policy was to catch up with the United States in many high-technology industries. In formulating and implementing industrial policy, the state rarely secures

full independence. Instead, it formulates and implements policy through a process of continuous consultation and coordination with private sector actors (Wade 1990, 26).

Not all states are well suited for the design and implementation of an effective industrial policy. The critical factor is state strength. **State strength** refers to the degree to which the state is insulated from domestic interest group pressures. **Strong states** are states in which policymakers are highly insulated from such pressure, while **weak states** are those in which policymakers are fully exposed to such pressures. Strong states are characterized by a high degree of centralization of authority, a high degree of coordination among state agencies, and a limited number of channels through which societal actors can attempt to influence policy. In contrast, weak states are characterized by decentralized authority, a lack of coordination among agencies, and a large number of channels through which domestic interest groups can influence economic policy. These political institutional characteristics make it easier for strong states to formulate long-term plans embodying the national interest. In weak states, policymakers must respond to the particularistic and often short-run demands of interest groups. Strong states may also be more able than a weak state to remove protection once an infant industry has matured. In addition, strong states may be more able to implement industrial policies that redistribute societal resources because policymakers need worry less that policies that redistribute resources from one domestic group to another will have a negative impact on their position in power.

Japan is often depicted as the preeminent example of a strong state that has been able and willing to use industrial policy to promote economic development (see, e.g., Johnson 1982). The Japanese state centralizes power and provides limited channels of access to domestic interest groups. Because of this highly centralized state, Japan has been able to pursue a coherent industrial policy throughout the postwar period. The Ministry of International Trade and Industry (MITI) (now called METI) and the Ministry of Finance (MoF) were the principal agencies involved in developing and implementing industrial policy. In the immediate postwar period, these agencies gave priority to economic reconstruction and to improving the prewar industrial economy. Since the 1960s, greater emphasis has been placed on promoting rapid economic growth and developing internationally competitive high technology industries (Pempel 1977, 732). With this goal firmly in mind, the Japanese state pursued an active industrial policy (called administrative guidance) through which it channeled resources to those industries it determined critical to Japanese success. Together, MITI and MoF targeted specific industries for development, starting with heavy industries (steel, shipbuilding, automobiles) in the early postwar period and then shifting to high technology industries during the 1970s. The state pressured firms to invest in the industries targeted for development, and those that made such investments benefited from tariff and nontariff forms of protection, tax credits, low-cost financing, and other government subsidies. Some scholars suggest that Japan's remarkable postwar economic performance was a direct result of this state-centered approach to economic development (Johnson 1982).

France also relied heavily upon industrial policies throughout much of the postwar period (Wilkinson 1984; Hart 1992). The French state is highly centralized and French bureaucracies are tightly insulated from societal group pressures, as in Japan. This structure allowed the French government to pursue an industrial policy aimed at developing key industries with little direct influence from domestic interest groups. A

former Director of the Ministry of Industry described the policymaking process: "first, we make out a report or draw up a text, then we pass it around discreetly within the administration. Once everyone concerned within the administration is agreed on the final version, then we pass this version around outside the administration. Of course, by then it is a *fait accompli* and [interest group] pressure cannot have any effect" (quoted in Katzenstein 1977, 18). In the early postwar period, the French state formulated development plans to "establish a competitive economy as an essential base for political independence, economic growth, and social progress" (Katzenstein 1977, 22). French industrial policy in this period was based on a strategy of "National Champions," under which specific firms in industries deemed by the French state to be critical to French economic development received support. In the 1950s and 1960s, for example, two French steel companies and a small number of French auto producers (Renault, Simca, Peugeot) received state support. During the 1960s and 1970s, the French state attempted to develop a domestic computer industry by channeling resources to specific French computer companies such as Machines Bull. This strategy is now widely acknowledged to have been unsuccessful as French national champions failed to become competitive in international markets (Hart 1992).

In contrast to Japan and France, the United States is characterized as a weak state (Katzenstein 1977; Ikenberry et al. 1988). Political power in the United States is decentralized through federalism, through the division of powers within the federal government, and through independent bureaucratic agencies. This decentralization of power in turn provides multiple channels through which domestic interest groups can attempt to influence policy. Consequently, "American state officials find it difficult to act purposefully and coherently, to realize their preferences in the face of significant opposition, and to manipulate or restructure their domestic environment" (Ikenberry et al. 1988, 11). American trade and economic policy therefore more often reflects the interests of societal pressure groups than the "national interest" defined by state policymakers. This does not mean that the United States has been unable to support critical industries. American national security and defense policies have channeled substantial resources to maintaining technological leadership over potential rivals. To maintain this lead, the U.S. government has financed the basic research that underlies many high technology products, including computers, telecommunications, lasers, advanced materials, and even the internet. In addition, Department of Defense contracts have supported firms that produce both military and civilian items. Thus, even though the United States is a weak state, we do see a form of industrial policy in the U.S. government's support for basic research and in its defense-related procurement practices designed to meet national security objectives.

The state-centered approach therefore argues that state policymakers can use industrial policy to promote domestic economic development by helping domestic firms gain international competitiveness. The ability of policymakers to pursue such policies, however, is strongly influenced by the institutional structure of the state in which they operate. In strong states, such as Japan and France, policymakers are insulated from domestic interest groups and can therefore use industrial policy to promote economic development in line with the national interest. In weak states, such as the United States, policymakers cannot easily escape interest group pressures and as a consequence trade and economic policy is more likely to reflect the particularistic demands of these groups than any broader conceptions of the national interest.

Industrial Policy in High-technology Industries

High-technology industries have been one area in which governments in many of the advanced industrialized countries have relied heavily upon industrial policies. Boosting the international competitiveness of such industries has been the principal goal of such policies. High-technology industries are highly valued for the contribution they make to national income. These industries tend to earn **rents,** that is, they earn a higher than normal return on an investment, and they pay higher wages to workers than standard manufacturing industries. In addition, relatively recent developments in economic theory that build on the basic insight of the infant industry case for protection suggest that governments can use industrial policy to create internationally competitive domestic high technology industries. We examine these issues here, focusing first on the economic theories that justify the use of industrial policy in high-technology industries and then examining two cases in which industrial policy appears to have enabled high-technology firms based in Japan and the EU to become internationally competitive at the apparent expense of high-technology firms based in the United States.

Strategic trade theory. Strategic trade theory provides the theoretical justification for industrial policy in high technology industries. **Strategic trade theory** expands on the basic insight of the infant-industry case for protection, and asserts that government intervention can help domestic firms gain international competitiveness in high-technology industries by helping them overcome the competitive advantages enjoyed by established firms. Competitive advantage in high-technology industries often comes from the combination of economies of scale and oligopoly. **Economies of scale** occur when the unit cost of producing a good falls as the number of goods produced increases. Economies of scale often arise from the knowledge acquired in production. In early stages of production, workers continually confront new tasks, learn new techniques, and discover unrecognized bugs in the production line. As the number of units produced rises, tasks and techniques that had once been novel become routine and workers become better at producing the good. The time it takes to produce a particular good falls and consequently the costs of production fall as well. For example, when the European commercial aircraft producer Airbus Industrie built its first jet, 340,000 man-hours were required to assemble the jet's fuselage. As output expanded, however, this time fell rapidly. By the time that Airbus had produced 75 aircraft, only 85,000 man-hours were required to assemble the fuselage, and eventually this number fell to 43,000 man-hours (McIntyre 1992, 36). The cost savings realized as a result of these dynamics are often called "moving down the learning curve."

Economies of scale give rise to oligopolistic market structures. **Oligopoly** refers to markets in which a very limited number of firms operate. In contrast to perfectly competitive markets in which all firms are price takers, that is, a single firm's output has no impact on the market price of its good, in oligopolistic markets each firm is a price maker—the decisions it makes about how much to produce will have an impact on the market price of its products. Oligopoly so often characterizes high-technology industries because world demand for the goods produced in these industries is usually large enough to support only a few firms operating at the level of output necessary to realize economies of scale. The market for commercial jets, for example, is large enough to support only two or three aircraft manufacturers operating at peak efficiency. In oligopolistic market structures, the behavior of each individual firm has an

impact on other firms. The successful entry of a new firm into an established industry, for example, will reduce the profitability of established firms and can even force these firms to exit the industry. But in such an environment, economies of scale provide the firms that enter a particular high-tech industry first with a large cost advantage over potential rivals. As a consequence, firms that would be competitive if they could move down the learning curve and realize economies of scale are deterred from entering the industry because the cost advantage enjoyed by the established firm makes success unlikely. The nature of the disadvantage is simple: who will buy the new entrant's higher cost output? Absent such sales the new firm will never realize the scale economies essential to long-term success. As a consequence, international competitiveness, as well as the pattern of international specialization in high-technology industries, can be attributed as much to the timing of market entry as to underlying factor endowments.

The dynamics of competition in high-technology industries can be illustrated with a simple game borrowed from work by the economist Paul Krugman (Krugman 1987). This game highlights how industrial policy can help a new firm entering a high-technology industry gain competitiveness at the expense of established firms. Let's assume that there are two firms, one American and one Japanese, interacting in a high-tech industry that will support only one producer. Each firm has two strategies, to produce or to not produce. The payoffs that each firm gains from the four possible outcomes are depicted in Table 3.4a. There are two possible equilibrium outcomes in this game, one in which the American firm produces and the Japanese firm does not (cell II), and one in which the Japanese firm produces and the American firm does not (cell IV). Thus, this particular high-tech industry will be based in the United States or in Japan, but never in both.

Which country will capture the industry? That depends upon which firm is first to enter the market. Let's suppose that the American firm is first to enter the industry and has realized economies of scale. The Japanese firm has no incentive to enter the industry because by doing so it would earn a profit of negative 5. If we assume that the Japanese firm is first to enter the market, then it realizes scale economies and the American firm has no incentive to enter the market. Thus, even though both firms could produce the product equally well, the firm that enters first dominates the industry. According to strategic trade theory, therefore, international specialization in high-technology industries has little to do with underlying factor endowments. The firm that is first to enter a particular high-technology industry will hold a competitive advantage, and the country that is home to this firm will capture the rents available in this industry.

Against this backdrop we can examine how governments can use industrial policy to help domestic high-technology firms. Government intervention can help new firms enter an established high-technology industry to challenge and eventually compete with established firms. Government assistance to these new firms can come in many forms. Governments may provide financial assistance to help their new firms pay for the costs of research and development. Such subsidies help reduce the costs that private firms must bear in the early stages of product development, thereby reducing the up-front investment a firm must make to enter the industry. Governments may also guarantee a market for the early and more expensive versions of the firm's products. Tariffs and quotas can be used to keep foreign goods out, and government purchasing decisions can favor domestic producers over imports. The Japanese government, for example, purchased most of its supercomputers from Japanese suppliers in the 1980s, even though the supercomputers produced by the American firm Cray Industries were cheaper and

performed at a higher level. The guaranteed market allows domestic firms to sell their high-cost output from early stages of production at high prices. The combination of financial support and guaranteed markets allows domestic firms to enter the market and move down the learning curve. Once the new firms have realized economies of scale, they can compete against established firms in international markets.

We can see the impact of such policies on firms' production decisions using the simple game developed above (see Figure 3.4b). Suppose that the American firm is the first to enter and dominates the industry. Suppose now that the Japanese government provides a subsidy of 10 units to the Japanese firm. The subsidy changes the payoffs the Japanese firm receives if it produces. In contrast to the no subsidy case, the Japanese firm now makes a profit of 5 units when it produces even if the American firm stays in the market. The subsidy therefore makes it rational for the Japanese firm to start producing. Government support for domestic high-technology firms has a second consequence that stems from the oligopolistic nature of high-tech industries. Because such industries support only a small number of firms at profitable levels of output, the entry of new firms into the sector must eventually cause other firms to exit. Thus, government policies that promote the creation of a successful industry in one country undermine the established industry in other countries. This outcome is also clear in our simple game. Once the Japanese firm begins producing, the American firm earns a profit of negative 5 if it continues to produce, and a profit of 0 if it exits the industry. Exit, therefore, is the American firm's rational response to the entry of the Japanese firm. Thus, the small 10-unit subsidy provided by the Japanese government enables the Japanese firm to eliminate the first mover advantage enjoyed by the American firm and ultimately drive the American firm out of the industry. As a consequence, Japan's national income rises by 100 units (the 110 unit profit realized by the Japanese firm minus the 10 unit subsidy from the Japanese government) while America's national income falls by 100 units. A small subsidy has allowed Japan to increase its national income at the expense of the United States.

		Japanese Firm	
		Produce	Not Produce
American Firm	Produce	–5, –5	100, 0
	Not Produce	0, 100	0, 0

3.4a Payoff Matrix with No Subsidy

		Japanese Firm	
		Produce	Not Produce
American Firm	Produce	–5, 5	100, 0
	Not Produce	0, 110	0, 0

3.4b Payoff Matrix with Japanese Subsidy

Figure 3.4 The Impact of Industrial Policy in High-Technology Industries.
Source: Based on Krugman 1987.

Strategic rivalry in semiconductors and commercial aircraft. The semiconductor industry and the commercial aircraft industry illustrate these kinds of strategic trade rivalries between the United States, Japan, and the EU in the contemporary global economy. In the semiconductor industry, American producers enjoyed first mover advantages and dominated the world market until the early 1980s. The semiconductor industry prospered in the United States in part due to government support in the form of funding for research and development (R&D) and for defense-related purchases. The U.S. government financed a large portion of the basic research in electronics—as much as 85 percent of all R&D prior to 1958, and as much as 50 percent during the 1960s. At the same time, the U.S. defense industry provided a critical market for semiconductors. Defense-related purchases by the United States government absorbed as much as 100 percent of total production in the early years. Even in the late 1960s the government continued to purchase as much as 40 percent of production. These policies allowed American semiconductor firms to move down the learning curve and realize economies of scale. This first mover advantage was transformed into a dominant position in the global market. In the early 1970s, U.S. semiconductor producers controlled 98 percent of the American market and 78 percent of the European market.

Beginning in the 1970s, the Japanese government targeted semiconductors as a sector for priority development and used two policy measures to foster a Japanese semiconductor industry. First and most important, the Japanese government used a variety of measures to protect Japanese semiconductor producers from American competition. Tariffs and quotas kept American chips out of the Japanese market. The Japanese government also approved very few applications for investment by foreign semiconductor firms and restricted the ability of American semiconductor firms to purchase existing Japanese firms. As a direct result, American semiconductor firms were unable to jump over trade barriers by building semiconductor production plants in Japan. Japanese industrial structure—a structure in which producers develop long-term relationships with input suppliers—helped ensure that Japanese firms that used semiconductors as inputs purchased from Japanese rather than American suppliers. Finally, government purchases of computer equipment discriminated against products that used American chips in favor of computers that used Japanese semiconductors. The extent of Japanese protectionism can be appreciated by comparing U.S. market shares in the United States, EU, and Japanese markets. Whereas American semiconductor firms controlled 98 percent of the American market and 78 percent of the EU market in the mid-1970s, they held only 20 percent of the Japanese market (Tyson 1992, 93). Second, the Japanese government provided financial assistance to more than 60 projects connected to the semiconductor and computer industry. Such financial assistance helped cover many of the research and development costs Japanese producers faced.

By 1976, Japanese firms were producing highly sophisticated chips and had displaced American products from all but the most sophisticated applications in the Japanese market. Success in the Japanese market was followed by success in the global market. Japan exported more semiconductors than it imported for the first time in 1979. By 1986 Japanese firms had captured about 46 percent of global semiconductor revenues, while the American firms' share had fallen to 40 percent (Tyson 1992, 104–105). By protecting domestic producers and subsidizing research and development costs, the Japanese government helped Japanese firms successfully challenge American dominance of the semiconductor industry.

A similar dynamic is evident in U.S.-European competition in the commercial aircraft sector. Two American firms, Boeing and Douglas (later McDonnell Douglas) dominated the global market for commercial aircraft throughout the postwar period, in part because of U.S. government support to the industry provided through the procurement of military aircraft (Newhouse 1982; Office of Technology Assessment 1991, 345). Work on military contracts enabled the two major American producers to achieve economies of scale in their commercial aircraft operations. Boeing, for example, developed one of its most successful commercial airliners, the 707, as a modified version of a military tanker craft, the KC-135. This allowed Boeing to reduce the cost of developing the commercial airliner. Both jets in turn benefited from the experience Boeing had gained in developing the B-47 and the B-52 bombers (OTA 1991, 345). As Joseph Sutter, a Boeing executive vice president noted, "We are good . . . partly because we build so many airplanes. We learn from our mistakes, and each of our airplanes embodies everything we have learned from our other airplanes" (quoted in Newhouse 1982, 7). The accumulated knowledge from military and commercial production gave the two American producers a first-mover advantage in the global market for commercial airliners sufficient to deter new entrants.

In 1967, the French, German, and British governments launched Airbus Industrie to challenge the global dominance of Boeing and McDonnell Douglas. Between 1970 and 1991, these three European governments provided between $10 and $18 billion of financial support to Airbus Industrie, an amount equal to about 75 percent of the cost of developing Airbus airliners (OTA 1991, 354). As a consequence, by the early 1990s Airbus Industrie had developed a family of commercial aircraft capable of serving the long-range, medium-range, large passenger, and smaller passenger routes. Airbus's entry into the commercial aircraft industry had a dramatic impact on global market share. As Table 3.7 makes clear, in the mid-1970s Boeing and McDonnell Douglas dominated the market for large commercial airliners. Airbus began to capture market share in the 1980s, however, and by 1990 it had gained control of 30 percent of the market for large commercial airliners. In 1994 Airbus sold more airliners than Boeing. As a consequence of Airbus's success, a substantial portion of the rents available from the production and sale of commercial airliners has been transferred from the United States to Europe. Thus, by subsidizing the initial costs of aircraft development, European governments have been able to capture a significant share of the global market for commercial aircraft, and the income generated in this sector, at the expense of the United States.

Strategic trade rivalries of this kind have been a source of conflict in the international trade system. Countries losing high-technology industries as a consequence of the industrial policies pursued by other countries can respond by supporting their own

Table 3.7
Market Share in Global Commercial Aircraft

	Boeing	McDonnell Douglas	Airbus
1975	67%	33%	0
1985	63%	20%	17%
1990	54%	16%	30%

Source: Calculated from Data in Tyson 1992, 158–159.

firms to offset the advantages enjoyed by foreign firms or by attempting to prevent foreign governments from using industrial policy. In the United States, which considered itself a victim of the industrial policies adopted by Japan and the EU, the national debate has focused on both responses. Considerable pressure emerged during the 1980s and early 1990s for a national technology policy. Proposals were advanced for the creation of a government agency charged with reviewing global technology and "evaluating the likely course of key American industries; comparing these baseline projections with visions of industry paths that would be compatible with a prosperous and competitive economy; and monitoring the activities of foreign governments and firms in these industries to provide an early warning of potential competitive problems in the future" (Tyson 1992, 289). Many recommended that the U.S. government reduce its R&D support for military and dual use projects (dual use refers to projects with military and commercial applications) and increase the amount of support provided to strictly commercial applications. Proponents of a national technology strategy also encouraged greater cooperation between the public and private sector on precompetitive research in a wide range of advanced technologies. Such proposals played an important role in the first Clinton Administration's thinking about international trade, a role reflected in Clinton's selection of Laura D'Andrea Tyson, an economist and one of the most prominent proponents of such policies, to be the Chair of his Council of Economic Advisors.

The United States also put considerable pressure on other governments to stop their support of high-technology industries. A series of negotiations with Japan that were conducted during the 1980s and early 1990s were designed to pry open the Japanese market to internationally competitive American high-technology industries. Such negotiations took place in semiconductors, computers, telecommunications, and other sectors. The rationale for these negotiations is evident from the previous discussion about first mover advantages. If Japanese firms could be denied a protected market for their early production runs, they would never realize the scale economies required to compete in international markets. Opening the Japanese market to American high-technology producers would prevent the emergence of competitive Japanese high-technology firms and thereby help maintain American high-technology leadership. During the 1980s and early 1990s, therefore, the United States responded strategically to the use of industrial policies by Japan and, to a lesser extent, the EU and adopted policies designed to counter them.

Weaknesses of the State-centered Approach

While a state-centered approach directs our attention to the important role that states play in shaping the structure of their domestic economies, it does have some important weaknesses. Three such weaknesses are perhaps most important. First, the state-centered approach lacks explicit micro-foundations. The approach asserts that states act in ways that enhance national welfare. A critical student must respond to this assertion by asking one simple question: what incentive does the state have to act in ways that do in fact enhance national welfare? Anyone who has visited the Palace of Versailles in France, or that has spent anytime reading about the experience of other autonomous rulers knows that autonomous states have as much (if not more) incentive to act in the private interests of state officials as they have to act in

the interest of society as a whole. Why then would autonomous state actors enrich society when they might just as easily enrich themselves? Answering this question requires us to think about how state actors are rewarded for promoting policies that enhance national welfare and punished for failing to do so. In answering this question we develop micro-foundations—an explanation that sets out the incentive structure that encourages state officials to adopt policies that promote national welfare. But the state-centered approach currently does not offer a good answer to this question. The reward structure that state policymakers face cannot be elections, for that pushes us back toward a society-centered approach. The reward structure might be security related; one could reasonably argue that states intervene to enhance the power and position of the nation in the international system. We must still explain, however, how these broad concerns about national security create incentives for individual policymakers to make specific decisions about resource allocation. The point is not that such micro-foundations could not be developed, but rather that as far as I am aware, no one has yet done so. As a result, the state-centered approach provides little justification for its central assertion that states will regularly act in ways that enhance national welfare.

Second, the assumption that states make policy independent of domestic interest group pressure is misleading. Even highly autonomous states do not stand above *all* societal interests. While interest groups need not dictate policy, as the society-centered approach claims, they do establish the parameters in which policy must be made. Even in Japan, which comes closest to the ideal autonomous state, the LDP's position in government was based in part on the support of big business. Is it merely a coincidence that Japanese industrial policy channeled resources to big business, or did the Japanese state adopt such policies because they were in the interest of one of the LDP's principal supporters? Thus, whereas the society-centered approach assumes too little room for autonomous state action, the state-centered approach assumes too much state autonomy. We may learn more by fitting the two approaches together. This would lead us to expect governments to intervene in the economy to promote specific economic outcomes, but that often such policies are consistent with and shaped by the interests of the coalition of societal groups upon which the government's power rests.

Finally, strategic trade theory itself, which provides the intellectual justification for government intervention in high-technology industries, has considerable weaknesses. Strategic trade theory is as much a prescriptive theory—one used to derive policy proposals—as it is an explanatory theory. As such, it has some important limitations. The claim that government intervention can improve national welfare is not particularly robust. The conclusions one derives from any theory are sensitive to the assumptions one makes when building the theory. If the conclusions change greatly when one alters some of the underlying assumptions, then the confidence one has in the accuracy of the theory must be greatly diminished. Strategic trade theory has been criticized for producing strong conclusions only under a relatively restrictive set of assumptions. While the specific criticisms are too detailed to consider here, the bottom line is that altering the assumptions about how one country's established firms respond to a foreign government's subsidy of its firms, about how many firms are in the sector in question, and about where firms sell their products can either weaken the central

claim considerably or introduce so much complexity into the model that the policy implications become opaque.

Thus, strategic trade theory does not provide unambiguous support for the claim that government intervention in high-technology industries can raise national income. In addition, even if we assume that strategic trade theory is correct, it is not easy for governments to identify sectors in which intervention will raise national income. It is difficult to identify sectors that offer such gains and then to calculate the correct subsidy that will shift this activity to domestic producers at a net gain to social welfare. If governments choose the wrong sectors, or provide too little or too much support, intervention can reduce rather than raise national welfare. Thus, the precise policy implications of strategic trade theory are unclear, in part because the theory itself is weak, and in part because it is not easy to translate its simpler conclusions into effective policies.

Conclusion

This chapter has focused on one basic question: how do we explain the pattern of trade liberalization and protection that we see in the advanced industrialized countries? We saw that while the multilateral trade regime did promote the reduction of barriers to trade during the postwar period, governments in the industrialized world continue to protect certain sectors of their economies. This pattern of protection and liberalization corresponds with advanced industrialized countries' comparative advantages. Governments have been willing to liberalize trade in sectors in which their producers are comparatively advantaged, such as capital-intensive manufacturing. These same governments have been reluctant to liberalize those sectors in which their domestic producers are comparatively disadvantaged, such as labor-intensive manufacturing for most advanced industrialized countries, and agriculture and high technology for Japan and the EU.

We have explored how this pattern of protectionism and liberalization is a product of the interaction between interests and institutions in the domestic political arena. This chapter has presented two different ways of thinking about how domestic politics shape trade policy. The society-centered approach emphasizes the central role of societal interest groups to assert that trade policy emerges from competition between the winners and losers from international trade. Firms and workers in some industries realize rising incomes from international trade and therefore want trade liberalization, while firms and workers in other industries realize falling incomes from trade and therefore want protection. Because politicians must represent the interests of the districts and states that elect them, these groups' interests are brought into the legislative process where they give rise to competition over trade policy. In the advanced industrialized countries, this approach expects governments to liberalize sectors in which they are comparatively advantaged—capital intensive manufacturing—and to resist liberalization in industries in which they are comparatively disadvantaged—labor-intensive manufacturing for all countries, and agriculture in the case of the EU and Japan. The state-centered approach emphasizes state-level interests and political institutions and asserts that trade policy is produced by autonomous states pursuing the national interest. In conjunction with strategic trade theory, this approach leads us to expect states to intervene in the domestic economy to protect and to subsidize domestic high-technology industries. Together, these two theories provide a good explanation of the pattern of protection and liberalization that we see in the advanced industrialized countries.

Key Terms

Collective Action Problem
Comparative Statics
Consumer Surplus
Consumption Distortion
Economies of Scale
Efficiency Losses
Export-oriented Sector
Factor Mobility
Factor Model
Factor Price Equalization
Fast Track
Free Riding
Import-competing Sector
Industrial Policy
Infant Industry Case for Protection
Late Industrializers
Logrolling
Ministry of Economy, Trade, and Industry
Oligopoly
Producer Surplus
Production Distortion
Productivity
Quota Rent
Reciprocal Trade Agreements Act
Rents
Sector
Smoot-Hawley Act
Specific Factors Model
State Strength
Strategic Trade Theory
Strong States
United States International Trade Commission
United States Trade Representative
Weak States

Web Links

You can visit the United States Trade Representative at *http://www.ustr.gov*. See the links in Chapter 2 for trade policy in Japan and the EU.

For the positions of American businesses on international trade, visit:

The U.S. Trade Alliance at *http://www.us-trade.org/other/about_ustrade.htm*.
The Business Round Table at *http://www.brtable.org/issue.cfm/9*.

For the positions of American unions on international trade, visit:

The AFL-CIO at *www.afl-cio.org*.
UNITE at *http://www.uniteunion.org/index.htm*.

The United Steelworkers of America maintain a number of trade-related websites that can be reached through *http://www.uswa.org/tradesites.html*.

Suggestions for Further Reading

The literature on U.S. trade politics is enormous. The best available introduction is probably I.M. Destler, *American Trade Politics*, 3rd edition. (Washington, D.C.: Institute for International Economics, 1992). Unfortunately, there has been much less written in English on the trade policy process in the EU and Japan. For the EU, see John P. Hayes, *Making Trade Policy in the European Community* (London: The MacMillan Press, 1993). For Japan, see Chikara Higashi, *Japanese Trade Policy Formulation* (New York: Praeger, 1983).

On the issues posed by industrial policy in high-technology industries, see Laura D'Andrea Tyson, *Who's Bashing Whom? Trade Conflict in High Technology Industry* (Washington, D.C.: Institute for International Economics, 1995). For a more polemical discussion written by a former trade negotiator in the Reagan Administration, see Clyde V. Prestowitz, *Trading Places: How We are Giving Our Future to Japan and How to Reclaim It* (New York: Basic Books, 1988). For a more technical treatment, see Paul R. Krugman, ed., *Strategic Trade Policy and the New International Economics* (Cambridge: Cambridge University Press, 1986).

CHAPTER 4

Trade and Economic Development in the South

The relationship between developing countries and the international trade system has changed fundamentally during the last 20 years. Throughout most of the postwar period, developing countries participated little in the multilateral trade system. Instead, in an attempt to promote industrialization most governments constructed very high trade barriers and intervened extensively in the domestic economy. To the extent that developing countries participated at all in the GATT, they sought to alter the rules governing international trade. Convinced that the GATT was biased against their interests, developing countries worked through the United Nations to create international trade rules that they believed would be more favorable toward industrialization in the developing world. These policy orientations have both changed fundamentally since the late 1980s. Most developing countries have dismantled the protectionist systems they had created and maintained in the first 30 years of the postwar period, and most have greatly reduced the degree of government intervention in the domestic economy. At the same time, developing countries have abandoned the quest for far-reaching changes to international trade rules and have become active participants in the WTO, seeking to liberalize trade to further their own interests.

This chapter examines how political and economic forces have shaped these trade and development policies. We look first at why governments in most developing countries chose to insulate their economies from international trade, why they greatly expanded their participation in the domestic economy, and why they sought changes in international trade rules. To understand these policies, we focus specifically upon how economic theories concerning rapid industrialization dovetailed with the interests of domestic groups to shape the trade and development policies adopted by most governments in developing countries. We then turn our attention to why so many developing countries have reversed course during the last 20 years. Why, after having pursued protectionism at home and reform abroad for more than 30 years, did developing countries begin to dismantle protection at home, abandon reform in the international system, and become active participants in the WTO? In making sense of this change, we focus upon the interaction between domestic and international developments.

We conclude the chapter with a brief look at the challenges that developing countries face in the contemporary multilateral trade system.

Insulation and Systemic Reform

Until the mid-1980s governments in most developing countries pursued trade and development policies characterized by heavy state involvement in the domestic economy and limited participation in the international trade system. At home, most governments intervened extensively in their economies and restricted imports in an attempt to promote rapid industrialization. In the international system, these same governments played little role in GATT negotiations and launched a coordinated and sustained effort to change the rules governing international trade. We begin our examination of the political economy of developing countries by examining these two dimensions of postwar trade and development policy. We look first at how economic and political change brought to power throughout the developing world governments that were supported by import-competing interests. We then examine the economic theory that guided policy in this era. As we shall see, this theory provided governments in the developing world with a compelling justification for transforming the protectionism sought by the import-competing producers that supported them into policies that emphasized industrialization through state leadership. Having built this base, we turn our attention to the specific policies that governments pursued in this period, looking first at their domestic strategy for industrialization and then examining their efforts to reform the international trade system.

Domestic Interests, International Pressures, and Protectionist Coalitions

Developing countries' trade policies underwent a sea change in the first half of the twentieth century. Up until the First World War, those developing countries that were independent, as well as those regions of the world that were held in colonial empires, pursued largely liberal trade policies. They produced and exported agricultural goods and other primary commodities to the advanced industrialized countries and imported most of the manufactured goods they consumed. Governments and colonial rulers made little effort to restrict this trade. But by the late 1950s, these liberal trade policies had largely been replaced by the protectionism that dominated developing countries' trade policies until the late 1980s, and whose remnants remain important in many countries today. We begin our investigation of developing countries' trade and development policies by looking at this initial shift to protectionism. As we shall see, this shift was driven by the interaction between domestic interests and a variety of international pressures. During the late nineteenth and early twentieth century, developing countries' trade policies were most strongly shaped by export-oriented producers. Between the beginning of the First World War and the conclusion of decolonization in Sub-Saharan Africa in the 1960s, however, the political influence of export-oriented interests gave way to the political dominance of import-competing groups. As this political transformation took place, developing countries shifted from liberal trade policies to protectionism.

Domestic interests. Trade and development policies in developing countries have been powerfully shaped by political competition between the country and the city, or in slightly different terms, between rural-based agriculture and urban-based manufacturing. Political competition between these two groups reflects, in turn, the pattern of comparative advantage generated by the factor endowments common to most developing countries. In general, developing countries are abundantly endowed with land and poorly endowed with capital (Lal and Myint 1996, 104–110). The relative importance of land and capital in developing countries' economies can be appreciated by examining the structure of developing countries' economies and exports as presented in Tables 4.1 and 4.2. For the time being we will focus on 1960, as this will allow us to put to the side the consequences of the development policies that governments adopted during the postwar period. Table 4.1 shows quite clearly that agriculture accounts for a very large share and manufacturing activity for only a small share of developing countries' economies. With a few exceptions (particularly in Latin America), between one-third and one-half of all economic activity in developing countries in 1960 was based in the agricultural sector, while less than 15 percent was based in manufacturing. By contrast, agriculture accounts for only 5 percent of GDP in the advanced industrial economies. If we include the "other industry" category, which incorporates mining, then in all regions of the developing world other than Latin America, agriculture and nonmanufacturing industries account for more than half of all economic activity.

A similar pattern is evident in the commodity composition of developing countries' exports (Table 4.2). The **commodity composition of exports** measures the types of goods that a country exports. In 1962 developing countries' exports were heavily concentrated in primary commodities: agricultural products, minerals, and other raw

Table 4.1
Economic Structure in Developing Countries (sector as percent of GDP)

	Agriculture			Manufacturing		
	1960	1980	1995	1960	1980	1995
Sub-Saharan Africa	36	24	20	12	12	15
East Asia and the Pacific	46	27	18	16	27	32
South Asia	49	39	30	13	15	17
Latin America	16	10	10	21	25	21
	Other Industry[a]			Services		
	1960	1980	1995	1960	1980	1995
Sub-Saharan Africa	18	24	15	40	38	48
East Asia and the Pacific	7	12	12	31	32	38
South Asia	6	9	10	33	35	41
Latin America	10	12	12	53	51	55

Figures may not sum to 100 because of rounding.
[a]Includes mining, construction, gas, and water.
Sources: Data for 1962 from World Bank. 1983. *World Tables,* 3rd edition. Washington, D.C.: The World Bank. Data for 1980 and 1995 from World Bank 1997. *World Development Indicators.* Washington, DC.: The World Bank.

Table 4.2
Developing Countries' Export Composition (sector as percent of total exports)

	Fuels, Minerals, and Metals			Other Primary Commodities			Manufactures		
	1962	1980	1993	1962	1980	1993	1962	1980	1993
Sub-Saharan Africa									
Cameroon	21	33	51	75	64	35	4	4	14
Ghana	73	17	25	31	82	52	1	1	23
Kenya	2	36	16	89	52	66	9	13	19
Nigeria	11	97	94	81	2	4	8	0	2
South Africa	23	33	16	47	28	11	26	40	74
Zaire	16	56	69	75	14	13	10	31	18
East Asia and the Pacific									
Hong Kong	2	2	2	3	5	3	93	93	96
Indonesia	37	76	32	63	22	15	0	3	53
Malaysia	n.a.	35	14	n.a.	46	21	n.a.	20	65
Singapore	52	31	14	18	18	6	30	51	80
South Korea	24	1	3	57	9	4	20	90	94
Taiwan	n.a.	2	2	n.a.	10	5	n.a.	88	93
South Asia									
India	9	8	7	47	33	18	44	59	75
Pakistan	0	8	1	75	44	14	25	48	85
Latin America									
Argentina	2	6	11	95	71	57	3	23	32
Bolivia	91	86	56	4	11	25	5	3	19
Brazil	9	11	12	88	50	28	3	39	60
Chile	87	65	43	8	25	38	4	10	19
Mexico	24	73	17	60	15	9	16	12	75

Sources: Data for 1962 from World Bank 1983. *World Tables*, 3rd edition. Washington, D.C.: The World Bank. Data for 1980 and 1993 from World Bank 1997. *World Development Indicators*. Washington, DC.: The World Bank.

materials. Primary commodities accounted for more than 50 percent of the exports for all of the countries and for more than 80 percent of the exports for more than half the countries listed in Table 4.2. In addition, the range of primary commodities each developing country exports is generally quite small. Some countries are **mono-exporters,** that is, their exports are almost fully accounted for by one product. In the mid-1980s, for example, more than 80 percent of Burundi's export earnings came from coffee, while cocoa accounted for 75 percent of Ghana's export earnings (Cypher and Dietz 1997, 339). Similar patterns are evident in Latin America. In 1950 about 69 percent of Brazil's exports were composed of coffee and cocoa, and about 74 percent of Chile's exports were composed of copper and nitrates (Thorp 1998, 346). The structure of their economies and the composition of their exports thus underline the central point: developing countries are abundantly endowed with land and have little capital.

The specific factors model allows us to examine how these factor endowments have shaped developing countries' trade policies during the last 100 years. As we learned in Chapter 3, a specific factor is a factor of production that cannot easily be shifted from one economic sector to another. In the context of developing countries, the specific factors model leads us to focus on two traded goods sectors, agriculture and manufacturing. Economic agents based in each sector use combinations of labor, land, and capital to produce their goods. In keeping with the assumption of limited factor mobility that is central to the specific factors model, we will assume that land is specific to agriculture while capital is specific to manufacturing. We also assume that our third factor, labor, is mobile across sectors. Most labor in developing countries is low skilled and can be readily employed in either low-skill manufacturing or in agriculture. Such labor is highly mobile between sectors and will move to whichever sector is paying the higher wage. If wages in agriculture are higher than manufacturing, labor will move into agricultural production; if wages are higher in manufacturing than in farming, then labor will move to manufacturing activities. Finally, because land is abundant while capital is scarce, we know that agriculture is the export-oriented sector and manufacturing is the import-competing sector. The export-oriented sector, landowners in this case, realize rising incomes from trade openness and see their incomes fall under protection. The import-competing sector, manufacturing industry in this case, realizes income gains from protection and loses from trade liberalization. This simple model allows us to generate some basic expectations about trade policies in developing countries. When agricultural interests dominate politics, trade policy will be open and liberal. Because the returns are higher in agriculture than in manufacturing, most labor will be employed in agriculture. When manufacturing interests dominate politics, however, trade policy will be protectionist. And because protection raises the return to labor and capital employed in manufacturing relative to agriculture, labor will move out of agriculture and into manufacturing. The specific factors model suggests, therefore, that trade politics in developing countries will be characterized by competition between agricultural and manufacturing interests.

While this two-sector model highlights political competition between rural agriculture and urban manufacturing, it omits an important element of urban interests. Many urban residents in developing countries are not employed in manufacturing. Instead, they work for the government, in the retail sector, or in other nonmanufacturing activities. We can capture this group's trade policy interests by adding a third sector,

called the nontraded goods sector, to manufacturing and agriculture. The **nontraded goods sector** encompasses all economic activities that do not enter into international trade, either because the good is too costly to transport, like houses or concrete, or because in some cases the good or service must be performed locally, such as the railway system, many public utilities, health care, auto repair, and the retail sector more generally. In addition, government employees, such as civil servants, teachers, and military personnel also work in the nontraded goods sector. Because nontraded goods do not face international competition, international trade affects incomes in the nontraded good sector primarily through the impact it has on the prices of the traded goods that people employed in the nontraded goods sector purchase. People employed in the nontraded sector realize income gains from policies that reduce the prices of traded goods and lose from policies that raise these prices.

External influence and the rise of protectionist coalitions. Developing countries pursued liberal trade policies prior to World War I because export-oriented agricultural interests dominated developing countries' political systems. The precise political form of this domination differed considerably across regions. In Latin America, an indigenous land-owning elite dominated domestic politics. In Argentina and Chile, for example, the landowners controlled government, often acting in alliance with the military. While these political systems were constitutionally democratic, participation was restricted to the elite, a group that amounted to about 5 percent of the population, in a system that has been characterized as "oligarchic democracy" (Skidmore and Smith 1989, 47). In other Latin American countries such as Mexico, Venezuela, and Peru, dictatorial and often military governments ruled, but they pursued policies that protected the interests of the landowners (Skidmore and Smith 1989, 47). With landowners dominating domestic politics, Latin American governments pursued liberal trade policies that favored agricultural production and export at the expense of manufactured goods (Rogowski 1989, 47). As a result, most Latin American countries were highly open to international trade, producing and exporting agricultural goods and other primary commodities and importing manufactured goods from Great Britain, Europe, and the United States.

In Asia and in Africa, export-oriented agricultural interests dominated local politics through colonial structures. In Taiwan and Korea, for example, Japanese colonization led to the development of **enclave agriculture,** that is, export-oriented agricultural sectors that had few linkages to other parts of the local economy (Haggard 1991). Agricultural producers bought little from local suppliers and exported most of their production. In both countries, agricultural production centered on the production and export of rice, and in Taiwan, on sugar cane as well. In Africa, colonial powers, Britain and France in particular, encouraged the production of cash crops and raw materials that could be exported to the colonial power (Hopkins 1979; Ake 1981; 1996). In the Gold Coast (now Ghana), the cocoa industry was a small part of the economy in 1870. British colonists promoted the development of cocoa production so that by 1910 the Gold Coast had become the world's largest cocoa producer and cocoa accounted for 80 percent of the Gold Coast's exports. In Senegal, France promoted the production of groundnuts, so that production rose from 200,000 tons to 600,000 tons between 1914 and 1937, and close to half of the land cultivated in Senegal was dedicated to groundnut production (Ka and Van de Walle 1994, 296). Similar patterns with other commodities were evident in other African colonies (Hopkins 1979).

These political arrangements began to change in the early twentieth century. As they did, the dominance of export-oriented interests gave way to the interests of import-competing manufacturers. In many instances, the most important triggers for this change originated in developments outside of developing societies. In Latin America, international economic shocks beginning with the First World War and extending into the Second World War played a central role (Thorp 1998, Chapter 4). Government-mandated rationing of goods and primary commodities in the United States and Europe during the two World Wars made it difficult for Latin American countries to import many of the consumer goods they had previously purchased from the industrialized countries. In addition, the falling commodity prices associated with the Great Depression and the disruption of normal trade patterns arising from the Second World War reduced the amount of foreign exchange that Latin American countries earned from their primary commodity exports. The interruption of "normal" Latin American trade patterns led governments in many countries to introduce trade barriers and to begin producing many of the manufactured goods that they had previously imported. The rise of domestic manufacturing in turn produced a growing urban middle class as workers and industrialists began to move out of agricultural production and into manufacturing industries.

The emergence of manufacturing industries gave rise to interest groups, industry-based associations, and labor unions to promote economic policies favorable to people working in the import-competing sector. The creation of organized groups to represent the interests of import-competing manufacturing generated its own political logic. On the one hand, the groups that saw their incomes rise from protection had a strong incentive to see these policies continued in the postwar period (see Rogowski 1987; Haggard 1990). On the other hand, the emergence of new organized interests and a growing urban middle class created an opportunity for politicians to construct new political coalitions based on the support of the urban sectors. In Argentina, for example, Juan Peron rose to power in the late 1940s with the support of labor, industrialists, and the military. A similar pattern was evident in Brazil, where Getulio Vargas was elected to the presidency in 1950 with the support of industrialists, government civil servants, and urban labor. Argentina and Brazil were not unique. Throughout Latin America, postwar governments were much less tightly linked to landed interests than governments had been before World War I. Instead, governments rose to power on the basis of political support from interest groups whose incomes were derived from import-competing manufacturing (Cardoso and Faletto 1979). Such governments had a clear incentive to maintain trade policies that protected these incomes.

In Asia and Africa, the declining political influence of export-oriented agricultural interests and the growing influence of import-competing manufacturing occurred as a result of de-colonization. In Asia, particularly in Korea and Taiwan, political change resulted from the defeat of Imperial Japan in World War II (see Haggard 1990). In South Korea, the defeat of Japan transferred power from a foreign colonizer to indigenous groups. And while the South Korean land-owning class initially dominated postwar politics, the Korean War of the early 1950s and a series of land reforms implemented in the 1950s greatly reduced the power of rural landowners and increased the relative

power of the emerging urban sector. In Taiwan, the Japanese defeat was followed by the defeat of the nationalist Chinese government on Mainland China and the migration of the Chinese nationalists to the island of Taiwan. Once installed in Taiwan, the Chinese nationalists instituted land reforms to assert their authority over indigenous landowners and to prevent a repeat of their experience on the mainland, where the rural sectors had supported the Communists. As in South Korea, these land reforms reduced the power of landowners and increased the power of urban-industrial sectors.

Africa's transition came later, as the de-colonization of Sub-Saharan Africa occurred only in the 1950s and early 1960s, and it took a slightly different form. The push toward de-colonization was led by a coalition of indigenous professional elite who had been educated by the colonial powers and had then acquired positions in the administration of colonial economic and political rule. One factor motivating Africa's push for independence was dissatisfaction with the discriminatory practices of colonial administration. Colonial rulers had tightly restricted the ability of the local population to share in the wealth generated by domestic economic activity. Colonies were run for the profit of the colonists, and colonial economic enterprises were staffed and managed by men from the colonial power. The local population had limited opportunities to participate in these economic arrangements other than as workers. The nationalist struggles for independence that emerged in the 1950s and succeeded over the next 15 years sought to transfer control over existing economic practices from the colonial governments to the indigenous elite. As a consequence, import-competing manufacturing in Africa played a much smaller role in early post-independence politics than the nontraded goods sector. This indigenous elite, as Claude Ake (1981, 142) has argued, "wanted to inherit a system rather than to revolutionise it."

The period demarcated by the start of the First World War and the end of decolonization in Sub-Saharan Africa thus brought a fundamental change to patterns of political influence in developing countries. Political structures once dominated by export-oriented agricultural interests were now largely under the control of import-competing manufacturing interests. Governments beholden to the import-competing sector had a clear incentive to abandon liberal trade policies and continue the protectionist arrangements that had been put in place during the 1930s. These protectionist policies would remain in place until the late 1980s.

Markets, Trade, and Economic Development: The Structuralist Critique

The adoption of protectionism in most developing countries reflected the interests of the politically influential import-competing manufacturing sector, but it did not represent a coherent strategy for economic development. And most governments were committed, at least rhetorically, to the adoption of policies that would promote economic development. Most governments wanted to see societal resources shifted out of agricultural production and into manufacturing industries because they believed that poverty resulted from too heavy a concentration on agricultural production and that a higher standard of living could be achieved only through industrialization. And according to what was then the dominant branch of development economics, called **structralism**, the shift of resources from agriculture to manufacturing would not occur unless the state adopted policies to bring it about (see Lal 1983; Little 1982). The theoretical belief that the market would not promote industrialization provided the intellectual and theoretical justification for the two central aspects of the development strategies adopted by most governments during the 1950s, 1960s, and 1970s. Because structuralism played such an important role in shaping developing countries' trade and development policies, understanding the policies governments adopted requires us to understand the structuralist critique of the market. We look first at the critique of the market within developing countries and then turn our attention to the structuralist critique of the international market and the international trade system.

Market imperfections within developing countries. Structuralists argued that imperfections within developing countries' markets posed serious obstacles to industrialization. Industrialization would require a fairly substantial reallocation of resources from agricultural production to manufacturing industries. The critical question for industrialization, therefore, was how best to bring about this reallocation. Structuralists argued that the domestic market could not be expected to bring about the necessary shift of resources. They were skeptical about the market because they believe that developing world economies were inflexible. "[Economic] change is inhibited by obstacles, bottlenecks, and constraints. People find it hard to move or adapt, and resources tend to be stuck" in the sectors in which they are currently employed (Little 1982, 20).

Most important, according to the structuralists, was the belief that the market would not promote investment in manufacturing industries. As economist Tibor Scitovsky wrote at the time:

> In an economy in which economic decisions are decentralized, [that is, in a market economy], a system of communication is needed to enable each person who makes economic decisions to learn about the economic decisions of others and coordinate his decision with theirs. In the market economy, prices are the signaling device that informs each person of other people's economic decisions; and the merit of perfect competition is that it would cause prices to transmit information reliably and people to respond to this information properly. Market prices, however, reflect the economic situation as it is and not as it will be. For this reason, they are more useful for co-ordinating current production decisions, which are immediately effective and guided by short-run considerations, than they are for co-ordinating investment decisions, which have a delayed effect and—looking ahead to a long future period—should be governed not by what the present economic situation is but by what the future economic situation is expected to be. The proper co-ordination of investment decisions, therefore, would require a signaling device to transmit information about present plans and future conditions as they are determined by present plans; and the pricing system fails to provide this. (1954, 150)

The structuralists pointed to two coordination problems that would limit the amount of investment in manufacturing industries. The first coordination problem, called **complementary demand** arose in the initial transformation from an economy based largely on subsistence agriculture (agricultural production in which people consume their farm production rather than sell it for cash) to a manufacturing economy (Rosenstein-Rodan 1943). In an economy in which few people earned a money wage, no single manufacturing firm would be able to sell its products unless a large number of other manufacturing industries were started simultaneously. Suppose, for example, that

100 people are taken out of subsistence agriculture and paid a wage to manufacture shoes while the rest of the population remains in nonwage agriculture. To whom will the new shoe factory sell its shoes? The only workers earning money are those producing shoes, and it is unlikely that these 100 workers will purchase all of the shoes that they make. In order for this shoe factory to succeed, other factories employing other people must be created at the same time. Suppose, for example, that 500,000 workers rather than just 100 are taken out of subsistence agriculture and simultaneously employed in a large number of factories producing a variety of different manufactured goods—some make shoes, others make clothing, and still others produce refrigerators or processed foods. With this larger number of wage earners, manufacturing enterprises can easily sell their goods. Shoe workers can buy refrigerators and clothes, workers in the clothing factory can purchase shoes, and so on. Thus, a manufacturing enterprise will be successful if a large number of other manufacturing firms are started at the same time, but it will be unsuccessful if it is created in isolation. The coordination problem arises because no single entrepreneur has an incentive to create a manufacturing enterprise unless he or she is certain that others will invest as well. Thus, no one will invest in a manufacturing industry unless the potential investors can somehow coordinate their behavior to ensure that all will invest in manufacturing industries at the same time. Structuralists argued that the market, which encouraged autonomous investment decisions by independent economic actors, would not promote the necessary coordination. The problem of complementary demand meant that if investment were left to the market, there would be little investment in manufacturing industries.

The second coordination problem, called **pecuniary external economies,** arose from interdependencies in market processes (Scitovsky 1954). Think about the economic relationship between a steel plant and an automobile factory. Suppose that the owners of a steel factory make an investment that increases the amount of steel they can produce. As steel production increases, steel prices will begin to fall. The automobile factory, which uses a lot of steel in the production of cars, will realize rising profits as the price of one of its most important inputs falls. These increasing profits in the automobile industry could induce the owners of the car plant to make a new investment to expand their production capacity. Such a simultaneous expansion of the steel and auto industries would raise national income. But the two firms face a coordination problem. The owners of the steel plant have no incentive to increase the amount of steel they produce unless they are sure that the auto industry will increase the number of cars they produce. The owners of the auto plant have no incentive to invest resources in expanding car production unless they are certain that the steel producer will make the investments needed to expand steel output. Thus, unless investment decisions in the steel and auto industry are coordinated, neither firm will invest to increase the amount they can produce. Once again, structuralists argued that the market could not be expected to solve this coordination problem.

The inability of the market to coordinate investment decisions was a serious problem for governments that were intent on transforming the structure of their economies. If the market would not coordinate investment decisions, the investments in manufacturing industries necessary to drive the process of industrialization would not be made. Structuralists argued that the way to overcome the coordination problems and begin the process of industrialization was with a state-led **big push.** The

state would engage in economic planning and either make necessary investments itself or help coordinate the investments of private economic actors. Thus, what the market could not bring about, the state could achieve through direct intervention in the economy. The structuralist critique of market imperfections therefore provided a compelling theoretical justification for state-led strategies of industrialization.

Market imperfections in the international economy. Structuralists also argued that international trade between developing countries and the advanced industrialized world was highly advantageous to the industrialized countries, but provided few benefits for developing countries. This argument was developed during the 1950s, principally by Raul Prebisch, an Argentinean economist who worked for the United Nations Economic Commission for Latin America (ECLA), and Hans Singer, an academic development economist. According to the **Singer-Prebisch theory,** participation in the GATT-based multilateral trade system would actually make it harder for developing countries to industrialize by depriving them of critical resources.

The Singer-Prebisch theory divides the world into two distinct blocks, the advanced industrialized **core** and the developing world **periphery,** and then focuses on the terms of trade between them. The **terms of trade** relate the price of a country's exports to the price of its imports. An improvement in a country's terms of trade means that the price of the goods it exports is rising relative to the price of the goods it imports, while a decline in a country's terms of trade means that the price of the goods it exports is falling relative to the price of the goods it imports. As a country's terms of trade decline, it must exchange a larger volume of domestic production (it must export more) for any given amount of foreign production (imports). As a country's terms of trade improve, it is able to acquire a given amount of imports for a smaller quantity of exports. Thus, an improvement in its terms of trade makes a country richer while a decline in its terms of trade makes it poorer. Because the typical developing country produces and exports primary commodities and imports manufactured goods, income in developing countries is very sensitive to the terms of trade between primary commodities and manufactured goods. A fall in primary commodity prices relative to manufactured goods lowers developing countries' incomes while a rise in the price of primary commodities relative to manufactured goods raises their incomes.

The Singer-Prebisch theory argues that developing countries face a secular decline in their terms of trade, meaning that their terms of trade deteriorate steadily over time. Structuralists highlighted two distinct mechanisms that caused this secular decline. First, the periphery's terms of trade deteriorated due to the different consequences of productivity improvements in the core and periphery (see Lewis 1954; United Nations 1964; Gilpin 1987, 275–276;). A productivity improvement reduces the cost of producing a single good, and such a cost reduction allows the firm to either reduce the price they charge for the good or pay a higher wage to its workers. Core countries, the structuralists argued, had economies characterized by full employment and by a high degree of union organization. With little excess labor and strong labor unions negotiating wage contracts with firms, productivity improvements in the core were transformed into rising wages and stable prices. Developing countries, by contrast, had large amounts of under-employed labor and rarely was labor organized in well-developed and powerful unions. As a consequence, productivity improvements in the periphery were transformed into stable wages and falling prices (United Nations 1964, 15). Because productivity

gains lead to stable prices for core country manufactured goods and falling prices for periphery country commodities, developing countries' terms of trade deteriorate—the price of their exports in terms of their imports falls continuously over time.

Structuralists also emphasized differences in the income elasticity of demand for primary commodities and industrial goods. **Income elasticity of demand** refers to the degree to which a change in a society's income will affect that society's demand for a particular good. Low income elasticity of demand means that a large increase in per capita income has little or no effect on demand for a particular good, while a high income elasticity of demand means that a small increase in per capita income will have a large effect on demand for a particular good. Structuralists argued that the income elasticity of demand for primary commodities was quite low. **Engel's Law,** which informed the structuralists, holds that people spend smaller percentages of their total income on food and other primary commodities as their incomes rise. The income elasticity of demand for manufactured goods was believed to be quite high, however, because higher income societies purchase more manufactured consumer items. Thus, as incomes rise in the core countries, a smaller and smaller percentage of core country income will be spent on primary commodity imports. But as income rises in the periphery countries, a larger percentage of periphery income will be spent on manufactured imports from the core. Falling demand for primary commodities will cause the periphery countries' export prices to fall, while rising demand for manufactured goods will cause the periphery countries' import prices to rise. Rising import prices relative to export prices equals a deteriorating terms of trade.

Stripped of all the economic terminology, the structuralists' point was remarkably simple: in contrast to classical trade theory's claim that free trade provides clear benefits to all countries, the structuralists argued that developing countries did not necessarily benefit from international trade. In a world in which developing countries exchange primary commodities for manufactured goods, core countries capture most of the gains available from trade. According to the structuralists, therefore, the GATT-based multilateral trade system was highly disadvantageous for developing countries. Moreover, the income losses caused by the secular decline in their terms of trade imposed a significant constraint on the ability of developing countries to industrialize. In order to industrialize, developing countries had to import **capital goods,** that is, machines used to produce other goods, as well as many intermediate inputs. The ability of developing countries to import capital and intermediate goods, however, was determined in large part by their export earnings. Yet, the purchasing power obtained by way of their export earnings was falling over time. Thus, the secular decline in the terms of trade made it harder for developing countries to import the things that were critical for industrialization.

The validity of the Singer-Prebisch theory has been questioned. Most controversial has been the claim that developing countries face a continuous decline in their terms of trade. Measuring the long-term trend in a country's terms of trade is complicated by the fact that developing countries experience frequent terms of trade shocks. A **term of trade shock** is a sudden and unanticipated but usually temporary change in a country's terms of trade caused by factors outside the country's direct control. In the mid-1970s, for example, a severe frost in Brazil, one of the world's largest coffee producers, destroyed a significant portion of the Brazilian coffee crop and coffee trees.

This steeply raised the world price of coffee. By April 1977 the world price of coffee had risen to more than six times the price that had prevailed in June 1975 (Deaton 1999, 28). As a result, the terms of trade for other coffee exporting nations such as Colombia, Kenya, and Tanzania improved suddenly and dramatically for reasons fully exogenous to their economies. Other shocks are negative. The decline in world economic activity during the late 1990s and early 2000s, for example, reduced the global demand for petroleum, and lower demand was associated with falling oil prices in world markets.

When terms of trade shocks are frequent, a country will experience a decline in its terms of trade in some years and a rise in others. The conclusion we reach about the general trend over a longer period of time will be sensitive to when we begin and end our measurement. If, for example, you compare a country's terms of trade following a positive shock in 1960 with its terms of trade 40 years later immediately following a large negative shock, you are likely to conclude that the country's terms of trade have declined over the entire period. Conversely, if you compare a country's terms of trade following a negative shock in 1960 and a positive shock in 2000, you may conclude that terms of trade have generally improved over the intervening 40 years. Still, even taking into account the measurement problems arising from the volatility of developing countries' terms of trade, recent research does lend some support to the structuralists' claim (Borensztein et al. 1994; see also Sapsford 1985). Between 1957 and 1987, primary commodity prices other than oil fell by about three-quarters of 1 percent per year relative to manufactured goods, while between 1968 and 1987, the deterioration increased to 1.57 percent per year (see Cypher and Dietz 1997, 180).

While structuralism's critique of markets within developing countries and of the international trade system has been severely criticized, the objective validity of structuralism is not our central concern. What matters for understanding the trade and development policies adopted in many developing countries is their belief that the structuralist critique of domestic markets and the international trade system was correct. Governments were convinced that industrialization would not occur if left to markets at home, or if they participated in the GATT-based international trade system. This conviction played an important role in shaping the trade and development policies that developing countries adopted.

Domestic and International Elements of Trade and Development Strategies

Structuralism enabled governments to transform the protectionist trade policies that benefited their principal political supporters into comprehensive state-led development strategies. The trade and development policies that most governments adopted following World War II had both a domestic and an international dimension. At home, the desire to promote rapid industrialization led governments to adopt state-led development strategies characterized by a high degree of government intervention designed to promote industrialization behind high protectionist barriers. In the international arena, concern about the distributional implications of international trade led the developing countries to attempt to change the rules governing the GATT-based trade system. This reform effort was characterized by a concerted attempt

to shift the international trade system away from the market-based liberalism embodied in the GATT toward an alternative set of rules and institutions that they believed would better enable them to industrialize. We examine each dimension in turn.

Import substitution industrialization. Industrialization required a shift of resources out of agricultural and into manufacturing. Skepticism about the ability of the market to promote this necessary reallocation of resources implied that industrialization would occur only if the state played a leading role. States played this leading role by adopting development strategies called **import substitution industrialization** or ISI. Import substitution industrialization was based on a simple logic: countries would industrialize by substituting domestically produced goods for manufactured items that had previously been imported. Import substitution industrialization was conceptualized as a two-stage strategy (see Table 4.3). In its initial stage, import substitution "is wholly a matter of imitation and importation of tried and tested procedures" (Hirschman 1968, 7). **Easy ISI,** as this first stage was often called, focused on developing domestic manufacturing industries capable of producing relatively simple consumer goods such as soda, beer, apparel, shoes, and furniture. The rationale behind the focus on these simple consumer goods was three-fold. First, there was a large domestic demand for these products that was currently satisfied by imports. Second, because these items were standardized or mature products, developing countries could easily purchase the technology and the machines necessary to produce them from the advanced industrialized countries. Third, the production of these goods relies heavily on low-skill labor, allowing developing societies to draw their populations into manufacturing activities without making large investments to upgrade their skills. Governments expected to realize two broad benefits from this easy stage of ISI. The expansion of manufacturing activities, particularly if a portion of the resulting profits was reinvested, would increase wage-based employment as under-utilized labor was drawn out of agriculture and into manufacturing. In addition, the experience gained in these manufacturing industries would allow domestic workers to develop skills, collectively referred to as **general human capital,** that could be subsequently applied to other manufacturing businesses. Of particular importance were the management and entrepreneurial skills that would be gained by the people that worked in and managed the manufacturing enterprises established in this stage. Success in the easy stage would therefore create many of the ingredients necessary to make the transition to the second, harder stage of ISI.

Table 4.3
Stages of Industrialization in Mexico and Brazil, 1880–1970

	Commodity Exports 1880–1930	Primary ISI 1930–1955	Secondary ISI 1955–1968
Main Industries	Mexico: Precious metals, minerals, oil Brazil: Coffee, rubber, cocoa, cotton	Mexico and Brazil: Textiles, food, cement, iron and steel,paper, chemicals, machinery	Mexico and Brazil: Automobiles, electrical and nonelectrical machinery, petrochemicals, pharmaceuticals
Major Economic Actors	Mexico: Foreign investors Brazil: National private firms	Mexico and Brazil: National private firms	Mexico and Brazil: State-owned enterprises, transnational corporations, and national private firms
Orientation of the Economy	World Market	Domestic Market	Domestic Market

Source: Gereffi 1990, 19.

Easy ISI would eventually cease to bear fruit. The domestic market's capacity to absorb the kinds of simple consumer goods produced in this stage would quickly be exhausted, and the range of such goods that could be produced was limited. At some point, therefore, developing countries would need to shift from easy ISI to a second-stage strategy that pushed them into more complex manufacturing activities. One possibility would be to shift to what some have called an **export substitution strategy,** in which the labor-intensive manufactured industries developed in easy ISI begin to export rather than continue to produce exclusively for the domestic market. This strategy is called export substitution because manufactured goods begin to substitute for primary commodities in the country's exports. The second alternative, and the one actually adopted by many governments in Latin America and Africa, was called **secondary ISI.** In secondary ISI emphasis shifts away from simple consumer goods to the production of consumer durable goods, intermediate inputs, and the capital goods that are needed to produce consumer durables. In Argentina, Brazil, and Chile, for example, governments decided to promote domestic automobile production as a central component of secondary ISI. Each country imported cars in pieces, called "complete knock downs," and assembled the pieces into a car for sale in the domestic market. The domestic auto firms were then required to gradually increase the percentage of locally produced parts used in the cars they assembled. In Chile, for example, 27 percent of a locally produced car's components had to be manufactured in Chile in 1964. This percentage rose to 32 percent in 1965, and then to 45 percent in 1966 (Johnson 1967). By increasing the local content of cars and other goods in this manner, governments hoped to promote the development of backward linkages throughout the economy (Hirschman 1958). **Backward linkages** arise when production of one good, like a car, increases domestic demand in industries that supply parts for this good. Increasing the locally produced content of cars, by increasing the demand for individual car parts, would increase the amount of domestic car part production. Increased production of car parts would in turn increase domestic demand for the inputs into this activity—steel, glass, and rubber for example. Industrialization, therefore, would spread backwards from final goods to intermediate inputs and capital goods as these backward linkages multiplied.

Governments promoted secondary ISI by relying heavily on three policy instruments: tariffs and nontariff barriers, government planning, and investment policy. The justification for trade barriers was provided by the infant industry argument and by recurrent shortages of foreign exchange. Because export earnings were limited while

many elements critical to industrialization—many of the intermediate inputs as well as almost all of the capital goods (at least at first)—had to be imported, governments tightly controlled foreign trade. Governments managed trade to ensure that expenditures of scarce foreign exchange were consistent with their overall development objectives (Bhagwati 1978, 20–33). Protection also allowed infant industries to gain experience needed to compete against established producers. In Brazil and India, for example, the state prohibited imports of any good for which there was a domestic substitute, regardless of price differences and to a large extent of quality differences as well. The scale and the structure of protection that governments used to promote industrialization are illustrated in Table 4.4, which focuses on Latin America in 1960. In all but two of the countries listed in the table, nominal protection on nondurable consumer goods was well over 100 percent, and for all but three countries, the nominal tariffs on consumer durables was also over 100 percent. While Mexico and Uruguay stand out as clear exceptions to this pattern, this has more to do with extensive use of import quotas in place of tariffs than with an unwillingness to protect domestic producers (Bulmer-Thomas 1994, 279). It is also clear that tariffs were lower for semi-manufactured goods, industrial raw materials, and capital goods, all of which are items that developing countries needed to import in connection with industrialization, than they were for consumer goods. The pattern of tariff escalation that we see in Latin America, wherein final manufactured goods received high levels of protection while intermediate inputs and raw materials received much lower levels of protection, is illustrative of the use of trade barriers in much of the developing world (Balassa and Associates 1971).

Most governments based their ISI strategies on explicit five-year plans. Developed by government agencies, these plans were designed to "serve as guidelines for public expenditures and for economic policies" (Little 1982, 35). Planning was used to determine which industries would be targeted for development and which would not, to figure out how much should be invested in a particular industry, and to evaluate how investment in one industry would influence the rest of the economy. The plan thus served as the coordination device that governments believed was necessary given the belief that the market could not itself coordinate investment decisions.

Table 4.4
Nominal Protection in Latin America, *circa* 1960 (percent)

	Non-durable Consumer Goods	Durable Consumer Goods	Semi-manufactured Goods	Industrial Raw Materials	Capital Goods
Argentina	176	266	95	55	98
Brazil	260	328	80	106	84
Chile	328	90	98	111	45
Colombia	247	108	28	57	18
Mexico	114	147	28	38	14
Uruguay	23	24	23	14	27
EEC	17	19	7	1	13

Source: Bulmer-Thomas 1994, Table 9.1, p 280.

With a plan in place, governments then used investment policies to promote development of targeted industries. In most countries the financial system was nationalized or heavily controlled by the government. While we will look at this in greater detail in Chapter 8, here it is important to note that the ability of the state to control the financial system allowed it to set interest rates on deposits and loans. As a result, industries that the state targeted for development were able to gain access to credit on better terms than those that were not. This created an incentive to invest in some industries—those favored by state planners—and disincentives to invest in others. Frequently the state also invested directly in economic activities where it was thought the private sector would not make the desired investments. Much of the infrastructure necessary for industrialization, things such as roads and other transportation networks, electricity, and telecommunications systems, it was argued, would not be created by the private sector. In addition, the private sector lacked access to the large sums of financial support needed to make huge investments in a steel or auto plant. Moreover, it was claimed that private sector actors lacked the technical sophistication required for the large-scale industrial activity involved in secondary ISI. Governments accepted responsibility for investment in these areas by creating **state-owned enterprises,** firms that were fully owned by the state, or by creating mixed ownership enterprises that combined state and private sector participation. In Brazil, for example, state-owned enterprises controlled more than 50 percent of total productive assets in the chemical industry, telecommunications, electricity, and railways, and slightly more than one-third of all productive assets in metal fabrication (Franco 1999, 59). In Africa, governments in Ghana, Mozambique, Nigeria, and Tanzania each created more than 300 state-owned enterprises, and in many African countries, state-owned enterprises accounted for 20 percent of total wage-based employment (World Bank 1994, 101). In India, state-owned enterprises accounted for 27 percent of total employment and 62 percent of all productive capital (Krueger 1993a, 24–5).

While import-competing manufacturing industry benefited from the policies adopted under ISI, export-oriented agriculture bore many of the costs (see Krueger 1992; Krueger, Schiff, and Valdes 1991; Binswanger and Deininger 1997). Governments taxed agricultural exports. In Brazil and Colombia, governments taxed coffee exports; the Thai government taxed rubber and rice exports; and in the Dominican Republic the government taxed all commodity exports, including sugar, coffee, and cocoa (Krueger 1992, 16). Taxation was frequently implemented through government-owned marketing boards that controlled the purchase and export of agricultural commodities. Often established as the sole entity with the legal right to purchase, transport, and export agricultural products, marketing boards set the price that farmers received for their crops. In the typical arrangement, the marketing board would purchase crops from domestic farmers at prices well below the world price and then sell the commodities in the world market at the world price. The difference between the price paid to domestic farmers and the world price represented a tax on agricultural incomes that the state could use to finance government-favored projects in industry (Amsden 1979; Bates 1988; Krueger 1992). The trade barriers used to protect domestic manufacturing firms from foreign competition also represented a tax on the incomes of people working in agriculture. Tariffs and quantitative restrictions raised the domestic price of manufactured goods well above the

A Closer Look

Import Substitution Industrialization in Brazil

In the late nineteenth and early twentieth century Brazil was the classic case of a primary commodity exporting country. Its principal crop, coffee, accounted for a large share of its production and the overwhelming majority of its export earnings. This economic structure was supported by a political system dominated by the interests of coffee producers and other agricultural exporters (Bates 1997). Political authority was decentralized in Brazil, and the states used their power in Brazil's federal system to influence government policy. As a result, Brazil pursued a liberal trade policy throughout the late nineteenth and early twentieth centuries. The First World War and the Great Depression disrupted these arrangements. The world price for coffee fell sharply in the late 1920s and early 1930s, generating declining terms of trade and rising trade deficits. The government responded to this crisis by adopting protectionist measures to limit imports. The initial turn to protectionism was accompanied by political change. A military coup in 1930 handed power to Getulio Vargas, and Vargas centralized power by shifting political authority from the states to the federal government. While Vargas did not adopt an import substitution industrialization strategy, this period represented in many respects the easy stage of ISI (Haggard 1990,165–166). Protectionism promoted the growth of light manufacturing industries, which grew at a rate of 6 percent per year between 1929 and 1945 (Thorp 1998, 322). Concurrently, the centralization of power created a state that could intervene effectively in the Brazilian economy. While the export-oriented interests did not lose all political influence in this new political climate, the balance of power had clearly shifted toward new groups emerging in urban centers—the professionals, managers, and bureaucrats that comprised the emerging middle class and the nascent manufacturing interests. As Brazil moved into the post-World War II period, therefore, the stage was set for the transition to secondary ISI.

A full-blown import substitution industrialization strategy emerged in the 1950s. The government tightly restricted imports with the so-called "Law of Similars", which effectively prohibited the import of goods similar to those produced in Brazil. In 1952, the Brazilian government created the National Economic Development Bank (BNDE), an important instrument for industrial policy through which the Brazilian state could finance industrial projects. In the late 1950s, the government created a new agency, the National Development Council, to coordinate and plan its industrialization strategy. In taking up its task, the Council was heavily influenced by structuralist ideas (Haggard 1990 174). Studies conducted within these agencies, and in some instances in collaboration with international agencies like the UN Economic Commission on Latin America, focused on how best to promote industrialization (Leff 1968, 46). Most of these studies came to similar conclusions: industrialization in Brazil would quickly run into constraints caused by inadequate transportation networks (road, rail, and sea), shortages of electric power, and the under-development of basic heavy industries such as steel, petroleum, chemicals, and nonferrous metals. Building up these industries thus became the focus of the government's development policies. The Brazilian government had little faith that these critically important industries would be created and expanded by the private sector. Instead, policymakers determined that the state would have to play a leading role. In the early 1950s the

Continued

state nationalized the oil and electricity industries and began investing heavily in the expansion of capacity in both industries. A similar approach was adopted in the transportation sector, where the government owned the railways and other infrastructure, in the steel industry, and in telecommunications. By the end of the 1950s, the state accounted for 37 percent of all investment made in the Brazilian economy. As a result, the number of state-owned enterprises grew rapidly from fewer than 35 in 1950 to more than 600 by 1980.

Beyond creating these basic industries, Brazil also sought to create domestic capacity to produce complex consumer goods. To achieve this objective, Brazil, in contrast to many other developing countries, sought to draw heavily upon foreign investment to promote the development of certain industries. The auto industry is an excellent example. In 1956, the Brazilian government prohibited all imports of cars. Any foreign producer that wanted to sell cars in the Brazilian market would have to set up production facilities in the country. To ensure that such foreign investments were not simple assembly operations in which the foreign company imported all parts from its suppliers at home, the Brazilian government instituted local content rules that required the foreign automakers operating in Brazil to purchase 90 percent of their parts from Brazilian firms. In order to induce foreign automakers to invest in Brazil under these conditions, the government offered subsidies; by one account, the subsidies offset about 87 percent of the total investment between 1956 and 1969. Using this strategy, Brazilian auto production rose from close to zero in 1950 to almost 200,000 cars in 1962.

This strategy helped transform the Brazilian economy in a remarkably short period of time. Imported consumer nondurable goods (the products targeted during easy ISI) had been almost completely replaced with domestic production by the early 1950s (Bergsman and Candal 1969, 37). Imported consumer durables, the final goods targeted in secondary ISI, fell from 60 percent of total consumption to less than 10 percent of total consumption by 1959. Imports of capital goods also fell, from 60 percent of total domestic consumption in 1949, to about 35 percent of consumption in 1959, and then to only 10 percent by 1964. Finally, imports of intermediate goods, the inputs used in producing final goods, also fell continually throughout the decade to less than 10 percent of total consumption by 1964. Thus, as imports were barred and domestic industries created, Brazilian consumers and producers purchased a much larger percentage of the goods they used from domestic producers and a much smaller percentage of these goods from foreign producers. As a consequence, the importance of manufacturing in the Brazilian economy increased sharply. Whereas manufacturing accounted for only 26 percent of total Brazilian production in 1949, by 1964, it accounted for 34 percent.

world price. People employed in the agricultural sector, who were consumers rather than producers of these manufactured goods, therefore paid a much higher price for them than they would have in the absence of tariffs and quantitative restrictions (Krueger 1992, 9).

Such government policies transferred income from rural agriculture to the urban manufacturing and nontraded goods sectors. The size of these income transfers was substantial. As a recent study sponsored by the World Bank has summarized,

> the total impact of interventions . . . on relative prices [between agriculture and manufacturing] was in some countries very large. In Ghana . . . farmers received only about 40 percent of what they would have received under free trade. Stated in another way, the real incomes of farmers would have increased by 2.5 times had farmers been able to buy and sell under free trade prices given the commodities they in fact produced. While Ghanaian total discrimination against agriculture was huge, Argentina, Cote d'Ivoire, the Dominican Republic, Egypt, Pakistan, Sri Lanka, Thailand, and Zambia also had total discrimination against agriculture in excess of 33 percent, implying that in all those cases, farm incomes in real terms could have been increased by more than 50 percent by removal of these interventions. (Krueger 1992, 63)

Thus, one important consequence of ISI was the redistribution of societal income: groups in the export-oriented sector who enjoyed little political influence saw their incomes fall while groups in the import-competing sector who enjoyed considerable influence with ruling elites saw their incomes rise.

The strategy of import substitution industrialization promoted rapid economic growth during the 1960s and 1970s: developing countries' economies grew at annual average rates of between 6 percent and 7.6 percent in this period. In many countries it was the manufacturing sector that drove economic growth. Argentina, Brazil, Chile, Mexico, Mozambique, Nigeria, Pakistan, and India, to select only a few examples, all enjoyed average annual rates of manufacturing growth between 5 and 10 percent during the 1960s. A glimpse back at Table 4.1 indicates that in Latin America, manufacturing's share of the total economy increased substantially between 1960 and 1980, and a quite similar pattern is evident in Africa as well. Thus, while the policies that governments adopted had important effects on the distribution of income, they also appeared to be transforming developing societies from producers of primary commodities into modern industrialized economies.

Reforming the international trade system. Developing countries also tried to alter the rules governing international trade. One of their principal objectives in pursuing such reforms was to create mechanisms that would transfer income from core countries to the periphery as compensation for the losses resulting from their deteriorating terms of trade. As early as the 1947 negotiations over the International Trade Organization, developing countries, led by India, Brazil, Chile, and Australia, expressed concerns that the rules the United States and Great Britain were writing for the GATT and ITO failed to address the economic problems faced by developing countries (Kock 1969, 38–42). Advancing the infant industry justification for protection, developing countries argued that developing countries' firms would be unable to compete with established producers in the United States and Europe. Yet, GATT rules not only made no provision for the infant industry justification for tariffs and quantitative restrictions, they explicitly prohibited the use of quantitative restrictions and tightly restricted the use of tariffs. Governments in developing countries insisted that the ITO give them a relatively free hand in the use of trade restrictions to promote economic development. And while the ITO did go some way toward accommodating their demands, its development components were irrelevant once the U.S. Congress refused to ratify American participation.

During the 1950s, developing countries pressed for moderate reforms of the GATT charter (Kock 1969, 238; Finger 1991). While few concrete reforms resulted from these early efforts, they did produce a study, called the **Haberler Report,** that was conducted under the guidance of the GATT and published in 1958. The GATT initiated this study in order to examine why developing countries' trade performance was so poor, focusing in particular upon how fluctuations in primary commodity prices and agricultural protection in the advanced industrialized countries affected developing countries (see Campos et al. 1958). The Haberler Report represented a "turning point in the GATT's relations with less-developed countries" (Dam 1970, 228). The Report provided intellectual support for the structuralists' main arguments by suggesting that the GATT-based trade system was "relatively unfavorable to primary producing countries" and concluding "that developing countries were losing ground under the GATT" (Finger 1991, 212). By providing support for the developing countries' principal claims, the Haberler Report altered the political dynamics of core-periphery relations in the international trade system. Henceforth, not only would the demands for reform made by the developing countries be more far-reaching, but the ability of the advanced industrialized countries to dismiss these demands out of hand would be greatly weakened.

By the early 1960s a coalition of developing countries dedicated to the pursuit of international trade reform had emerged. This coalition embarked on a 20-year campaign to achieve some fundamental changes in the rules governing international trade. The first important success was achieved with the formation of the **United Nations Conference on Trade and Development (UNCTAD)** in March of 1964. The UNCTAD was established in the UN as a body dedicated to promoting the developing countries' interests in the world trade system. At the conclusion of this first UNCTAD conference, 77 developing country governments signed a Joint Declaration that called for reform of the international trade system. Thus was born the **Group of 77 (G77),** which led the campaign for systemic reform during the next 20 years. During this period, trade relations between the developing world and the advanced industrialized countries revolved almost wholly around the competing conceptions of how to organize international trade that were embodied in the GATT and the UNCTAD. While the advanced industrialized nations defended the market-based GATT's position at the center of international trade, the Group of 77 used the UNCTAD, and the United Nations more broadly, to try to create mechanisms that would reduce GATT's role in international trade and redistribute global income from the core to the periphery.

During the 1960s, developing countries used the UNCTAD to pursue three international mechanisms that would provide them with a larger share of the gains from trade (Kock 1969; UNCTAD 1964; Williams 1991). Developing countries pressed for the creation of **commodity price stabilization** schemes. Commodity price stabilization was to be achieved by setting a floor price below which commodity prices would not be allowed to fall, and by creating a finance mechanism, funded largely by the advanced industrialized countries, to purchase commodities when prices threatened to fall below this established floor. If commodity prices could be effectively stabilized at relatively high levels, the deterioration of developing countries' terms of trade could be slowed, if not ended all together. Recognizing that commodity price stabilization schemes could not "offer a complete solution for all commodities or for all situations," developing countries also sought direct financial transfers from the advanced industrialized countries. Such transfers would compensate developing countries for the purchasing power they were losing from their declining terms of trade (UNCTAD 1964,

80). Developing countries also sought greater access to core country markets. They pressured the advanced industrialized countries to eliminate trade barriers on primary commodities and to provide manufactured exports from developing countries with preferential access to their markets.

These reform efforts yielded few concrete results. Core countries did modify the GATT Charter. In 1964, three articles focusing on developing countries' trade problems were included in **GATT Part IV.** These three articles called upon core countries to improve market access for commodity exporters, to refrain from raising barriers to the import of products of special interest to the developing world, and to engage in "joint action to promote trade and development" (Kock 1969, 242). In the absence of meaningful changes in the trade policies pursued by the advanced industrialized countries, however, Part IV offered few concrete gains to developing countries. The advanced industrialized countries also allowed the developing countries to opt out from strict reciprocity during GATT tariff negotiations. The developing countries that belonged to the GATT were therefore able to benefit from the tariff reductions made by the advanced industrialized countries without having to make tariff reductions in return. Benefits from this concession were more apparent than real, however. GATT negotiations focused primarily on manufactured goods produced by the advanced industrialized countries and excluded agriculture, textiles, and many other labor-intensive goods. Developing countries were therefore exporting few of the goods on which the advanced industrialized countries were actually reducing tariffs. In the late 1960s, the advanced industrialized countries agreed to the **Generalized System of Preferences** (GSP), under which manufactured exports from developing countries gained preferential access to advanced industrialized country markets. This concession was also of limited importance. Advanced industrialized countries often limited the quantity of goods that could enter under preferential tariff rates and excluded some manufacturing sectors from the arrangement entirely.

Even though their efforts during the 1960s had achieved few concrete gains, the Group of 77 escalated its demands for systemic reform in the early 1970s. The limited success realized during the 1960s heightened the Group of 77's dissatisfaction with the structure of the international trade system. Then, in 1973 the world's major oil producing countries working together in the Organization of Petroleum Exporting Countries (OPEC) used their control of the supply of petroleum to improve their terms of trade. OPEC's ability to use commodity power to improve its terms of trade with the advanced industrialized countries and in doing so extract income from the core strengthened the belief within the Group of 77 that commodity power could be exploited to force fundamental systemic change. Growing dissatisfaction and greater confidence combined to produce a set of more radical demands called the New International Economic Order (Krasner 1985). The **New International Economic Order** (NIEO) represented an attempt by the Group of 77 to create an international trade system whose operation was to be made "subordinate to the perceived development needs" of developing countries (Gilpin 1987, 299). The NIEO, which was adopted by the UN General Assembly in December 1974, embodied a set of reform objectives that, if implemented, would have radically altered the nature and the operation of the international economy. In addition to the commodity stabilization programs, compensation mechanisms, and market access elements that developing countries had demanded during the 1960s, the NIEO included rules that would give governments in developing countries greater control over the multinational corporations that operated in their countries, easier and cheaper access to northern technology, reduction of foreign debt, increased foreign aid flows, and a larger role for the developing world in the decision making processes of the World Bank and International Monetary Fund.

Governments in the advanced industrialized countries again proved unwilling to make significant concessions and by the mid-1980s the NIEO had been dropped from the agenda of the world trade system. The failure of the NIEO has been attributed to a number of factors. Developing countries were unable to develop and maintain a cohesive coalition. The heterogeneity of developing countries' interests made it relatively easy for the advanced industrialized countries to divide the Group of 77 by offering limited concessions to a small number of governments in exchange for defection from the broader group. In addition, the Group of 77 had hoped that OPEC would assist them by linking access to oil to acceptance of the NIEO. But OPEC governments were unwilling to use their oil power to help other developing countries achieve broader trade and development objectives. Finally, by the late 1970s many developing countries were facing serious balance of payments problems and were forced to turn to the International Monetary Fund (IMF) and the World Bank for financial support. The need to obtain IMF and World Bank assistance gave the advanced industrialized countries considerable influence over economic and trade policies in the developing world.

During much of the postwar period, therefore, developing countries insulated themselves from and sought systematic reform of the multilateral trade system. The interaction between domestic politics on the one hand and economic shocks and decolonization on the other gave rise to governments throughout the developing world that were highly responsive to the interests of import-competing manufacturing industries. Influenced greatly by structuralism, most governments transformed the existing political incentive to protect domestic industry into ambitious state-led development strategies. Structuralism's critique of the ability of domestic and international markets to promote industrialization led governments to adopt two-pronged strategies for industrialization: they intervened in domestic markets to overcome market imperfections that reduced private incentives to invest; they battled to change the rules governing international trade in order to capture a larger share of the gains from North-South trade.

Dismantling ISI: Trade Policy Reform in the Developing Countries

Developing countries' trade and development policies have changed dramatically since the early 1980s. Extensive protection of domestic markets, government intervention in the economy, government ownership of industry, and production geared toward the domestic market have all been dismantled. In their place governments have opened their economies to trade, withdrawn from the domestic economy, and geared production toward export markets. In the international trade system, the New International Economic Order and its demands for far-reaching reforms have disappeared. Since the mid-1980s about 35 developing countries have joined the WTO. Over the last 20 years, therefore, most developing countries have shifted from

policies that emphasize insulation from and opposition to the multilateral trade system to an emphasis on deeper integration into the global economy and greater participation in and support for the multilateral trade system.

These changes were the consequence of developments inside and outside developing countries that we examine here. Inside developing countries, a clear contrast emerged between problems arising from import substitution strategies and the much greater success being achieved by a group of East Asia countries on the basis of a very different development strategy. This contrast created a compelling economic rationale for Latin American and African governments to abandon ISI in favor of this more successful strategy. The actual adoption of this alternative development strategy came only in response to the debt crisis of the 1980s. The debt crisis forced many developing countries to turn to the International Monetary Fund and World Bank for financial assistance, and the condition of such assistance was the dismantling of import substitution industrialization. The extent to which developing countries have been willing and able to implement such reforms, however, has been shaped by domestic politics, as the distributional consequences of the policy changes have generated political conflicts that make reform difficult. We examine this transformation here, looking first at the weaknesses of ISI and then examining the greater economic success realized by the East Asian countries. Our attention then turns to the debt crisis and to the policy reforms that emerged in response to this crisis. We conclude by looking at how domestic politics have shaped the implementation of these reforms.

Emerging Problems with Import Substitution Industrialization

One important factor driving the reform of trade and development policies during the 1980s and 1990s was the diminished performance of the strategy of import substitution industrialization. While ISI contributed to the rapid growth of manufacturing industries in many developing countries during the fifties and sixties, weaknesses in this approach emerged in the late sixties and became ever more apparent during the seventies. These weaknesses suggested that this strategy had reached its limits and that some reform was needed. Problems with ISI, however, were insufficient to prompt governments to adopt far-reaching reforms. A continued commitment to the logic of structuralism and domestic political constraints limited both the willingness and the ability of most governments to abandon ISI in favor of an alternative strategy. We look at these developments here, focusing first on the weaknesses in the economic structures created by ISI and then turning our attention to why domestic politics created few incentives for reform in spite of these weaknesses.

Economic weaknesses. By the late 1960s, import substitution industrialization was generating important economic imbalances in developing countries, indicating that the approach might be approaching its limit as a useful development strategy. Two such imbalances were particularly important. The first lay in government budgets. ISI generated persistent budget deficits because it prescribed heavy government involvement in the economy. Because governments believed that private industry would not invest in industries that were important for the success of secondary ISI, governments themselves often made the investments, either in partnership with private-sector groups or alone by creating state-owned enterprises. Many of these state-owned enterprises were

unprofitable. By the late 1970s, state-owned enterprises in developing countries were running combined operating deficits that averaged 4 percent of GDP (Waterbury 1992, 190). Governments kept the enterprises afloat by using funds from the state budget. The combination of government investment and the subsequent need to cover the losses of the state-owned enterprises contributed to large budget deficits throughout the developing world.

Domestic politics aggravated the budget deficits generated by ISI. For many governments, the urban residents employed in the nontraded goods sector were a key source of political support. Governments maintained their support with policies that raised the standard of living of urban residents. Governments subsidized the cost of essential items. Electricity, water and sewer, transportation, telephone service, and food were all made available to urban residents at prices well below the market price. This was possible only by using government revenues to cover the difference between the true cost and the price charged. In addition, many governments used state-owned enterprises and the civil service to provide jobs to urban dwellers. In Benin, for example, the civil service tripled in size between 1960 and 1980, not because the government needed so many civil servants, but because the government needed to find some way to employ urban residents. State owned enterprises were used for similar purposes in many countries. Such practices simply added to government expenditures while doing little to increase government revenues, thereby worsening the budget deficit.

Import substitution industrialization also generated a second important imbalance—persistent current account deficits. The **current account** registers a country's imports and exports of both goods and services. A current account deficit means that a country is importing more than it is exporting. Import substitution gave rise to current account deficits because it generated a considerable demand for imports without increasing the economy's ability to export. On the import side, ISI generated a steady demand for imported capital goods and inputs. Industrialization could not occur unless countries imported the necessary machines, and once these machines were in place, production could not take place unless the country continued to import critical intermediate inputs that were not produced in the domestic economy. Somewhat ironically, therefore, import substitution industrialization became heavily dependent upon imports. On the export side, import substitution did little to increase the ability of developing countries to export. In fact, for many countries the strategy actually weakened the export sector. Export performance declined for two reasons. First, the manufacturing industries created through import substitution could not compete in international markets. Production in many of the heavy industries that governments targeted in secondary ISI is characterized by economies of scale: production costs fall as the volume of output increases. The domestic market in most developing countries was too small to allow domestic producers to realize economies of scale. These inefficiencies were compounded by excess capacity—the creation of more production capacity than the domestic market could absorb (see Little, Scitovsky, and Scott 1970, 98). These uncompetitive manufacturing industries were unable to export to the world market. Second, the policies that governments used to promote manufacturing industries greatly weakened export-oriented agriculture, thereby causing agricultural exports to fall. The decline in agricultural production was most severe in Sub-Saharan Africa, which as a region taxed farmers more heavily than other developing countries

(Schiff and Valdes 1992). Heavy tax burdens reduced farmers' incentives to produce, and as a result the rate of growth of agriculture declined. In Ghana, for example, cocoa production dropped dramatically during the 1960s. The real value of the payments that cocoa farmers received from the government marketing board fell by about two-thirds between 1960 and 1965. Falling prices gave cocoa farmers little incentive to invest in order to maintain, let alone increase, cocoa output (Killick 1978, 119). In addition, cocoa farmers smuggled much of what they did produce into the Ivory Coast, where they could sell cocoa at world prices (Herbst 1993, 40). The dependence of ISI on imports and the inability to expand exports combined to generate persistent current account deficits throughout the developing world.

Government control of imports and other aspects of the economy introduced other inefficiencies into the economy by creating an environment conducive to rent seeking (Krueger 1974; Bhagwati 1982). **Rent seeking** in this context refers to efforts by private actors to use the political system to achieve a higher than market return on an economic activity. Consider, for example, the consequences of government controls on imports. Governments controlled imports by requiring all residents who wanted to import something to first gain the permission of government authorities. Such import-licensing systems created an incentive for rent seeking. The restrictions themselves meant that imported goods were scarce. As a consequence, imports purchased at the world price could be sold at a much higher price in the domestic market. The difference between the world price and the domestic price provided a rent to the person who imported the good. A government license to import, therefore, was potentially very valuable. People therefore had incentives to pay government civil servants to acquire licenses and government civil servants had incentives to sell them. Such behavior was extra-ordinarily costly as people invested considerable time and energy pursuing these licenses rather than engaging in productive behavior. It has been estimated, for example, that these forms of rent seeking cost India about 7 percent and Turkey about 15 percent of their national incomes during the 1960s (Krueger 1974, 294). The policy regime that emerged out of ISI thus contributed directly to growing budget deficits and worsened the underlying economic inefficiencies. Both further diminished economic performance.

The emergence of budget and current account deficits indicated that ISI was creating an economic structure that could not pay for itself. Many of the manufacturing industries created during secondary ISI could not sell their products at prices that covered their costs of production. Many developing countries could not export enough to pay for the imports demanded by the new manufacturing industries they were creating. Such imbalances could not persist forever; some reform was clearly necessary.

Domestic constraints on reform. Domestic politics limited the willingness and the ability of governments to implement far-reaching reforms that would remove these imbalances. On the one hand, most governments remained committed to rapid industrialization and the logic of ISI, and far-reaching reforms would require them to reevaluate both. The alternative to ISI was a market-oriented development strategy, and in the 1960s and 1970s this was precisely the policy that the Group of 77 was fighting against in the UNCTAD and with the NIEO. Even moderate reforms held little appeal. Reducing government expenditures to eliminate budget deficits would require governments to reduce investment and close unprofitable state owned enterprises.

Correcting current account deficits would require governments to reduce imports of capital goods and intermediate inputs. Most governments were unwilling to scale back their industrialization strategies. Instead, most governments looked for a way to cover these twin deficits without having to scale back their ambitious plans. The solution for many was foreign loans. Borrowing from commercial banks based in the advanced industrialized countries allowed governments to finance their budget deficits and to pay for imports in excess of exports. Beginning in the late 1960s and early 1970s, therefore, many governments borrowed heavily from the advanced industrialized countries to finance the budget and current account deficits generated by ISI.

The balance of power among domestic interest groups also greatly limited the ability of governments to embark on meaningful reform. Because governments depended so heavily upon urban residents for political support, they could not easily alter the policies that provided benefits to this group (Waterbury 1992, 192). To take an extreme example, in 1971 the Ghanaian prime minister devalued the exchange rate in an attempt to correct Ghana's current account deficit. Concern that devaluation would raise prices for many imported goods consumed by urban residents contributed to a coup against the government a few days later. The new regime restored the exchange rate to its previous over-valued rate. This exchange rate raised the standard of living for urban residents, but at the cost of a larger current account deficit (Herbst 1993, 22–3). More broadly, over time, an increasing number of groups in developing societies acquired a vested interest in the continuation of ISI. As one expert has commented, the "political support of special interests for import substitution grew . . . Rather than changing policies when the consequences of further restrictiveness of the trade and payments regime became obvious, the political process in the short run resulted in increased support for it" (Krueger 1993b, 353). At the same time, those groups that one might have expected to oppose this system, particularly the export-oriented producers, grew weaker over time as the incentives created by ISI caused them to exit export-oriented activities in favor of economic activities that were promoted and protected.

By the early 1970s, therefore, the strategy of import substitution industrialization had given rise to economic and political problems throughout the developing world. Large investments, unprofitable state-owned enterprises, and large social expenditures had generated large budget deficits. The need to import capital goods and inputs in connection with ISI, the creation of uncompetitive manufacturing industries, and the weakening of the agricultural sector contributed to the emergence of large current account deficits. While these twin economic imbalances generated the need for reform, they were not sufficient to bring about reform. Domestic politics created few incentives for governments to adopt far-reaching policy reforms. Instead, many governments borrowed from commercial banks to finance the gaps between government revenues and expenditures and between imports and exports. As a consequence, the continuation of import substitution strategies became dependent upon continued access to international financial markets.

The East Asian Model

While import substitution industrialization was generating imbalances in Latin America and Sub-Saharan Africa, a small number of East Asian countries were realizing

dramatic gains on the basis of an alternative development strategy. Four of these East Asian economies, Hong Kong, Singapore, South Korea, and Taiwan, had consistently out-performed all other developing countries throughout the entire postwar period. This superior economic performance is evident in three simple economic indicators (see Table 4.5). First, between 1965 and 1990 the rate of per capita income growth in these four East Asian economies was, on average, more than twice as high as the rate of income growth in Latin America and South Asia, and more than 26 times the rate of per capita income growth in Sub-Saharan Africa. Second, East Asian manufacturing output grew at a very rapid rate, averaging 10.3 percent per year between 1965 and 1990. While Latin America fared relatively well in comparison to East Asia for the early part of the postwar period, these rates of growth were not sustained. Third, East Asian exports grew rapidly, while exports from other developing countries grew hardly at all. The contrast with Latin America is perhaps most striking. Whereas East Asian exports grew at an annual average rate of 8.5 percent between 1965 and 1990, Latin American exports in the same period shrank by an average of 1 percent per year. And while exports from Sub-Saharan Africa grew relatively rapidly between 1965 and 1980, by the mid-1980s this rate of growth had dropped sharply.

The consequences of these faster growth rates are illustrated in Tables 4.1, 4.2, and 4.6. The importance of manufacturing industries in the East Asian economies grew while the importance of agriculture diminished. By contrast, while agriculture's share of GNP shrank in both Africa and Latin America, manufacturing's share failed to grow. The increased importance of manufacturing in East Asia was translated into

Table 4.5
Comparative Economic Performance, Selected Developing Countries (Average Annual Rates of Change)

	1965–1990	1985–1995
Growth of Per Capita GNP		
East Asia and the Pacific	5.3	7.2
Sub-Saharan Africa	0.2	−1.1
South Asia	1.9	2.9
Latin America and the Caribbean	1.8	0.3
Growth of Manufacturing		
East Asia and the Pacific	10.3	15.0
Sub-Saharan Africa	n.a.	0.2
South Asia	4.5	5.3
Latin America and the Caribbean	8.3	2.5
Growth of Exports		
East Asia and the Pacific	8.5	9.3
Sub-Saharan Africa	6.1	0.9
South Asia	1.8	6.6
Latin America and the Caribbean	−1.0	5.2

Source: World Bank. *World Development Report*, various issues.

Table 4.6
GNP per Capita, Selected Developing Countries (1985 US Dollars)

	1960	1990	Percent Change
Hong Kong	2,247	14,849	561
Singapore	1,658	11,710	606
Taiwan	1,256	8,063	542
South Korea	904	6,673	638
Mexico	2,836	5,827	105
Malaysia	1,420	5,124	261
Argentina	4,462	4,706	5
Chile	2,885	4,338	50
Brazil	1,784	4,042	127
Thailand	943	3,580	280
Zaire/Congo	489	2,211	352
Indonesia	638	1,974	211
Pakistan	638	1,394	118
India	766	1,264	65
Nigeria	567	995	75
Kenya	659	911	38
Zambia	965	689	−29
Tanzania	319	534*	67

Source: Penn World Tables.
*Data for 1988.

significant changes in the commodity composition of East Asia's exports (Table 4.2). By the mid-1990s, manufactured goods accounted for more than 80 percent of East Asian exports. By contrast, only in Brazil, Mexico, India, and Pakistan did manufactured goods account for more than 50 percent of total exports by the 1990s, and most of these gains were realized after 1980. Finally, incomes in East Asia soared above those in other developing countries (Table 4.6). While per capita incomes in East Asia were lower than per capita incomes in Latin America in 1960, by 1990 East Asian incomes were higher, and in some cases twice as large as per capita incomes in Latin America.

Why did the East Asian countries outperform other developing countries by such a large margin? Most who study East Asian development agree that the East Asian countries distinguished themselves from other developing countries by pursuing an export-oriented strategy of development. In an **export-oriented strategy** emphasis is placed on producing manufactured goods that can be sold in international markets. Such an approach contrasts sharply with the emphasis on producing for the domestic market that is at the center of ISI. Where scholars disagree is on the relative importance of the market and the state in creating export-oriented industries. One position, articulated most forcefully by the International Monetary Fund and the World Bank, argues that East Asia's success was a product of market-friendly development strategies. A second position, advanced by many who specialize in East Asian political economy, argues that East Asia's success is due in large part to well-designed state-led industrial policies.

A market-based approach to development. The IMF and the World Bank contend that East Asia's economic success is the result of development strategies that embraced international markets and emphasized macroeconomic stability (see World Bank 1989; 1991; 1993; 1994; Little 1982; Lal 1983; for critiques see Toye 1994 and Rodrik 1999). Most East Asian governments adopted ISI strategies in the immediate postwar period. Unlike governments in Latin America and Africa, however, East Asian governments shifted to export-oriented strategies once they had exhausted the gains from easy ISI. Thus, whereas Latin American and African governments followed easy ISI with secondary ISI, both of which emphasized production for the domestic market, the East Asian governments followed easy ISI by encouraging the manufacturing industries they had created under easy ISI to export to the advanced industrialized countries. In Taiwan, for example, the government shifted in 1958 from production for the domestic market to a strategy that emphasized production for export markets. South Korea adopted similar reforms in the early 1960s. A second wave of Newly Industrializing Countries (NICs), a group that includes Indonesia, Malaysia, and Thailand, adopted similar reforms beginning in the late 1960s (World Bank 1993). The emphasis on exports forced Asian manufacturing firms to worry about international competitiveness. This stood in great contrast to Latin American firms, which continued to produce for domestic markets and were heavily protected from foreign competition. As a result, the World Bank and IMF argue, Asian societies invested their resources in domestic industries that were profitable in world markets, while Latin American and African governments did not.

The shift to an export-oriented strategy by East Asian governments was followed by selective import liberalization. Asian governments did not engage in wholesale import liberalization. The Taiwanese and South Korean governments continued to rely heavily on tariff and nontariff barriers to protect domestic markets. In Taiwan, for example, approximately two-thirds of imports were subject to some form of tariff or nontariff barrier greater than 30 percent, and as late as 1980 more than 40 percent of imports faced protection greater than 30 percent (World Bank 1993, 297). A similar pattern is evident in South Korea, where as late as 1983, "most sectors were still protected by some combination of tariffs and nontariff barriers" (World Bank 1993, 297). However, selective liberalization helped promote exports by reducing the cost of critical inputs. By reducing tariffs on key intermediate goods, such as looms and yarn in the textile industry, domestic producers were able to acquire their inputs at world prices and this in turn made their exports competitive in international markets. The export orientation thus promoted investments in sectors that exploited underlying comparative advantage, while import liberalization helped ensure that these advantages were not eliminated by high input prices.

East Asian governments also maintained stable macroeconomic environments. Three elements of the macroeconomic environment were particularly important. First, inflation was much lower in East Asia than in other developing countries. Between 1961 and 1991, East Asian economies experienced an average rate of inflation of only 7.5 percent. By contrast, annual inflation rates in the rest of the developing world averaged 62 percent over the same period (World Bank 1993, 110). Second, because inflation was kept under control, East Asian governments were able to maintain their exchange rates at the correct level. In many developing countries, high inflation

caused the domestic currency to rise in value against foreign currencies. This **exchange rate appreciation** made it difficult for domestic firms to export their goods. In the East Asian countries, governments were able to maintain exchange rates that allowed domestic firms to remain competitive in foreign markets (we will explore exchange rate issues in greater detail in Chapter 8). Third, East Asian governments pursued relatively conservative fiscal policies. They borrowed little, and when they did borrow they tapped domestic savings rather than turning to international financial markets. This was in stark contrast to Latin American governments, which accumulated large public sector deficits financed with foreign capital. More conservative fiscal policies allowed East Asian governments to minimize the growth of foreign debt.

This stable macroeconomic environment had beneficial consequences for Asian economic performance. Low inflation promoted high rates of saving and investment (World Bank 1993, 12). Savings rates in the Asian NICs averaged more than 20 percent of GDP per year, almost twice the level attained in other developing countries, while investment rates were 7 percentage points of GDP higher, on average, than in other developing countries (World Bank 1993, 16, 221). A stable macroeconomic environment also made it easier to open the economy to international trade. Because inflation was low and exchange rates were maintained at appropriate levels, trade liberalization did not generate large current account deficits that would force the government to reimpose trade barriers. Finally, the ability to maintain relatively stable and appropriately valued real exchange rates encouraged private actors to invest in export-oriented industries.

The interaction between the export orientation, the relatively liberal trade policy, and the stable macroeconomic environment promoted economic development. As Doner and Hawes (1995, 150) summarize this argument, the "pattern of limited government intervention in the market, coupled with cheap labor and an open economy, have guaranteed the private sector stability and predictability, the means to achieve competitiveness on a global scale, and access to the international market so that entrepreneurs could actually discover areas where they have comparative advantage. In shorthand, the model is often reduced to 'getting the prices right' and letting market-based prices determine resource allocation. Doing so results in export growth that is in turn positively correlated with broader economic growth." According to the World Bank and IMF, therefore, East Asia succeeded where Latin America and African governments failed because markets played a larger role and states played a much smaller role in allocating their resources.

Industrial policy and East Asian development. Other scholars have argued that East Asia's successful pursuit of an export-oriented development strategy had little to do with markets and much more to do with well-designed government industrial policies (see Wade 1990; Amsden 1989; Haggard 1990). In what has come to be called the **East Asian model,** economic development is conceptualized as a series of distinct stages of industrialization. Government intervention in each stage is aimed at identifying and promoting specific industries that are likely to be profitable in the face of international competition. In the first stage, industrial policy promotes labor-intensive light industry, such as textiles and other consumer durables. In the second stage, the emphasis of industrial policy shifts to heavy industries such as steel, shipbuilding, petrochemicals, and synthetic fibers. In the third stage, governments target skill and research and development intensive consumer durables and industrial machinery, such as

machine tools, semiconductors, computers, telecommunications equipment, robotics, and biotechnology. Governments design policies and organizations to promote the transition from one stage to the other (Wade 1994, 70).

These three stages of industrialization are evident in Taiwan and South Korea (see Table 4.7). In Taiwan, industrialization focused initially on light manufacturing, and textiles in particular. By the mid-1950s textiles were Taiwan's most important export. Efforts were also made to encourage domestic production of simple consumer durable goods such as television sets. In the late 1950s the Taiwanese government began to emphasize the heavy industries characteristic of the second stage. A joint venture between several Taiwanese firms and an American firm was formed in 1954 to produce synthetic fibers (Wade 1990, 80). In 1957, a plant to produce polyvinyl chloride was constructed under government supervision and then handed to a private entrepreneur, Y.C. Wang (Wade 1990, 79). The government created state-owned enterprises in the steel, shipbuilding, and petro-chemical industries. During the 1970s, emphasis shifted to skill and R&D intensive industries, with emphasis placed in particular on machine tools, semiconductors, computers, telecommunications, robotics, and biotechnology (Wade 1990, 94). By the mid-1980s, electrical and electronic goods had replaced textiles as Taiwan's largest export (Wade 1990, 93).

The South Korean government adopted similar policies (Amsden 1989). In the 1950s, the government emphasized textile production, and textiles became South Korea's first important manufacturing export. During the late 1960s, emphasis shifted to the second stage, as the South Korean state initiated the development of the chemical and heavy machinery industries. The government created the Pohang Iron and Steel Company, known as POSCO, in 1968, which subsequently became one of the world's leading steel producers. It provided extensive support to Hyundai Heavy Industry,

Table 4.7
Stages of Industrialization in Taiwan and South Korea, 1880–1970

	Commodity Exports 1880–1930	Primary ISI 1930–1955	Primary EOI 1955–1968
Main Industries	Taiwan: Sugar, rice South Korea: Rice, beans	Taiwan and South Korea: Food, beverages, tobacco, textiles, clothing, cement, light manufactures (wood, leather, rubber, and paper products)	Taiwan and South Korea: Textiles and apparel, electronics, plywood, plastics (Taiwan), wigs (South Korea), intermediate goods (chemicals, petroleum, paper, and steel products)
Major Economic Actors	Taiwan and Korea: Local producers (colonial Japan)	Taiwan and South Korea: Private national firms	National private firms, multinational corporations, state-owned enterprises
Orientation of the Economy	External Markets	Internal Market	External Markets

Source: Gereffi 1990, 19.

a shipbuilder formed in the early 1970s, which subsequently became a world leader in this industry. During the late 1970s, the South Korean government began to give priority to skill and R&D intensive sectors, and it is during this period that the South Korean electronics and automobile industries began to emerge (Amsden 1989). In the East Asian model, therefore, government policy drives industrialization from initial low-skill, labor-intensive production to capital-intensive forms of production, and from there to industries that rely on high-skilled labor and research and development. Each stage is associated with particular types of government policies, and as each stage reaches the limits of rapid growth, emphasis shifts to the next stage in the sequence (Wade 1994, 71). Moreover, in each stage, governments stress the need to develop internationally competitive industries.

East Asian governments implemented industrial policies in pursuit of four broad objectives: reducing the cost of investment funds in the selected industries, creating incentives to export, protecting infant industries, and promoting the acquisition and application of skills. Taiwan and South Korea created incentives to invest in industries that state officials identified as critical to development. To do so, governments in both countries provided firms investing in these industries with preferential access to low-cost credit. In South Korea, the government nationalized the banks in the early 1960s, and in the following years fully controlled investment capital. Control of the banks allowed the government to provide targeted sectors with access to long-term investment capital at below market rates of interest (Haggard 1990, 132). While the banking sector was not nationalized in Taiwan, the government did influence banks' lending decisions. During the 1960s, banks were provided with government-formulated lists of industries that were to receive preferential access to bank loans. During the 1970s, the banks themselves were required to select five or six industries to target in the coming year. As a result, about 75 percent of investment capital was channeled to the government's targeted industries (Wade 1990, 166).

Asian governments also implemented policies that encouraged exports. One method was to link preferential access to investment capital to export performance. In Taiwan, for example, firms that exported paid interest rates of only 6–12 percent while other borrowers paid 20–22 percent (Haggard 1990, 94). In South Korea, short-term loans "without limit" were extended to firms with confirmed export orders (Haggard 1990, 65). Credit was also made available to exporters' input suppliers, and to these suppliers' suppliers (Haggard 1990, 65–66). In addition, "deliberately under-valued exchange rates" improved the competitiveness of exports in international markets (World Bank 1993, 125). Finally, a variety of measures were used to ensure that domestic firms could purchase their intermediate inputs at world prices. This often entailed the creation of free trade zones and export-processing zones, areas in the country into which intermediate goods could be imported duty free as long as the finished goods were exported. Export processing zones allowed domestic producers to avoid paying tariff duties that would raise the final cost of the goods they produced.

The Taiwanese and South Korean governments also protected infant industries in each stage. In some instances these measures were straightforward forms of protection. The South Korean government, for example, enacted legislation in 1983 that "prohibited the import of most microcomputers, some minicomputers, and selected models of disk drives," in order to protect domestic producers in the computer industry (Amsden 1989,

82). POSCO initially produced steel behind relatively high import barriers. In other instances, protection was less transparent. Hyundai Heavy Industry, for example, was protected in part through a government policy that required Korean crude oil imports to be carried in ships operated by a merchant marine that Hyundai Heavy Industry had itself created (Amsden 1989, 273). Similar policies were adopted in Taiwan. The China Steel Corporation, a state-owned enterprise, has been able to exclude imports of the types of steel it produces (Wade 1990, 131). In these ways new firms were protected against imports for a period of between two and five years (Wade 1990, 132).

Finally, the Taiwanese and South Korean governments put in place policies that raised the skill level of the population. These policies were of particular importance in the transition from second stage heavy industry to third stage skill- and research-intensive industries. Investments in education were made to improve labor skills. In Taiwan, enrollment in secondary schools had reached 75 percent of the eligible age group by 1980. Enrollment increases were accompanied by rising expenditures on education; per pupil expenditures on education increased 8 times in primary schools, 3 times in secondary schools, and doubled at the university level between the early 1960s and 1980s (Liu 1992, 369). Similar patterns are evident in South Korea. Enrollment in secondary schools increased from 35 percent in 1965 to 88 percent in 1987 and "real expenditures per pupil at the primary level rose by 355 percent in Korea" (World Bank 1993, 43, 45). Governments also invested in scientific infrastructure to facilitate the application of skills to research and development activities. In Taiwan, an Industrial Technology Research Institute was formed in 1973; nonprofit organizations were created during the 1970s to perform research and disseminate the results to firms in the private sector. A science-based industrial park designed to realize agglomeration effects was created in 1980 (Haggard 1990, 142). In South Korea, tax incentives were used to induce chaebols, the large South Korean firms, to create laboratories for research and development purposes. An industrial estate for computer and semiconductor production was created; the Electronics and Telecommunications Research Institute, a government-funded institute oriented toward product development was formed in the industrial estate (Amsden 1989, 82). These policies raised labor skill levels and at the same time created an infrastructure that allowed this more highly skilled labor force to work to its full potential. This skill upgrading was critical to the transition to the third stage of the industrialization process.

The two explanations thus present different arguments for East Asia's success. One suggests that East Asia succeeded because governments allowed markets to work. The other suggests that East Asia succeeded because governments used industrial policy to promote economic outcomes that the market could not produce. Which argument is correct? While we lack definitive answers, we may conclude that both explanations have value. By "getting prices right," the export orientation and the stable macroeconomic environment encouraged investments in industries in which East Asian countries had or could develop comparative advantage. By targeting sectors where comparative advantage could be created, by reducing the costs of firms operating in these sectors, by encouraging firms to export, and by upgrading skills, industrial policy encouraged investments in areas that could yield high returns. As Stephan Haggard (1990, 67) has summarized, "[macroeconomic] and trade policies established a permissive framework for the realization of comparative advantage, and more targeted policies pushed firms to exploit it."

While we may dispute the relative importance of the state and the market in accounting for East Asia's success, what is clear is that the experience of the East Asian NICs was vastly different from that of Latin America and Sub-Saharan Africa. East Asian governments had adopted different development strategies, emphasizing exports rather than the domestic market, and they had realized much better results. Given these differences, it is hardly surprising that when governments in Latin America and Sub-Saharan Africa moved to reform their economic policies, the export-oriented strategy adopted by East Asian governments provided the most compelling alternative to ISI.

International Financial Institutions and Structural Adjustment

While ISI generated the need for reform, and East Asia's success provided an attractive alternative to import substitution, it took the 1980s debt crisis to push governments to actually begin dismantling ISI in favor of export-oriented strategies. And while we will examine the debt crisis in greater detail in Chapter 8, we need to say a few words about it here to understand how it contributed to such far-reaching changes in trade and development policies. The debt crisis emerged in the early 1980s in part as a consequence of the decision made by many governments to cover the budget and current account deficits arising from ISI by borrowing from commercial banks based in the advanced industrialized countries. Using foreign debt to pay for budget and current account deficits is not an inherently poor choice. But two factors made this decision a particularly bad one for many developing countries in the 1970s. First, many of the funds that governments borrowed were used to pay for large infrastructure projects or domestic consumption, and neither of these uses generated the export revenues governments needed to repay the loans. As a result, the amount that developing countries owed to American and European commercial banks rose, but their ability to repay this debt did not. Second, between 1973 and 1982, developing countries were buffeted by three international economic shocks—an increase in the price of oil, a reduction in the terms-of-trade between primary commodities and manufactured goods, and higher interest rates on the foreign debt they had accumulated. These shocks increased the amount of foreign debt that developing countries owed to foreign banks, raised the cost of paying this debt, and greatly reduced their export earnings. By the early 1980s, many developing countries were unable to make the scheduled payments on their foreign debt.

As developing countries struggled to make payments on their foreign debt, many turned to the International Monetary Fund (IMF) and the World Bank for financial assistance. Assistance was forthcoming, but it was explicitly linked to the willingness of governments to implement economic policy reforms. The World Bank and IMF encouraged governments to adopt such reforms under the banner of structural adjustment programs. **Structural adjustment** refers to policy reforms designed and promoted by the World Bank and IMF that seek to increase the role of the market and reduce the role of the state in the economy. In less abstract terms, structural adjustment was designed to dismantle the central components of import substitution industrialization and to establish in their place the central components of export-oriented development strategies. The content of the policy reforms that the IMF and World Bank proposed were shaped by their belief that East Asia's economic success had resulted from export-oriented and

market-based development strategies (see World Bank 1991; 1993). In the World Bank's own words, "the approach to development that seems to have worked most reliably, and which seems to offer most promise, suggests a reappraisal of the respective roles for the market and the state. Put simply, governments need to do less in those areas where markets work, or can be made to work, reasonably well" (1991, 9).

To this end, structural adjustment emphasized macroeconomic stability, trade liberalization, and privatization of state-owned enterprises (Williamson 1990). Macroeconomic stability was to be achieved by transforming government budget deficits into budget surpluses. This change would reduce the demand for imports, thereby reducing developing countries' current account deficits. Governments also were encouraged to liberalize imports. They were encouraged to dismantle import-licensing systems, to shift from quota-based forms of protection to tariffs, to simplify complex tariff structures, and to then reduce tariffs and open their economies to imports. The IMF and the World Bank also encouraged the **privatization** of state-owned enterprises, that is, selling state-owned enterprises to private individuals and groups. The IMF and World Bank argued that reducing government involvement in the economy would foster competition, and that greater competition would in turn help create a more efficient private sector that could drive economic development. Through structural adjustment, therefore, governments were encouraged to scale back the role of the state in economic development and enhance the role played by the market.

Many governments did implement structural adjustment reforms between 1983 and 1995 (see Table 4.8). Tariffs throughout the developing world fell substantially beginning in the mid-1980s (see Figure 4.1). While average tariffs still remain higher in developing countries than in the advanced industrialized countries, on average they

Table 4.8
Countries Adopting Trade and Domestic Policy Reforms, 1980–1996

Africa		Latin America	
Benin	Malawi	Argentina	Honduras
Burkina Faso	Mali	Barbados	Mexico
Burundi	Mauritania	Bahamas	Nicaragua
Cameroon	Mauritius	Belize	Panama
Central African Republic	Mozambique	Bolivia	Paraguay
Chad	Niger	Brazil	Peru
Congo	Nigeria	Chile	Suriname
Cote d'Ivoire	Rwanda	Colombia	Trinidad and Tobago
Ethiopia	Senegal	Costa Rica	Uruguay
Gabon	Sierra Leone	Dominican Republic	Venezuela
The Gambia	Tanzania	Ecuador	
Ghana	Togo	El Salvador	
Guinea	Uganda	Guatemala	
Guinea-Bissau	Zambia	Guyana	
Kenya	Zimbabwe	Haiti	
Madagascar			

Source: World Bank 1994; Thorp 1998.

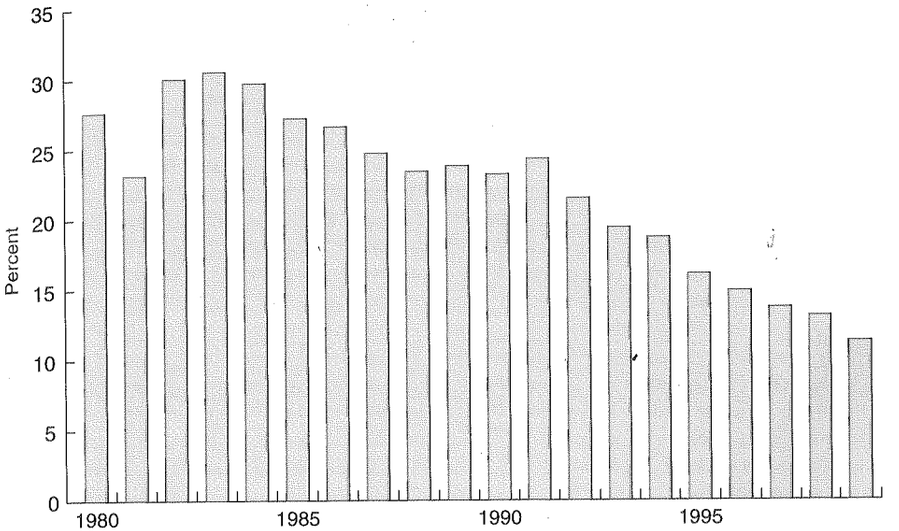

Figure 4.1 Average Tariffs, Developing Countries.
Source: World Bank.

have been cut in half since the early 1980s. Many governments have also substantially reduced their reliance upon nontariff barriers to trade. While it is hard to get accurate measures of the coverage of nontariff barriers, Table 4.9 provides some evidence on the scope of such measures in a number of developing countries—a general trend toward the elimination of these obstacles to trade is evident. Privatization became a priority objective in the late 1980s. In Latin America, "more than 2,000 publicly owned firms, including public utilities, banks, and insurance companies, highways, ports, airlines, and retail shops were privatized" between 1985 and 1992 (Edwards 1995, 170; see also Corbo 2000). In general, African governments have moved less rapidly than Latin American governments to carry out structural adjustment reforms (see World Bank 1994a; 1994b). Many African governments have begun to liberalize trade, shifting away from quotas and lowering tariffs, but progress has been slow. Privatization has moved even more slowly, with less than one-fifth of state-owned enterprises having been privatized by the mid-1990s.

The overall economic consequences of structural adjustment programs were reduced incomes in the short run and redistributed income in the long run. Most developing countries experienced a sharp fall in per capita income as they began to implement reforms. In Latin American countries, national incomes fell by about 8 percent between 1981 and 1984, while in African countries incomes fell, on average, by about 1.2 percent per year throughout the 1980s (Thorp 1998, 220; World Bank 1993). In the countries that have moved furthest along in the reform process the short-run drop in incomes has largely been reversed. In Latin America, for example, the negative growth that many countries experienced during the 1980s was followed by a return to positive growth rates in the 1990s.

Table 4.9
Nontariff Barriers in Developing Countries (as a percent of all industry categories)

	1989–1994	1995–1998
Hong Kong, China	2.1	2.1
Indonesia	53.6	31.3
Korea	50.0	25.0
Malaysia	56.3	19.6
Singapore	1.0	2.1
Thailand	36.5	17.5
India	99.0	93.8
Nigeria	14.4	11.5
South Africa	36.5	8.3
Morocco	58.3	13.4
Turkey	5.2	19.8
Argentina	3.1	2.1
Brazil	16.5	21.6
Chile	5.2	5.2
Colombia	55.2	10.3
Mexico	27.8	13.4
Uruguay	32.3	0.0

Source: World Bank.

The more long-lasting consequence of structural adjustment comes from the redistribution of income that it brings about. The dismantling of import substitution industrialization represents a shift from protection to liberalization. Such a shift should raise incomes in the export-oriented sector. In many countries this means gains for agricultural producers. In Guinea, for example, reforms produced a three-fold increase in the price coffee producers received for their crop (Arulpragasam and Sahn 1994, 73–76). In The Gambia, producer prices on groundnuts tripled as a consequence of structural adjustment policies (Jabara 1994, 309). At the same time, trade liberalization, privatization, and the scaling back of other government programs hurt producers based in the import-competing sector as well as those employed in the nontraded goods sector. In The Gambia, for example, the government raised the price of petroleum products, public transportation, water, electricity, and telecommunications in connection with structural adjustment (Jabara 1994, 309). In Guinea, the elimination of government rice subsidies doubled the price that households paid for rice, an important staple in their diets (Arulpragasam and Sahn 1994, 79). Privatization usually resulted in large job losses in these import-competing manufacturing industries, while scaling back the size of the civil service eliminated jobs in the nontraded goods sector. In Guinea, the civil service was reduced in size from 104,000 in 1985 to 71,000 in 1989 (Arulpragasam and Sahn 1994, 91). In The Gambia, government employees were reduced by 25 percent in 1985–1986, and wages and salaries of those retained in the government sector were frozen (Jabara 1994, 312, 318). In pursuing structural adjustment, therefore, governments redistributed income: export-oriented producers benefited from the successful implementation of these policies,

A Closer Look

Structural Adjustment in Mexico

The Mexican government embarked on structural adjustment in the mid-1980s. Between 1985 and 1990, the policies adopted in connection with structural adjustment radically shifted the direction of Mexico's economy (see Lustig 1998; Cordoba 1994). In part these changes reflected pressures exerted by the World Bank, from which Mexico borrowed $2.3 billion in 1986 and 1987. The scope of the reforms, however, suggested that the Mexican government was doing more than responding reluctantly to external pressure. Trade liberalization, one of the centerpieces of reform, began in earnest in 1985, and its initiation was heralded by the announcement that Mexico had applied to join the GATT. At that time Mexico was one of the most heavily protected economies in the world. More than 90 percent of the domestic economy was protected by import licenses, in some industries tariffs were as high as 100 percent, and the average tariff stood at 23.5 percent. Trade liberalization occurred in three stages between 1985 and 1993. The government reduced the coverage of the import-licensing system, so that by 1990 only 20 percent of imports were subject to explicit government approval, and these requirements were restricted to a limited number of sensitive sectors including natural gas, petroleum refining, automobiles, and agriculture. Next, the government simplified the tariff structure, shifting from a system with ten tariff rates to a system with only five rates, and capping the highest rate at 20 percent. From this base, the government then gradually reduced tariffs, which fell from the average of 23.5 in 1985 to an average of only 12.5 by 1990. Finally, in 1990 the Mexican government initiated negotiations with the United States and Canada that culminated in the creation of the North America Free Trade Area.

Trade liberalization was accompanied by the liberalization of foreign direct investment. Until the mid-1980s, the operation of foreign firms in the Mexican economy was tightly restricted. Foreigners were completely excluded from many sectors of the Mexican economy, and they could only hold a minority share of firms in all other sectors. In February 1984, the government relaxed some of these restrictions by allowing majority ownership by foreign firms in 33 selected industries. The restrictions were further relaxed in 1989 by an expansion of the sectors in which foreign firms could control as much as 100 percent of a Mexican firm. Thus, in addition to opening the Mexican economy to imports, the government also opened the economy to investments by multinational corporations.

The government also dismantled industrial policy, which had been a central component of Mexico's ISI strategy. Mexican industrial policies used financial incentives and import controls to promote specific industries. More than 700 specific programs had been put in place between 1965 and 1970, and 1,200 more had been established during the 1970s. The government began to dismantle these programs in the early 1980s as the crisis first hit. The programs were reduced in number and oriented toward critical industries, particularly in automobiles, pharmaceuticals, capital goods, and petrochemicals. But even these last remnants of ISI were dismantled in the late 1980s. The government eliminated many of the financial incentives it had previously used to encourage investment, it eliminated rules governing domestic content for foreign firms operating in these industries, and it relaxed the rules restricting foreign direct investment.

Continued

The government also began reducing its role in the Mexican economy in other ways. It began the process of privatization in 1983 by changing the Mexican constitution to limit the sectors in which the government could maintain state-run monopolies. Then, between 1985 and 1990 the government either sold to private investors or liquidated 875 of the 1,155 state-owned enterprises that had been in existence in 1982. Also greatly reduced was the degree to which the government directly controlled prices. Between 1950 and 1980 the government had used price controls to ensure that domestic industry could acquire its most important inputs at relatively low and stable prices. In the early 1990s, it began to dismantle this system. It shortened the list of items subject to price controls, reduced the difference between the controlled price and the international price, and attempted to inject greater flexibility into the price setting mechanism. The government liberalized many primary commodity sectors, eliminating regulations governing the production and marketing of cacao beans and products, coffee, and sugar among others. It relaxed restrictions on fishing, allowing private individuals, corporations, and foreigners to fish in Mexican waters. These and other de-regulations created greater competition within the industries concerned, and allowed market-based processes rather than state actors to play the more important role in determining the outcome of this competition.

These reforms had a dramatic impact on Mexican incomes. Overall, economic growth between 1982 and 1987 averaged −0.4%, and per capita income fell from $3,500 in 1981 to $3,024 in 1988. As a result, the percentage of the population living in poverty increased from about 42% in the early 1980s to about 48 percent in 1989. The sharp drop in incomes stabilized in the late 1980s, however, and positive growth resumed in the late 1980s. The Mexican economy has grown at an average rate of 3.5% per year since 1989, and per capita incomes have risen to $3,600 by 1999. Reform also affected the relative position of groups in the Mexican economy (Lustig 1998; Damian 2000). Hardest hit were those who had benefited most from ISI. Government employees saw their incomes fall by an average of 12% per year during the second half of the 1980s. Manufacturing workers were also hit hard, experiencing average income losses of 6.2% per year in the same period. People employed in agriculture and in export-oriented manufacturing industries manufacturing industries fared better. Incomes in these sectors did fall, but they fell much less than incomes in other sectors. Agricultural wages fell an average of only 3.8% per year. Workers employed in the export-oriented maquiladora industries fared substantially better than other manufacturing workers, as their wages fell by only .2% in 1986–1987.

while people employed in the import competing and nontraded goods sectors saw their incomes fall.

Domestic Politics and Structural Adjustment

While many factors created pressure for domestic reforms, domestic interests and institutions shaped the ability of governments to implement these reforms. The economic consequences of structural adjustment drove the domestic politics of reform. Groups that would lose from structural adjustment attempted to block the reforms while those who stood to gain attempted to promote reform. Governments were forced to mediate between them, and in many countries, governments were heavily dependent upon political

support from those groups that were going to lose: import-competing and nontraded goods. The existing political economy literature provides less than a full explanation for how governments were able to implement policies that cut against the interests of their principal supporters (Grindle 1991). Initially, scholars suggested that structural adjustment would be most easily implemented in authoritarian regimes and least easily implemented in democratic regimes. In democratic countries, interest groups opposed to adjustment could "use democratic channels or independent organizational resources to block or undermine reforms. Opposition parties could gain votes by promising to reverse the austere policies of the current government. The very nature of the democratic system and the legal guarantees it affords limit the state's ability to act" (Haggard 1985, 164). As a consequence, democratic regimes would be characterized by a political stalemate that would block reform. In authoritarian regimes, in contrast, fewer organized groups exist to oppose reform, and they have fewer political channels through which to influence politics. Moreover, authoritarian governments would be less constrained in how they respond to opposition. In the absence of legal guarantees, authoritarian regimes could respond to protest and opposition with repression. Governments in authoritarian regimes, therefore, would be more easily able to implement structural adjustment packages than governments in democratic regimes. Investigation of the politics of reform failed to support this initial belief, however (Nelson 1984, Haggard 1985; Remmer 1986; Haggard, Kaufman, and Webb 1992).

Three factors offer a better explanation of what shapes the ability of governments to implement and sustain reforms in the face of opposition from powerful domestic interest groups (Krueger 1993a). First, in many countries, governments adopted reforms only after the economic crisis precipitated by the debt crisis had reached dramatic proportions. The emergence of a severe domestic economic crisis can trigger a realignment of interests within society, discrediting those groups that are associated with the old regime and with the old policies, and giving greater influence to groups that are proposing an alternative approach. The economic crisis thus creates a new political consensus that the old order has failed and that reform is necessary. By weakening key interest groups and by forcing many of these same groups to redefine their interests, the economic crisis removes many of the political obstacles to far-reaching reform. As a consequence, in many countries, successful reforms were implemented only after new governments responsive to new interests had replaced the governments that had governed during import substitution industrialization. Second, new governments are often motivated to dismantle the corruption that characterized the previous regime, and the commitment to do so may encourage domestic groups to tolerate the short-run costs of reform in exchange for the promise of future gains.

Finally, but hardly least important, in order to sustain the reforms, the new governments that were implementing structural adjustment policies had to forge new political coalitions composed of the beneficiaries of the new policies. In Ghana, as in many other countries, political reform accompanied the introduction of economic reform (Bates 2001). The military government led by Flight Lieutenant Jerry Rawlings first organized local political councils in rural areas and then legalized the creation of political parties. This framework was used to educate the rural population about how they would benefit from the market-liberalizing reforms being put in place. "By securing the support of the rural majority, Rawlings was therefore able to retain office, even

while severing the ties between his government and its urban constituency" (Bates 2001, 95). In other words, just as ISI gave rise to interest groups that benefited from established policies and supported the politicians that kept such policies in place, so the shift to market-based policies could create interest groups that gain from trade liberalization and support governments that maintain such policies.

The radical reorientation of developing countries' trade and development policies, therefore, was shaped by a rather complex interaction between economic and political developments within developing societies and in the broader international economic system. The imbalances generated by the ISI model contrasted sharply with the spectacular success realized by the East Asian countries on the basis of export-oriented development strategies, and this contrast created a clear economic rationale for changing course. Yet, because governments beholden to domestic interest groups cannot easily implement such a far-reaching policy reorientation, it took a profound economic crisis to actually bring it about. And even then, successful implementation of structural adjustment programs has been constrained by the ability of governments to overcome opposition to reform from powerful domestic interests and to create new political coalitions based on the domestic groups that benefit from the new policy regime.

Developing Countries in the Contemporary Multilateral Trade System

The reorientation of trade and development strategies in the developing world has altered the role that developing countries play in the multilateral trade system. This changing role reflects in part the greater importance of developing countries in world trade. The share of total world trade accounted for by developing countries rose by 7 percentage points between 1990 and 1999, to about 25 percent of total world trade (World Bank 2001). In addition, developing countries have begun to play a larger political role in the multilateral trade system. Prior to the Uruguay Round, developing countries participated little in the GATT-based trade system. As we saw above, most of these governments believed that the UNCTAD provided the better institution through which to pursue their interests, and many did not even belong to the GATT. Those that did belong to the GATT played only a small part in trade negotiations.

Much has changed since the early 1980s. Starting with the Uruguay Round, developing countries have begun to play an active role in the multilateral trade system. The number of developing countries that are members of the multilateral trade system increased from 58 in 1982 to 100 by the end of the 1990s. As a result, developing countries now account for more than three-quarters of all WTO members. Developing countries have also begun to play a much more active role in shaping the agenda for multilateral trade negotiations and in the negotiations themselves. In the Uruguay Round, for example, pressure from developing countries helped put agriculture and textiles and apparel on the negotiating agenda, and helped force the advanced industrialized countries to begin the process of liberalization in these sectors. This greater influence has continued in the early stages of the Millenium Round, during which developing countries have helped shape the agenda. In spite of the larger role they now

play in the system, the pattern of protection and liberalization created within the multilateral trade system during the last 50 years is heavily biased in many respects against developing countries. These biases shape the objectives pursued by the developing countries in the current round of WTO trade negotiations. We conclude this chapter by examining the nature of these biases and considering the likelihood that the developing countries can use the WTO to eliminate them.

The central challenge that developing countries face in the multilateral trade system arises from the political economy of trade policy in the advanced industrialized countries. As we saw in Chapter Three, the political economy of trade policy in the advanced industrialized countries generates barriers to imports in many of the industries in which developing countries hold a comparative advantage. Agriculture on the one hand and textiles and apparel on the other are the two sectors in which the bias against developing countries' exports is greatest. Many developing countries have a comparative advantage in agriculture. Yet, three aspects of advanced industrialized country policies make it difficult for developing countries to capitalize on this advantage. Tariffs pose the most obvious obstacle to the ability of developing countries to export agricultural products to the United States, Western Europe, and Japan. In addition to tariffs, however, governments in the advanced industrialized countries also subsidize agricultural production very heavily. In the year 2000 alone, the advanced industrialized countries provided a total of $327 billion of financial assistance to domestic farmers. These subsidies increase agricultural production in the advanced industrialized countries and this reduces the demand for imports from developing countries. In addition, governments in the advanced industrialized countries subsidize exports, thereby displacing other countries' farm products from world markets and driving down the world price of these commodities. EU price supports, for example, caused EU wheat production to increase by 2.5 percent per year between 1970 and 1998. As a consequence, whereas the EU was a net importer of wheat in the early 1960s, by the early 1970s it had become a net exporter of wheat. Finally, **tariff escalation,** the practice of imposing higher tariffs on goods containing more processing, makes it difficult for developing countries to export processed food to the industrialized countries (see Figure 4.2). Unprocessed agricultural commodities face the lowest tariffs, semi-processed goods face higher tariffs, and fully processed goods face still higher tariffs. Such a structure of protection in the advanced industrialized countries makes it difficult for developing countries to move into the higher value added segments of the food industry.

Developing countries also have a comparative advantage in labor-intensive manufactures. Yet, as we saw in Chapter 3, many labor-intensive manufacturing industries remain heavily protected by the advanced industrialized countries. Protection is particularly prominent in the textile and apparel industries. As part of the Uruguay Round, the advanced industrialized countries agreed to dismantle the quota-based regime governing world trade in textiles and apparel, called the **multi-fiber arrangement.** Quotas limiting imports are to be replaced by tariff-based protection, and these tariffs are to then be liberalized. The advanced industrialized countries were allowed to defer most liberalization until the end of the ten-year phase-in, however, and most have taken advantage of this opportunity. According to one study, only 5 to 6 percent of the United States' and the EU's textile imports had been freed of quotas under this program by 2001 (World Bank 2001). As a result, the liberalization that has occurred

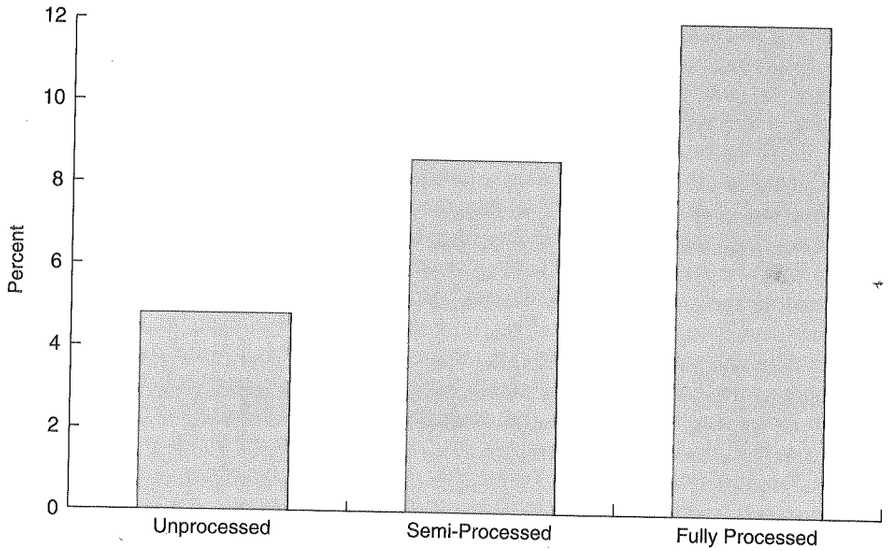

Figure 4.2 Tariff Escalation, Agriculture.
Source: World Bank.

thus far has done little to expand export opportunities for developing countries' producers. Even once quotas have been eliminated, this sector will remain heavily protected. About half of the advanced industrialized country textile imports face tariffs above 10 percent. Protection of textiles and apparel producers highlights the more general pattern of protection of labor-intensive sectors in the advanced industrialized countries. Labor-intensive goods often confront **tariff peaks,** defined as tariff rates above 15 percent. Such tariff peaks apply to about 5 percent of the advanced industrialized countries' imports from all developing countries, and to about 10 percent of their imports from the least developed countries. Eliminating these trade barriers would raise incomes in developing countries substantially. According to a recent analysis conducted by the World Bank, eliminating barriers to developing countries' exports completely could yield as much as $500 billion in additional income to developing countries over a ten-year period. This amount represents a full 5 percent increase in national incomes for developing countries (World Bank 2001, 168).

Developing countries also face a new threat from the more recent effort by the United States to bring labor standards into the WTO. Developing countries have strenuously resisted this initiative. India, Egypt, Indonesia, China, and Pakistan have been vocal opponents of these linkages, as has the Third World Network (TWN), a group of intellectuals based in research institutes in developing countries. It is not that all developing countries are unwilling to protect workers' rights (though some of them are). Instead, developing countries oppose the linkage between trade and labor standards for two reasons. First, many governments from developing countries and the TWN believe that protectionism motivates the push to include labor standards into the WTO. As Murasoli Maran, India's Minister of Commerce and Industry told the

Indian parliament shortly after the 1999 Seattle WTO Summit, the attempt to bring labor standards into the WTO represents a "pernicious way of robbing our comparative advantage. The developing countries consider it as a maneuver by wealthy nations to force our wages up, to undermine our competitiveness" (*New York Times* December 17, 1999, C4). Second, developing countries face a power imbalance in the WTO. The TWN argues that because the advanced industrialized countries dominate the WTO, any labor standards incorporated in this organization "would only be used as a weapon by developed countries against developing countries" (O'Brien et al. 2000, 87). For these reasons, many governments from the developing world and the TWN argue that it would be better to keep labor standards separate from trade.

Will developing countries be able to use the WTO to remove the obstacles that they face? Some signs are encouraging. The recently launched round of WTO trade negotiations places strong emphasis on the need to address the concerns of developing countries and highlights the positive contribution that trade can make to economic development. In addition, developing countries have thus far been able to keep labor standards out of the WTO. Other signs are less encouraging. The EU remains steadfastly opposed to meaningful reform of the Common Agriculture Policy, and liberalization of world trade in agriculture will make little progress as long as the EU maintains this position. Moreover, labor-intensive industries in the advanced industrialized countries are turning to administered forms of protection—antidumping and countervailing duty investigations—with growing frequency. Thus, even if tariff peaks in these industries are eliminated, the threat of new protectionist barriers remains. Only time will tell whether developing countries can gain the expanded access to markets in the advanced industrialized countries upon which the success of the new export-oriented development strategies so many of them have adopted depends.

Conclusion

Our examination of trade policies in the developing world highlights three central points. First, developing countries' trade policies have been determined by the interaction between interests and institutions in the domestic arena and in the international system. Political coalitions formed along the cleavage between import competing and export oriented sectors combined with changes in the international environment to produce liberal or protectionist policies. Indeed, the two most important changes in developing countries' policies were driven by domestic responses to external factors. Second, trade policy in developing countries was not determined independently of broader economic development objectives. Instead, governments have viewed trade policy as an integral component of economic development strategies. Third, the rules governing international trade cooperation shape the distribution of the gains from international trade. The structure of their trade, in which developing countries exchange primary commodities for manufactured goods shapes how the gains from trade are distributed between developing countries and the advanced industrialized countries. The nature of tariff reductions within the GATT opened advanced industrialized countries' markets to manufactured goods produced by other advanced industrialized countries, but kept them closed to the products produced by developing countries.

In closing, it is important to emphasize that while we have developed these three core concepts within the context of the developing world, they have a more general relevance. It is not the case that it is only in developing countries that trade policies are shaped by external factors and broader domestic development objectives. Nor is it the case that all of the distributional consequences of international trade fall along the North–South axis. Each of these elements is also relevant to trade politics within and among advanced industrialized countries. Thus, the differences between developing countries and the advanced industrialized countries are a matter of degree rather than of kind. External shocks and distributional conflict affect trade policies in all countries, but because developing countries have smaller and less diversified economies, these factors tend to affect them more strongly than the large, advanced, industrialized countries.

Key Terms

Backward Linkages
Big Push
Capital Goods
Commodity Composition of Exports
Commodity Price Stabilization
Complementary Demand
Current Account
Core and Periphery
East Asian Model
Easy ISI
Enclave Agriculture
Engel's Law
Export-oriented Strategy
Export Substitution Strategy
GATT Part IV
General Human Capital
Generalized System of Preferences
Group of 77
Haberler Report
Import Substitution Industrialization
Income Elasticity of Demand
Mono-Exporters
Multi-Fiber Arrangement
New International Economic Order
Nontraded Goods Sector
Pecuniary External Economies
Privatization
Real Exchange Rate Appreciation
Rent Seeking
Secondary ISI
Singer-Prebisch Theory
State-owned Enterprises
Structural Adjustment
Structuralism
Tariff Escalation
Tariff Peaks
Terms of Trade
Terms of Trade Shock
United Nations Conference on Trade and Development

Web Links

The United Nations Conference on Trade and Development can be found at *http://www.unctad.org* and the Group of 77 website at *http://www.g77.org*.

Visit the World Bank at *http://www.worldbank.org*.

You can also visit the regional development banks:

The African Development Bank: *http://www.afdb.org*.

The Inter-American Development Bank: *http://www.iadb.org*.

The Asian Development Bank: *http://www.adb.org*.

The WTO devotes a section of its site to developing countries and the international trade system: *http://www.wto.org/english/tratop_e/devel_e/devel_e.htm*.

The Electronic Development and Environment Information System (ELDIS), based at the Institute of Development Studies in Sussex, England, maintains a website with good links to information about development issues. This page can be found at *http://nt1.ids.ac.uk/eldis/eldis.htm*.

Suggestions for Further Reading

For a readable introduction to structuralism and development strategies more generally see Ian Little, *Economic Development* (New York: Basic Books, 1982).

On the New International Economic Order see Stephen Krasner, *Structural Conflict: the Third World against Global Liberalism* (Berkeley: University of California Press, 1985).

On the Asian Model, see Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990), and Stephan Haggard, *Pathways from the Periphery: the Politics of Growth in the Newly Industrializing Countries* (Ithaca: Cornell University Press, 1990). For a concise summary of the World Bank view see The World Bank *The East Asian Miracle: Economic Growth and Public Policy* (Washington, D.C.: The World Bank, 1994).

On structural adjustment see Tony Killick, *Aid and the Political Economy of Policy Change* (London: Routledge, 1998) and the World Bank *Adjustment in Africa: Lessons from Country Case Studies* (Washington, D.C.: the World Bank, 1998). On the politics of reform, a useful place to start is with Stephan Haggard and Robert Kaufman, eds., *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts, and the State* (Princeton: Princeton University Press, 1992) and John Williamson, ed., *The Political Economy of Policy Reform* (Washington, D.C.: Institute for International Economics, 1994). For a more recent work see Anne O. Krueger, *Economic Policy Reform* (Chicago: University of Chicago Press, 2000).

CHAPTER 5

MULTINATIONAL CORPORATIONS IN THE WORLD ECONOMY

Multinational corporations have occupied a prominent and often controversial role in the postwar international economic system. When a corporation based in one country creates a new production facility in a foreign country, or buys an existing one, it extends managerial control across national borders. This managerial control enables the firm to make decisions about how and where to employ resources that have consequences for the country in which it is based and for the country in which it invests. Jobs, income, and technology might be acquired or lost, and the economic agendas of national governments might be promoted or stymied as a result of the decisions made by such multinational corporations. In many instances, the decisions that firms make are based on global strategies for corporate success rather than on the basis of conditions within either of the two countries. As a result, multinational corporations, perhaps more than any other aspect of the international economic system, highlight the tensions inherent in an economy that is increasingly organized along global lines and political systems that continue to be organized along exclusive national territories.

Because multinational corporations operate simultaneously in national political systems and in global markets, they have been the subject of considerable controversy among governments and among observers of the international political economy. Some consider multinational corporations to be productive instruments of a liberal economic order: Multinational corporations ship capital to where it is scarce, transfer technology and management expertise from one country to another, and promote the efficient allocation of resources in the global economy. Others consider multinational corporations to be instruments of capitalist domination. Multinational corporations control critical sectors of their hosts' economies, make decisions about resource use with little regard for host country needs, and weaken labor and environmental standards. About all that these two divergent perspectives agree upon is that multinational corporations are the agents of globalization.

This chapter examines the role of multinational corporations in the global economy. We look first at the growth of foreign direct investment and multinational corporations in the postwar period, as well as at the motivations behind such investments.

Our attention then turns to the economic rationale for multinational corporations. We then examine the political economy of MNCs. We look first at MNCs in the domestic arena, and then focus on governments' efforts, unsuccessful to date, to craft international rules to govern foreign direct investment and MNCs.

MULTINATIONAL CORPORATIONS: THE AGENTS OF GLOBALIZATION

Multinational corporations are situated at the intersection of production, international trade, and cross-border investment. A multinational corporation, sometimes called a transnational corporation (TNC), is an "enterprise that controls and manages production establishments—plants—in at least two countries" (Caves 1996, 1). According to the United Nations Conference on Trade and Development, there are approximately 63,459 parent firms that together own a total of 689,520 foreign affiliates. Together, these parent firms and their foreign affiliates account for about 25 percent of the world's economic production and employ some 86 million people worldwide (UNCTAD 1999).

The activities of multinational corporations are not limited to production. MNCs are also important actors in international trade. MNCs generate almost two-thirds of the world's exports of goods and services (Dunning 1996, 77). A large portion of this trade is **intra-firm trade,** that is, trade that takes place between an MNC parent and its affiliates in other countries. In the United States, one-third of all exports are intra-firm exports, and as much as 40 percent of imports are intra-firm imports (Grimwade 2000, 134). For the world as a whole, it has been estimated that intra-firm trade accounts for 30 to 40 percent of world trade (Dunning 1996, 77).

While it is impossible to catalog the more than 60,000 parent firms that operate in the contemporary international economy, Table 5.1 lists the world's 50 largest MNCs, ranked by their foreign assets. The 100 largest MNCs account for more than 15 percent of total foreign assets controlled by all MNCs, and for 22 percent of their total sales. Ninety-nine of the 100 largest MNCs are headquartered in the United States, Western Europe, or Japan and more than five-sixths of all parent corporations are based in advanced industrial countries (see Table 5.2). Parent corporations are not exclusively based in developed countries, however. Hong Kong, China, South Korea, Venezuela, Mexico, and Brazil are also home to MNC parent firms, but these firms are considerably smaller. Only one MNC parent firm based in a developing country, Petroleos de Venezuela, ranks among the world's 100 largest. The 50 largest MNCs from developing countries control only $105 billion of foreign assets, less than 10 percent of the assets controlled by the 50 largest MNCs based in the advanced industrialized countries.

A firm becomes a multinational corporation by engaging in foreign direct investment (FDI). **Foreign direct investment** occurs when a firm based in one country builds a new plant or a factory in a second country or purchases an existing one. Historically, firms have engaged in foreign direct investment to achieve one of three objectives. Firms have invested across national borders to gain secure access to natural resources. For example, the American copper firms Anaconda and Kennecott made

Table 5.1
The 50 Largest MNCs, Ranked by Foreign Assets (1998)

Firm	Country	Industry	Foreign Assets	Total Assets	Foreign Employment
General Electric	United States	Electronics	97.4	304.0	111,000
Ford Motor Company	United States	Automotive	72.5	275.4	174,105
Royal Dutch Shell	Netherlands/UK	Petroleum	70	115	65,000
General Motors	United States	Automotive			
Exxon Corp	United States	Petroleum	54.6	96.1	
Toyota	Japan	Automotive	41.8	105.0	
IBM	United States	Computer	39.9	81.5	134,815
Volkswagen Group	Germany	Automotive		57.0	133,906
Nestle S.A.	Switzerland	Food and Beverages	31.6	47.6	219,442
Daimler-Benz	Germany	Automotive	30.9	76.2	74,802
Mobil	United States	Petroleum	30.4	43.6	22,200
Fiat Spa	Italy	Automotive	30	69.1	94,877
Hoechst AG	Germany	Chemicals	29.0	34.0	
Asea Brown Boveri (ABB)	Switzerland	Electrical Equipment		29.8	200,574
Bayer AG	Germany	Chemicals		30.3	
Elf Aquitaine SA	France	Petroleum	26.7	42.0	40,500
Nissan Motor	Japan	Automotive	26.5	57.6	
Unilever	Netherlands/Uk	Food and Beverages	25.6	30.8	262,840
Siemens AG	Germany	Electronics	25.6	67.1	201,141
Roche Holding AG	Switzerland	Pharmaceuticals		37.6	41,832
Sony Corp	Japan	Electronics		48.2	
Mitsubishi	Japan	Diversified	21.9	67.1	
Seagram	Canada	Beverages	21.8	22.2	
Honda Motor	Japan	Automotive	21.5	36.5	
BMW AG	Germany	Automotive	20.3	31.8	52,149

continued

Table 5.1 ***(continued)***
The 50 Largest MNCs, Ranked by Foreign Assets (1998)

Firm	Country	Industry	Foreign Assets	Total Assets	Foreign Employment
Alcatel	France	Electronics	20.3	41.9	
Philips Electronics	Netherlands	Electronics	20.1	25.5	206,236
News Corp	Australia	Media	20.0	30.7	
Phillip Morris	United States	Food/Tobacco	19.4	55.9	
British Petroleum	UK	Petroleum	19.2	32.6	37,600
Hewlett-Packard	United States	Electronics	18.5	31.7	
Total SA	France	Petroleum		25.2	
Renault SA	France	Automotive	18.3	34.9	45,860
Cable and Wireless Plc	UK	Telecommunication		21.6	33,740
Mitsui & Co. Ltd	Japan	Diversified	17.9	55.5	
Rhone-Poulenc SA	France	Chemicals/Pharmaceuticals	17.8	27.5	
Viag SA	Germany	Diversified	17.4	32.7	
BASF AG	Germany	Chemicals		26.8	
Itochu Corp	Japan	Trading	16.7	56.8	2,600
Nassho Iwei Corp	Japan	Trading	16.6	40.4	2,068
Du Pont	United States	Chemicals	16.6	42.7	
Diageo Plc	UK	Beverages		29.7	63,761
Novartis	Switzerland	Pharmaceuticals/Chemicals	16.0	36.7	71,403
Sumitomo Corp	Japan	Trading/machinery	15.4	43.0	
ENI Group	Italy	Petroleum	14.6	49.4	23,239
Chevron Corp	United States	Petroleum	14.3	35.5	8,610
Dow Chemical	United States	Chemicals	14.3	23.6	
Texaco Inc	United States	Petroleum	14.1	29.6	
BCE Inc	Canada	Telecommunication	13.6	28.2	
Xerox	United States	Photo Equipment	13.5	27.7	

Source: United Nations Conference on Trade and Development, 1999.

Table 5.2
Parent Corporations and Affiliates by Region

	Parent Corporations Based in Economy	Foreign Affiliates Located in Economy
Developed Economies		
Western Europe	37,580	61,594
United States	3,387	19,103
Japan	4,334	3,321
Developing Economies		
Africa	167	3,669
Latin America and Caribbean	2,019	24,345
Asia	9,883	327,310
Central and Eastern Europe	2,150	239,927

Source: UNCTAD 2000, 11–13.

large direct investments in mining operations in Chile in order to secure copper supplies for production done in the United States. Oil companies have invested heavily in Middle Eastern countries because they hold such a large proportion of the world's petroleum reserves. Indeed, as Table 5.3 illustrates, petroleum and mining together represent the third most important area for MNC activity, accounting for 11 of the 100 largest MNCs.

Firms also invest across borders to gain secure access to foreign markets. In many instances, tariff and nontariff barriers make it difficult for firms to export into important

Table 5.3
Industry Composition of the Top 100 MNCs

	1990	1998
Electronics/electrical equipment/computers	14	17
Motor vehicle and parts	13	14
Petroleum (exploration, refining, distribution) and mining	13	11
Food, beverages, tobacco	9	10
Chemicals	12	8
Pharmaceuticals	6	8
Diversified	2	6
Telecommunications	2	6
Trading	7	4
Retailing	–	3
Utilities	–	3
Metals	6	2
Media	2	2
Construction	4	1
Machinery/engineering	3	–
Other	7	5
Total	100	100

Source: UNCTAD 2000, 78.

markets. By investing inside the country, firms can jump over such barriers and produce and sell in the local market. Much of the cross-border investment in auto production within the advanced industrialized world fits into this category. During the 1960s, many American automotive MNCs made direct investments in the European Union to gain access to the emerging common market. During the 1980s and early 1990s, Japanese and German automotive MNCs such as Toyota, Nissan, Honda, BMW, and Mercedes built production facilities in the United States in response to the emergence of VERs that limited auto imports. As Table 5.3 indicates, the auto industry is the second most heavily represented industry among the largest MNCs, accounting for 14 of the top 100 MNCs. Of course, the desire to gain access to foreign markets has not been limited to the auto industry, but has been an important motivation for much foreign direct investment in manufacturing.

Finally, MNCs make cross-border investments to improve the efficiency of their operations. These types of investment account for a substantial and rapidly increasing share of cross-border investment, and it is this type of investment that is creating the global production networks that underlie the emerging global division of labor. In these efficiency-oriented investments, parent firms allocate different elements of the production process to different parts of the world. In computers, electronics, and electrical equipment, for example, the human and physical capital-intensive stages of production such as design and chip fabrication, are performed in the advanced industrialized countries, while the more labor-intensive assembly stages of production are performed in developing countries. In the auto industry, the capital-intensive design and production of individual parts such as body panels, engines, and transmissions is performed in developed countries, and the more labor-intensive assembly of the individual components into automobiles is performed in developing countries.

Neither foreign direct investment nor multinational corporations are recent inventions. Prior to the nineteenth century, however, most foreign direct investment was relatively short-lived (Jones 1996, 25). Foreign direct investment and multinational corporations began to emerge as significant and enduring components of the international economy only during the late nineteenth century. By 1914, multinational manufacturing was taking place in a large number of industries, including chemicals, pharmaceuticals, electrical, machinery, automobiles, tires, and processed food (Jones 1996, 29). This first wave of multinational business was dominated by Britain, the world's largest capital exporting country in the nineteenth century. British firms invested in natural resources and in manufacturing within the British Empire, the United States, Latin America, and Asia. In 1914, British investors controlled almost half of the world's total stock of foreign direct investment (Jones 1996, 30). American firms began investing abroad in the late nineteenth century. Singer Sewing Machines became the first American firm to create a permanent manufacturing facility abroad when it built a plant in Glasgow, Scotland, in 1867 (Wilkins 1970, 41–42). By the interwar period, the United States was overtaking Britain as the world's largest source of foreign direct investment (see Jones 1996).

American firms dominated foreign direct investment following the Second World War. Concerned with postwar reconstruction and unwilling to risk the balance of payments consequences of capital outflows, European and Japanese governments discouraged outward foreign direct investment. As a consequence, American firms

accounted for two-thirds of all new MNC affiliates created between 1945 and 1960 (Dunning 1996). The largest share of American FDI went to Europe for manufacturing. The push by American firms to invest in Europe was given additional impetus by the formation of the European Economic Community in the late 1950s. Much of this investment was market-oriented as American firms positioned themselves to secure access to the newly integrated European market. Other American firms invested in developing countries, in Canada, and in Australia, and much of this investment was oriented toward natural resource extraction.

The dominance of American multinational corporations has diminished since 1960 as first European and then Japanese firms began to invest overseas. The increased role of other advanced industrialized countries has more recently been accompanied by the emergence of foreign direct investment by MNCs based in Asia and Latin America. Thus, while American firms continue to play a large role in the international economy, they are not nearly as dominant today as they were in the early postwar period. Since the late 1960s, the relative importance of market oriented and natural resource oriented investments has fallen and that of efficiency oriented investments has increased. As Dunning (1996) notes, MNCs increasingly view "each of their foreign affiliates and, frequently, their associated suppliers and industrial customers, not as self-contained entities, but as part of a regional or global network of activities." The increased importance of efficiency oriented investments has been made possible in large part by improvements in transportation and communications technology and, as we saw in Chapter 2, by the reduction of trade barriers accomplished through the GATT process.

The volume of foreign direct investment, and thus the importance of MNCs in the global economy, has grown dramatically during the last 20 years (see Table 5.4). During the late 1980s, cross-border flows of FDI equaled $180 billion per year. This figure had almost doubled by the mid-1990s and then continued to increase throughout the second half of the 1990s. As a consequence, the world's stock of FDI has

Table 5.4
Foreign Direct Investment Outflows, 1986–1997 ($US Millions)

	1986–1991	1992	1993	1994	1995
World	180,510	200,800	240,900	284,261	355,284
Western Europe	100,367	115,629	107,063	133,579	173,624
North America	31,278	42,525	80,716	82,379	103,538
Japan	33,095	17,390	13,830	18,090	22,508
Southeast Asia	8,315	17,478	30,419	35,562	41,824
	1996	**1997**	**1998**	**1999**	**2000**
World	391,554	466,030	711,914	1,005,782	1,149,903
Western Europe	204,317	242,425	475,226	761,102	820,322
North America	97,523	118,835	165,588	160,966	183,304
Japan	23,442	26,059	24,152	22,743	32,886
Southeast Asia	49,663	49,482	29,985	34,447	83,641

Source: UNCTAD 1999. *World Investment Report 1998: Trends and Determinants* and UNCTAD 2001. *World Investment Report 2001: Promoting Linkages.*

grown from $495.2 billion in 1980 to $4.8 trillion in 1999, close to a ten-fold increase in a 20-year period (UNCTAD 2001, 294). The advanced industrialized countries are the main suppliers of FDI. The United States, Western Europe, and Japan together supplied about 90 percent of total FDI in the late 1980s and at the end of the 1990s accounted for about 82 percent of the world's total. The reduction of the advanced industrialized economies' share of FDI is due to the emergence of the East Asian economies as a source of FDI. Between the late 1980s and the mid-1990s Hong Kong, Singapore, South Korea, and Taiwan emerged as important providers of FDI.

The advanced industrialized economies are also the largest recipients of FDI (see Table 5.5). Within the advanced industrialized world, Western Europe as a whole is the largest recipient. Within Western Europe, Great Britain is the single largest recipient, accounting for about one-third of all FDI into Western Europe, an amount equal to $240.5 billion between 1990 and 1998 (OECD 1999, 111–112). France is the second largest recipient within Western Europe, attracting $178.3 billion between 1990 and 1998 (ibid., 111–112). If the EU is not counted as a single market, then the United States is the world's single largest recipient, attracting more than twice as much FDI between 1990 and 1998 ($605.1 billion) as Great Britain.

The developing world's share of FDI has increased substantially since the mid-1980s. This change is apparent in Figures 5.1 and 5.2, which show regional shares of FDI inflows in the late 1980s and in 2000. During the 1980s, Western Europe and the United States attracted about three-quarters of all FDI inflows, with the other quarter distributed across the rest of the world. By 1997 the European and American share of FDI inflows had fallen to just greater than half while that of the developing world had

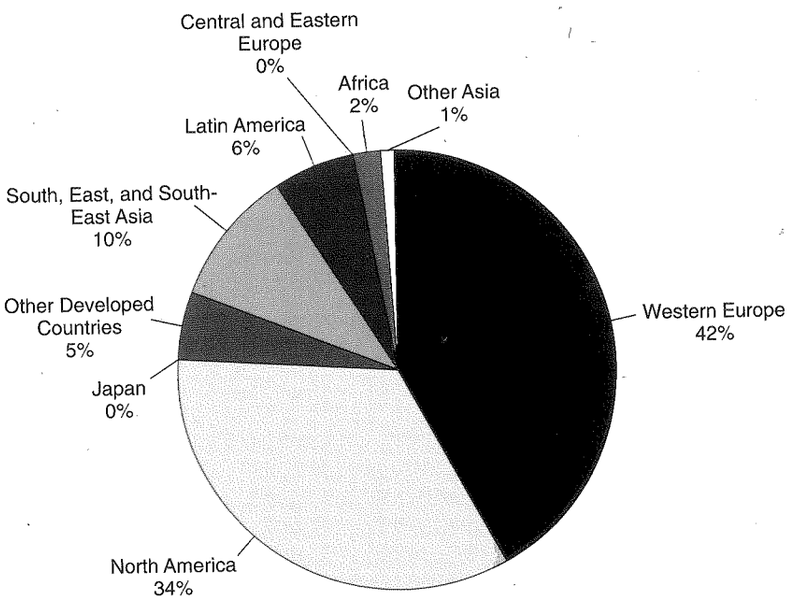

Figure 5.1 Distribution of FDI, 1986–1991.
Source: UNCTAD, 1999.

Table 5.5
Foreign Direct Investment Inflows, 1986–1997 ($US Millions)

	1986–1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Developed World	129,583	120,294	138,887	141,503	203,462	219,688	271,378	486,165	829,818	1,005,178
Of which										
Western Europe	66,470	85,837	83,877	78,417	117,175	114,852	137,516	273,398	485,321	633,163
United States	49,088	18,885	43,534	45,095	58,772	84,455	103,398	174,434	294,976	281,115
Canada	5,586	4,777	4,768	8,476	9,257	9,635	11,525	22,575	25,150	63,335
Japan	556	2,756	210	888	39	200	3,200	3,268	12,741	8,187
Developing World	29,090	51,108	72,528	95,582	113,338	152,493	187,352	188,371	222,010	240,167
Of which										
Southeast Asia	15,135	27,683	47,348	58,265	73,369	89,406	98,507	86,004	96,224	137,348
Latin America	9,460	17,611	17,247	28,687	32,311	51,279	71,152	83,200	110,285	86,172
Eastern Europe	658	4,439	6,143	5,914	14,268	12,730	19,188	21,008	23,222	25,419
Africa	2,869	3,171	3,647	5,693	4,694	5,622	7,153	7,713	8,971	8,198
West Asia	1,329	1,827	3,447	1,518	–2	2,892	5,488	6,580	936	3,427
Central Asia	4	142	424	896	1,655	2,053	3,210	3,015	2,568	2,704

Source: UNCTAD 1999. *World Investment Report 1998: Trends and Determinants* and UNCTAD 2001. *World Investment Report 2001: Promoting Linkages.*

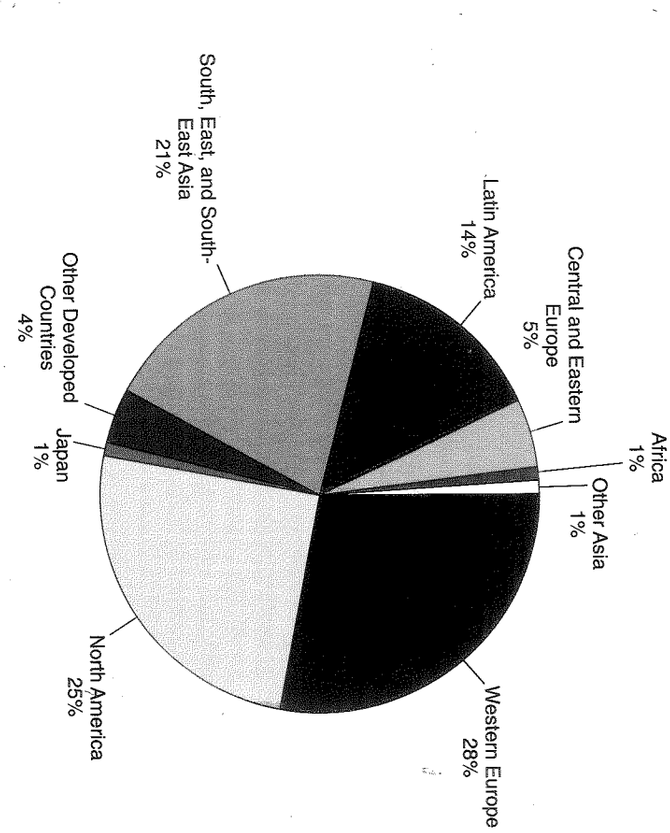

Figure 5.2 Distribution of FDI Inflows, 1997.
Source: UNCTAD, 1999.

increased to about 42 percent. FDI flows to developing countries have been concentrated in Asia and Latin America. The Asian NICs' share of FDI inflows increased from one-tenth to one-fifth between 1986 and 1997, while Latin America's share increased from 6 percent in the late 1980s to 14 percent by 1997. Much of this investment has been channeled to a small group of countries in each region. In Asia, China emerged as the most important destination in Asia during the 1990s, accounting for more than half of all FDI inflows into East Asia between 1993 and 1997. Malaysia, Indonesia, and Thailand also became important destinations for multi-national investments during the 1990s. In Latin America, FDI has been similarly concentrated in a few countries. Brazil alone accounted for about one-third of all FDI inflows in 1997, and only four countries—Brazil, Argentina, Chile, and Mexico—account for 53 percent of all FDI flows into Latin American in that same year.

In summary, multinational corporations are important participants in international production and trade. They extend managerial control across borders, and they account for about a quarter of global production and a third of global trade. It is this central role that has led many to consider MNCs to be the agents of globalization, more responsible than any other group of actors for the integration of national economies. As we saw, MNCs invest overseas for a variety of reasons—to gain access to critical markets, to acquire raw materials, and to enhance the efficiency of their production processes. Despite their prominence, however, MNC activity is concentrated within a relatively

restricted set of countries. As was the case with world trade flows, most MNC activity takes place among Western Europe, North America, and Pacific Asia.

Economic Explanations for MNCs

The prevalence of multinational corporations in the contemporary international economy is puzzling for neo-classical economics, because firms can choose how they will participate in the international economy. A firm can rely upon market-based transactions to carry out its international activities, importing its inputs from foreign suppliers and exporting its products to foreign markets. Or a firm can internalize these international transactions within a single corporate structure by owning the foreign firms that supply its input and by locating production in foreign markets rather than exporting its products. The existence of MNCs implies that many firms have chosen to internalize their international transactions. Why would firms internalize their cross-border transactions rather than rely on the market? As we will see in this section, economists explain this choice by focusing on the interaction between market imperfections and locational advantages (see e.g., Hymer 1970; Vernon 1966; Caves 1982; Dunning 1988).

Market Imperfections

Market imperfections are the primary factors that drive firms to internalize their transactions within a single corporate structure. A **market imperfection** arises when the price mechanism fails to promote a welfare-improving transaction. Two different kinds of market imperfection have been used to understand two different types of internalization: horizontal integration and vertical integration.

Horizontal integration occurs when a firm creates multiple production facilities, each producing the same good or goods. In the international economy, horizontally integrated MNCs produce the same product in multiple national markets. Auto producers are a good example. Ford, General Motors, Volkswagen, and the major Japanese auto producers each produce essentially the same line of cars in factories located in the United States, in Western Europe, and in Japan. Firms integrate horizontally when a cost advantage is gained by placing a number of plants under common administrative control (Caves 1996, 2). Such cost advantages can arise when firms have "intangible assets." An **intangible asset** is something whose value is derived from knowledge or from "a set of skills or repertory routines possessed by the firm's team of human (and other) inputs" (Caves 1996, 3). An intangible asset can be based on a patented process or design, or it can arise from "know-how shared among employees of the firm" (ibid., 3). Coca-Cola, for example, transformed a single piece of knowledge—the formula for Coke—into a global soft drink empire. The income of most pharmaceutical firms is also based on knowledge in the form of the chemical composition of the drugs they produce. Microsoft is able to dominate the global software industry in part because its programmers have a deep understanding of the operating system used on most PCs. Microsoft programmers can use this knowledge to develop software that performs better on Windows-based computers than the software produced by its competitors. In all of these examples, firms are deriving income from an intangible asset, that is, from knowledge in some form.

Intangible assets are difficult to sell or license to other firms at a price that accurately reflects their true value. Firms that own knowledge-based assets confront what has been called the "fundamental paradox of information": "[the] value [of the information] for the purchaser is not known until he has the information, but then he has in effect acquired it without cost" (Teece 1993, 172). In other words, in order to convey the true value of an intangible asset the owner must reveal so much of the information upon which the asset's value is based that the potential purchaser no longer needs to pay to acquire the asset. If the owner is unwilling to reveal the knowledge upon which the intangible asset's value is based, potential buyers will be unsure of the asset's true value and they will therefore be reluctant to pay the asset's true value. Suppose, for example, that I have developed a production process that reduces by one-half the cost of manufacturing cars. This innovation is purely a matter of how the production process is managed, and has nothing to do with the machines and technology actually used to produce cars. I try to sell this process to Ford Motors, but in our negotiations Ford's board of directors is skeptical of my claim that they can reduce their costs by as much as 50 percent. They insist that I disclose fully how changes in the management of the production process yield these cost savings before they will even consider purchasing the process, and they are not satisfied with my general responses—they want specifics. Once I disclose the details, however, they will know exactly what changes they need to make in order to realize the cost reductions. They then have no reason to pay me to acquire this knowledge. I, like all other owners of intangible assets, will receive less than my asset's true worth when selling it to another firm.

Such market failures create incentives for horizontal integration. Suppose an individual owns an intangible asset that can generate more revenue than is currently being earned—demand for the goods produced using this asset is greater than can be met from the existing production facility. How can the owner earn the additional revenue that this asset will generate? The only way is by creating additional production sites, that is, to horizontally integrate, and allow each of these facilities to use the intangible asset. Because the same firm owns all of these production sites, it can realize the full value of its intangible asset. Horizontal integration, therefore, internalizes economic transactions for intangible assets.

Vertical integration refers to instances in which firms internalize their transactions for intermediate goods. An intermediate good is an output of one production process that serves as an input into another production process. Standard Oil, which dominated the American oil industry in the late nineteenth century, is a classic example of a vertically integrated firm. Standard Oil owned oil wells, the network through which crude oil was transported from the well to the refinery, the refineries, and it owned the retail outlets at which the final product was sold. Thus, each stage of the production process was contained within a single corporate structure. Why would a single firm incorporate the various stages of the production process under a single administrative control rather than purchase its inputs from independent producers and sell outputs to other independent firms, either as inputs into additional production or as final goods to independent retailers?

To explain the internalization of transactions within a single vertically integrated firm, economists have focused on problems caused by specific assets. A **specific asset** is an investment that is dedicated to a particular long-term economic relationship. Consider a hypothetical case of a ship owner and a railroad. The ship owner would like to transport the goods he delivers to his dock to market by rail. He contacts the railroad and asks that a rail spur be built from the main line down to the dock so that he can offload goods directly onto rail cars. If the railroad agrees to build the spur, then this spur will be dedicated to the transport of that particular ship owner's goods to the main rail line. Moreover, once the rail spur down to the dock is built, the resources used to build it can be reallocated only at some cost to the railroad. In other words, this rail spur is an asset—an investment that will yield a return—that is dedicated to, or specific to, the ongoing relationship between the ship owner and the railroad owner. This rail spur is a specific asset.

The existence of specific assets creates incentives for vertical integration because it is difficult to write and enforce long-term contracts. Returning to our example of the ship owner and railroad, suppose that under the terms of the initial agreement, the ship owner agreed to pay the railroad a certain per-ton fee to carry goods to market once the spur was built. This initial fee made it profitable for the railroad to build the spur. Once the spur has been built, however, the ship owner has an incentive to renegotiate the initial contract to achieve a more favorable shipping rate. Because the railroad must incur costs if it decides to reallocate the resources it used to build the spur, the ship owner recognizes that the railroad owner will be better off accepting renegotiated terms than refusing to carry the goods. Thus, the existence of a specific asset creates possibilities for opportunistic behavior once the investment has been made. One party in the long-term relationship can take advantage of the specific nature of the asset to extract a larger share of the value from the transaction (Teece 1993, 166–169; Williamson 1985). This problem would disappear if it were costless to enforce the initial contract. But even where the judicial system will enforce contracts, the legal fees associated with the dispute, along with the income lost by the railroad as the dispute works its way through civil litigation, can be substantial. The railroad owner might be better off accepting a renegotiated contract at slightly lower rates than paying the costs arising from enforcing the initial contract.

The recognition that asset specificity creates incentives for opportunistic behavior after the investment has been made can cause economic actors to refuse to make investments. In our example, the railroad owner will recognize that the ship owner has an incentive to behave opportunistically after the spur is built and quite rationally refuse to build the spur. As a result, a mutually beneficial transaction between the shipper and the railroad—the creation of a rail spur in exchange for payments for transporting goods from the dock to market—will go unrealized. Vertical integration eliminates the problems arising from specific assets by incorporating the two parties to the transaction within the same administrative structure. If the ship owner also owned the railroad (or vice versa), there would be little incentive for opportunistic behavior once the rail spur had been built. The shipping division of this now vertically-integrated firm could pay the firm's railroad division a smaller fee for transporting its goods, but this would simply shift revenues and expenditures between units of the same firm; the firm's overall bottom line would remain constant. By internalizing transactions involving specific assets, therefore, vertical integration enables welfare-improving investments that would not otherwise be made.

Locational Advantages

Market imperfections tell us why firms shift their economic transactions out of the market and into a single corporate structure. In doing so they tell us one important thing about MNCs, most of which are horizontally or vertically integrated firms. The existence of market imperfections tells us nothing, however, about why vertically or horizontally integrated corporations sometimes expand across borders. To understand this we need to add locational advantages. **Locational advantages** refer to characteristics of host countries that make direct investment potentially profitable. The specific locational advantages that matter depend upon the type of investment that is being contemplated. For market-oriented investments, the presence of large consumer markets in the host country and the expected rate of growth of these markets over time are important considerations. Firms looking to invest abroad in order to sell their products inside the countries where they base production clearly prefer countries with large and growing demand to those with small and stagnant demand. In addition, the degree of industry competition within the host country is important. The less indigenous competition, the easier it will be for the MNC affiliate to sell its products in the foreign market. Finally, the existence of tariff and nontariff barriers to imports is another important consideration for this type of investment. Countries that have large and fast-growing markets, with a relatively small number of indigenous firms in the particular industry, and that are sheltered from international competition represent attractive opportunities for market-oriented MNC investment. By this logic, the EU, the United States, China, and India may offer attractive locations for firms contemplating a market-oriented investment, while Costa Rica, Madagascar, and Burma would be much less attractive.

For natural resource direct investments, locational advantages obviously arise from the existence of important deposits of the appropriate natural resource. Oil companies invest heavily in the Arabian Peninsula because that is where such a large portion of the world's oil reserves are located. American mining companies invested heavily in Chile because of that country's rich deposits of copper. Complementary assets, things that are necessary to support the drilling, mining, or farming, are also important for natural resource oriented direct investments. Complementary assets include the state of the host country's infrastructure, such as the rail system and seaports that allow firms to transport raw materials from the source to the final market, as well as the availability and cost of utilities such as water and electricity.

For efficiency-oriented direct investments, locational advantages arise from the characteristics of the factor endowments of the host country. Where the contemplated investment is in low-skilled, labor-intensive production, labor-abundant countries have obvious advantages over labor-scarce countries. It is not surprising, therefore, that American car companies looking to create foreign factories to assemble cars that are sold in the American market would choose to base such plants in Mexico, where labor is abundant and wages relatively low, rather than in the European Union, where labor is scarce and wages relatively high. Where efficiency gains arise from potential

economies of scale, then the characteristics of a country's infrastructure—its transportation and communications network—are likely to be important. Where the contemplated investment draws heavily upon advanced technology, the availability of a pool of highly trained scientists is important. American firms in the computer industry, for example, have opted to base many of their overseas activities in East Asian countries where the average skill level is very high, rather than in Latin America where, on average, skill levels are lower.

Locational advantages thus provide the economic rationale for a firm's decision to internationalize its transactions. They can arise from a country's underlying comparative advantage, as in mineral deposits or abundant labor. They can also be a product of government policies, as in the existence of high tariffs or the creation of a reliable economic infrastructure. Whatever the underlying source, locational advantages create a compelling motivation to engage in international transactions.

While market imperfections and locational advantages often occur independently of each other, we expect to see multinational corporations when both are present. Table 5.6 presents a simple matrix that illustrates how the interaction between market imperfections and locational advantages shapes the kinds of multinational corporations we see in the global economy. When locational advantages and intangible assets both exist, we expect to find horizontally integrated MNCs that have undertaken foreign investment to gain market access. Horizontally integrated MNCs are therefore often present in manufacturing sectors. Foreign direct investments by auto producers in other advanced industrial country markets are perhaps the prototypical example of this type of MNC. In the auto industry, intangible assets arising from knowledge about the production process is of great value to individual firms, but hard to price accurately in the market. Together with important locational advantages they induce foreign investment. Western Europe and the United States offer large markets for automobiles, and governments in the EU and in the United States have used VERs to restrict imports from foreign auto producers. The combination of market imperfections and locational advantages in the auto industry has therefore led to considerable foreign direct investment by all of the major auto producers in the European and American markets.

When locational advantages combine with specific assets, we expect to find vertically integrated MNCs that have invested in a foreign country either to gain secure access to natural resources or to reduce their costs of production. The best example of firms investing to secure access to natural resources is found in the oil industry. An oil refinery must have repeated transactions with the firms that are drilling for oil. The refinery is

Table 5.6
Market Imperfections, Locational Advantages, and MNCs

		Market Imperfection	
		Intangible Assets	**Specific Assets**
Locational Advantages	**Yes**	Horizontally Integrated MNC Market-based	Vertically Integrated MNC Natural Resource-based Cost-based
	No	Horizontally Integrated Firm	Vertically Integrated Firm

highly vulnerable to threats to shut off the flow of oil because an inconsistent supply would be highly disruptive to its oil refineries and distribution networks. Thus, we would expect a high degree of vertical integration in the oil industry. This helps us understand why petroleum companies are so heavily represented in the world's 100 largest MNCs. The best example of firms investing abroad to reduce the cost of production may be found in the factories built by auto producers in developing countries. The individual components involved in auto production are complex and specific to the final good—one cannot produce a Ford with parts designed for a Nissan. Thus, auto producers must have long-term relationships with their parts suppliers, and these relationships create incentives for vertical integration across borders. It is no surprise, therefore, that the auto industry is also heavily represented in the 100 largest MNCs.

This matrix also points to those industries in which we would not expect to find a significant amount of MNC activity. When locational advantages exist but there are neither intangible nor specific assets, we do not expect to find a significant amount of MNC activity. Instead, firms will prefer to purchase their inputs from independent suppliers and sell their products through international trade or to enter into sub-contracting arrangements with firms located in the foreign country and owned by foreign residents. Apparel production fits nicely into this category. Apparel production is a labor-intensive activity, and is increasingly done in labor-abundant developing countries. The major retailers in the advanced industrialized world, such as the GAP and the Limited, rely heavily upon producers located in developing countries, but they rarely own the firms that produce the apparel they sell. Instead, they enter into contracting relationships with independent firms.

Nor would we expect to find significant amounts of MNC activity in those industries in which market imperfections exist but locational advantages are absent. In such instances firms do have an incentive to integrate horizontally and vertically, but these integrated firms cannot easily expand sales into foreign markets, are not heavily dependent upon foreign sources of raw materials, and cannot easily reduce their costs by exploiting cost-differentials between their home country and foreign countries. As a result, these firms have little incentive to extend their activities across national borders. Such firms are most typically found in the nontraded goods sector of the economy.

In summary, MNCs are firms that internalize transactions across borders. Their existence is the result of corporate responses to market imperfections and locational advantages. Intangible and specific assets create incentives for firms to shift their economic transactions out of the market and into a single corporate structure. Locational advantages create incentives to extend the operations of these horizontally or vertically integrated firms across borders. When market imperfections and locational advantages coexist, we expect to find MNCs—firms that have internalized transactions across national borders.

Domestic Politics and MNCs

Former Speaker of the House of Representatives Tip O'Neil once said, "All politics is local." He might have said the same thing about economic production. For no matter how "globalized" the world economy becomes, economic production—the use of

capital and labor to transform inputs into goods—will always be based in some local community and will always employ resources drawn from these local communities. The existence of MNCs does not alter this basic reality. What MNCs do alter, however, is the nature of economic decision-making. Historically, decisions about production have been made by local owners in reference to local conditions. When MNCs are involved, however, decisions about production are often made by foreign owners in reference to global conditions. Yet, while the frame of reference for much economic decision-making has shifted, the frame of reference for political decision-making has not. Governments continue to make decisions that address local concerns in response to the demands of local interest groups.

The domestic politics of multinational corporations emerge from the tension inherent in these two decision-making frameworks. As one prominent scholar of MNCs has written, "the regime of nation states is built on the principle that the people in any national jurisdiction have a right to try to maximize their well being, as they define it, within that jurisdiction. The MNC, on the other hand, is bent on maximizing the well being of its stakeholders from global operations, without accepting any responsibility for the consequences of its actions in individual national jurisdictions" (Vernon 1998, 28). Because governments and MNCs pursue independent objectives that often call upon the same resources, the global objectives of MNCs will sometimes conflict with the local objectives that governments pursue. The domestic politics of MNCs emerges from these conflicts, as governments and firms each attempt to ensure that local resources are used in a manner that best allows them to achieve their respective objectives.

While such conflicts are not specific to multinational corporations—all private firms sometimes make decisions that work against the goals of a local government—they become particularly sensitive when foreigners control the firms that are making the decisions, and when the firm's decisions have a large impact on the local economy. It is for this reason that the relationship between MNCs and developing countries has received the largest share of scholarly attention even though developing countries account for only a small share of total foreign direct investment. But such conflicts are not restricted to developing countries. All countries that host MNC affiliates, developing and advanced industrialized countries alike, face an identical dilemma. On the one hand, foreign direct investment provides the host country a bundle of resources that have the potential to make an important contribution to economic development. On the other hand, foreign ownership means that there is no assurance that the use of these resources will conform to the economic objectives of the host country government. Governments in both groups of countries have responded to this dilemma in similar ways by seeking to manage the terms under which MNCs are allowed to operate in their national economies.

Along with these similarities, however, there exist some tremendously important differences between the developing countries and the advanced industrialized countries. As we will see, different domestic economic structures, different positions in the global economy, and different attitudes about the role of the government in the national economy have combined to produce considerable variation in the degree to which developing and advanced industrialized countries have sought to regulate foreign direct investment. As a result of these differences, governments in the advanced

industrialized countries have adopted much less restrictive policies toward inward foreign direct investment than governments in developing countries.

The Host Country Dilemma

All countries that host MNC affiliates face a dilemma in their relationship with multinational corporations. Foreign direct investment brings a bundle of resources to the host country that can make a positive contribution to the host country's welfare. At the same time, however, because inward investment transfers decision-making authority to foreign managers, there is no guarantee that the resources controlled by the MNC will be used in a manner consistent with the host countries' economic objectives. The politics of host country-MNC relations revolve around governments' efforts to manage this dilemma.

MNCs can bring important resources to host countries. Foreign direct investment can transfer savings from one country to another. Moreover, because MNCs create fixed investments, this form of cross-border capital flow is not subject to many of the problems posed by other kinds of capital flows. Fixed investment is substantially more stable than financial capital flows, and thus does not generate the boom and bust cycles we will examine in Chapter 8. In addition, because MNCs invest by creating domestic affiliates, direct investment does not raise host countries' external indebtedness. Of the many possible ways that savings can be transferred across borders, direct investment might be the most stable and least burdensome for the recipient countries.

MNCs can also transfer technology and managerial expertise to host countries. Because MNCs control intangible assets that are often based on specialized knowledge, the investments they make in host countries can often lead to this knowledge being transferred to indigenous firms. In Malaysia, for example, Motorola Malaysia transferred the technology required to produce a particular type of printed circuit board to a Malaysian firm, which then developed the capacity to produce these circuit boards on its own (Moran 1999, 77–78). In the absence of the technology transfer, the indigenous firm would not have been able to produce these products. Such technology transfers can generate significant positive externalities with wider implications for development (see Graham 1996, 123–130). **Positive externalities** arise when economic actors in the host country that are not directly involved in the transfer of technology from an MNC to a local affiliate also benefit from this transaction. If the Malaysian Motorola affiliate, for example, was able to use the technology it acquired from Motorola to produce inputs for other Malaysian firms at a lower cost than these inputs were available elsewhere, then the technology transfer would have a positive externality on the Malaysian economy. MNCs can also transfer managerial expertise to host countries. Greater experience at managing large firms allows MNC personnel to organize production and coordinate the activities of multiple enterprises more efficiently than host country managers. This knowledge is applied to the host country affiliates, allowing them to operate more efficiently as well. Indigenous managers in these affiliates learn these management practices and can then apply them to indigenous firms. In this way, managerial expertise is transferred from the MNC to the host country.

Finally, MNCs can enable host country producers to gain access to marketing networks. When direct investments are made as part of a global production strategy, the local affiliates of the MNC and the domestic firms that supply these affiliates become integrated into a global marketing chain. This opens up export opportunities that are otherwise unavailable to indigenous producers. The Malaysian firm to which Motorola transferred the printed circuit board technology, for example, wound up supplying not only Motorola Malaysia, but also began to supply these components to 11 Motorola plants worldwide. These opportunities would not have arisen had the firm not been able to link up with Motorola Malaysia.

While FDI brings a bundle of resources into host countries, foreign ownership means that there is no guarantee that these resources will be used in a way that the host country government considers advantageous. Foreign managers retain control over how much capital and technology is actually transferred to the host country, over how the resources they bring will be combined with local inputs, and over how the revenues generated by the local affiliate will be used. Foreign control can diminish the contribution that FDI makes to the host country economy and lead to resource allocations that are substantially different from the economic agenda of the host country government.

Managerial decisions made in reference to the MNC parent's objectives can reduce the contribution that FDI makes to the host country in many ways. MNC decisions can reduce rather than increase the amount of funds available for investment in the host country. MNCs sometimes borrow on the host country capital market instead of bringing capital from their home country. When they do, MNC investment **crowds out** domestic investment, that is, by using scarce domestic savings, the MNC prevents domestic firms and individuals from making investments. MNCs also often earn rents on their products and repatriate most of these earnings. In addition, MNCs usually charge the host country affiliate licensing fees or royalties for the technology that is transferred, and these fees represent a transfer of funds from the host country to the MNC. Finally, MNCs often require the local affiliate to purchase inputs from other subsidiaries of the same corporation. These internal transactions take place at prices that are determined by the MNC parent, a practice called transfer pricing. Because these transactions are internal to the MNC, the parent can set the prices at whatever level best suits its global strategy. When the parent overcharges an affiliate for the goods it imports from affiliates based in other countries and under-prices the same affiliate's exports, revenues are transferred from the local affiliate to the MNC parent. Sometimes such transfers can be very large—an investigation revealed that Colombia paid $3 billion more for pharmaceutical imports through MNCs than it would have paid in market-based transactions. These practices reduce the availability of local funds to finance new projects.

MNCs also tightly control technology and managerial positions, in some cases limiting the transfer of both. As we saw above, one of the principal reasons for MNC investment arises from the desire to maintain control over intangible assets. Given this, it is indeed hard to understand why an MNC would make a large fixed investment in order to retain control over its technology but then transfer this technology to host-country firms. The transfer of managerial expertise may be limited also, because MNCs are often reluctant to hire host-country residents into top-level managerial positions. Thus, the second purported benefit of MNCs—the transfer of technology and managerial expertise—can be stymied by the very logic that causes MNCs to undertake FDI.

Finally, MNCs' decisions about how to use the revenues generated by their affiliates may bear no relationship to the host country government's economic objectives. In a world in which governments care little about the type of economic activity that is conducted within their borders, this would be of little consequence. But when governments use a wide variety of policy instruments to try to promote certain types of economic activity, whether this is manufacturing in a developing country or high-technology industries in an advanced industrialized country, foreign control of these revenues can pose serious obstacles to government policy. If, for example, a country's export earnings derive entirely from copper exports but a multinational corporation controls the country's copper mining operations, decisions about how to use the country's foreign exchange earnings will be made by the MNC rather than by the government. Or, if the revenues generated by the local affiliate are sufficient to finance additional investment, decisions about whether this investment will be made in the host country or somewhere else, and if in the host country then in which sector, are made by the MNC rather than by the government. In short, MNC control over the revenues generated by their affiliates makes it difficult for governments to channel resources toward the economic activities they are trying to encourage.

Host country governments therefore face a dilemma in dealing with MNCs. On the one hand, MNCs can bring a bundle of resources to host countries, including capital, technology, managerial expertise, and market linkages that are not available elsewhere. These resources have the potential to make important contributions to the host country economy. On the other hand, because foreign direct investment necessarily implies foreign control of host country resources, there is no guarantee that the MNC will use these resources in a manner that promotes the economic objectives of the host country.

Regulating MNC Activity

Governments have responded to this dilemma by trying to manage the terms under which MNCs operate in their countries. In regulating MNC activity, governments have sought to harness foreign direct investment to further their own economic policy objectives. While the effort to manage MNC activity has been common to developing and advanced industrialized countries alike, developing countries have relied far more heavily on such practices than have the advanced industrialized countries. As we will see, these differences arise from different domestic economic structures, from different positions in relation to MNCs, and from different government roles in the national economy.

Developing countries. Most developing countries have sought to manage the terms under which MNCs operate in their economies. In the 1950s and 1960s, governments in most developing countries viewed MNCs with considerable unease. As Jones (1996, 291) notes, "the association of foreign companies with former colonial powers, their employment of expatriates in senior positions, their past history (real or imagined) of discrimination against local workers, and their embodiment of alien cultural values all contributed to the suspicion with which foreign [multinational corporations] were regarded" in developing countries. Governments in newly independent developing countries wanted to establish their political and economic autonomy from former colonial powers, and often this entailed taking control of existing foreign investments and managing the terms under which new investments were made.

During the 1960s and 1970s, the desire to achieve greater economic autonomy translated into a large number of nationalizations of existing MNC affiliates and the creation of restrictive regimes governing new foreign direct investments. **Nationalization** occurs when the host country government assumes control of an affiliate created by an MNC. As Figure 5.3 illustrates, the number of nationalizations grew rapidly during the late 1960s and remained high throughout the first half of the 1970s. In most instances, when a host country government nationalizes a firm it compensates the MNC, but the amount of compensation is often controversial. Nationalizations occurred most often in the extractive industries and in public utilities such as power generation and telecommunications. To manage new investments, governments erected investment control regimes. MNCs were excluded from specific sectors of the economy, such as public utilities, iron and steel, retailing, insurance and banking, and extractive industries (Jenkins 1987, 172). Other regulations were used to shape the behavior of MNCs in the host country. Many developing countries required local affiliates to be majority owned by local shareholders through joint ventures instead of allowing MNCs to own 100 percent of the affiliate. Governments believed that majority local ownership would translate into local control of affiliate decisions. Most governments also limited the amount of profits that affiliates could repatriate and the amount that affiliates were allowed to pay parent firms for technology transfers. In addition, many governments imposed performance requirements on the local affiliates of MNCs. A **performance requirement** is a target imposed by the host country government in order to promote a specific government economic objective. If the government is trying to promote backwards linkages, for example, it will require the local affiliate to purchase a specific percentage of its input from domestic suppliers. If the government is attempting to promote export industries, it will require the local affiliate to export a specific percentage of its production. Some governments also sought to force MNCs to conduct research and development inside the host country. Finally, some countries have limited MNCs' access to the local capital market.

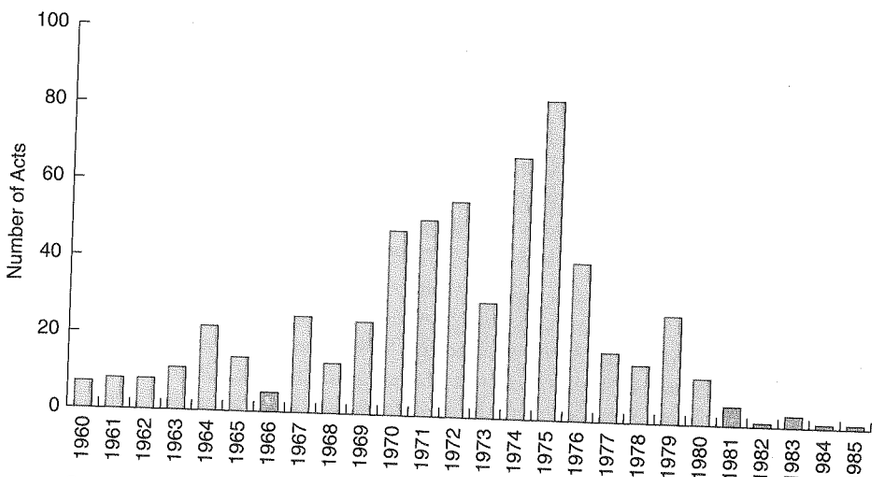

Figure 5.3 Expropriation Acts in Developing Countries.
Source: Vernon 1996, 6.

Developing countries' governments tried to regulate but not block foreign direct investment because they recognized that FDI could contribute to development, but were wary of the political and economic consequences of MNC dominance of the local economy. Concerns about foreign dominance arose from historical experience. As we saw in Chapter 4, most developing countries entered the postwar period as primary commodity producers and exporters. MNCs often controlled these sectors and the export revenues they generated. Data from the late 1970s illustrates the extent of this control. In the aluminum industry, six MNCs controlled 77 percent of the nonsocialist world's bauxite output, 87 percent of its alumina output, and 83 percent of its production of aluminum. In agricultural products, the 15 largest MNCs controlled approximately 80 percent of developing countries' exports (United Nations 1983). And while foreign direct investment shifted toward manufacturing activity during the 1960s, MNC affiliates also played an important role in these sectors. Data collected by the UNCTAD during the mid-1990s is suggestive (UNCTAD 2001). In Singapore, MNC affiliates account for 52 percent of all manufacturing employment, 75 percent of all sales, and approximately 61 percent of all exports. In Malaysia, the figures are comparable: 44 percent of manufacturing employment, 53 percent of sales, and 51 percent of exports. While Singapore and Malaysia sit at the high end of the spectrum, MNCs also control large segments of manufacturing activity in other developing countries. In Brazil and Mexico, for example, MNCs account for 13 percent and 18 percent of employment respectively, and in Mexico they account for 21 percent of exports.

Allowing foreign corporations to control critical sectors and to drive the process of industrialization raised both political and economic concerns. The central political concern was that foreign ownership of critical natural resource industries compromised the hard-won national autonomy achieved by the struggle for independence. It seemed incongruent to achieve political independence from colonial powers and yet continue to struggle under the economic dominance of the colonial power's multinational firms. Moreover, as Shafer (1983, 94) points out, governments could rally domestic political support and silence domestic critics "by taking over the most obvious symbols of 'foreign exploitation': the subsidiaries of multinational corporations." Such nationalism played an important role in the nationalizations that occurred during the 1960s and 1970s. But economic concerns also played an important part as governments adopted import substitution industrialization strategies. If MNCs were allowed to control export earnings, governments would be unable to allocate these revenues in line with their ISI development objectives. "Nationalization . . . would make rational economic planning possible for the economy as a whole and enhance the government's financial position sufficiently to make economic diversification and . . . balanced economic growth attainable" (Shafer 1983, 93–94). Moreover, if MNCs were allowed to enter the local economy freely, there would be no necessary relationship between the types of investment they made and the government's development goals. Counter to the prescriptions of import substitution industrialization, foreign direct investments might remain in the extractive industries, manufacturing investments might be accompanied by little transfer of technology or be labor rather than capital intensive. As a result, economic development would continue to

A Closer Look

Singer Sewing Machines in Taiwan

The experience of Singer Sewing Machines in Taiwan highlights how governments can manage foreign direct investment to ensure that such investments provide substantial benefits for the host country (UNCTAD 1999, 211). Singer first invested in Taiwan in 1964. At the time there were a large number of Taiwanese firms manufacturing sewing machines. Most of these firms relied on old technology and the industry as a whole lacked standardization. As a result, the Taiwanese producers found it difficult to compete in international markets. The Taiwanese government intended to use Singer to upgrade the capacity of this local industry, rather than to substitute for domestic firms.

To promote this transformation, the Taiwanese government imposed some strict conditions governing the terms of Singer's investment. Domestic content requirements required Singer to purchase 83 percent of the parts it used in the sewing machines it produced in Taiwan from Taiwanese producers within one year. To achieve this goal, the government demanded that Singer provide local parts producing firms with standardized blueprints for the necessary parts. In addition, Singer was required to provide technical experts that could assist the local firms as they began to produce the needed parts. The government also forced Singer to allow the Taiwanese firms that were manufacturing complete sewing machines to purchase parts from the local parts producers that Singer was assisting. Finally, the government imposed an export requirement on Singer under which exports of Singer machines produced in Taiwan would increase rapidly.

Singer complied with all of these requirements. Forced to purchase such a large share of its inputs from local suppliers, Singer quickly provided blueprints and part specifications to all local parts producers, thereby allowing them to work to common specifications and standards. Singer held classes for local parts producers in the technical and managerial aspects of the business. Technical and management experts were dispatched to train workers in local parts firms and to reorganize the entire system of production in Taiwan. Singer also provided technical assistance to Taiwanese sewing machine manufacturing firms—the firms that represented competition for Singer—at no cost to these firms. As a direct result of these measures, substantial technology was transferred from Singer to local sewing machine firms. In addition, the domestic content requirement created backward linkages between the final sewing machine producers and the parts suppliers. By the late 1960s, Singer was purchasing all of the parts (except the needles) it used to produce sewing machines in Taiwan from Taiwanese firms. Moreover, 86 percent of Singer's local production was exported. Taiwanese sewing machine manufacturers also became more competitive internationally and began capturing export markets. Thus, by regulating the terms under which Singer Sewing Machines invested in Taiwan, the Taiwanese government was able to use a foreign MNC to promote the development of an internationally competitive domestic sewing machine industry.

be shaped by external considerations rather than by the government's development objectives. Nationalizations and subsequent efforts to manage foreign direct investment in manufacturing industries, therefore, reflected an attempt by developing countries' governments to harness MNCs and the resources they controlled to their development strategies.

Of course, not all developing countries adopted identical regimes. As a general rule, governments that pursued import substitution industrialization strategies imposed the most restrictive regimes. When the Indian government, for example, came to power upon achieving independence, it hosted a large stock of foreign investment. The Indian Congress Party was determined to limit the role of MNCs in the Indian economy and to force existing subsidiaries of foreign corporations to transfer control of these enterprises to local hands (Jones 1996, 299). To achieve this goal, the Indian government enacted highly restrictive policies toward new foreign investments and then began trying to "dislodge" existing investments in the early 1970s (Encarnation 1989). It dislodged existing enterprises that owned more than 40 percent of the local subsidiary by forcing them to choose between reducing their ownership by selling equity to Indian firms or divesting from India altogether. Exceptions were made only for firms that were operating in high priority areas or that were using sophisticated technologies. As a result, India experienced a net capital outflow during the 1970s as some existing MNCs (such as Coca-Cola and IBM) left and few new investments arrived.

Other developing countries committed to ISI actively sought foreign investment in connection with the shift to secondary import substitution, but sought to regulate the terms under which MNCs could invest. Brazil, for example, was generally open to foreign direct investment, but the government sought to ensure that inward investment was consistent with its development objectives. In the auto industry, the government effectively banned the import of cars in 1956, thereby forcing foreign auto manufacturers to produce in Brazil in order to gain access to the Brazilian market. Because the Brazilian market was potentially quite large, and because many American and European producers populated the world auto industry, the Brazilian government was able to encourage foreign investment on terms that promoted the development of domestic auto production. The government imposed high domestic content requirements on the foreign producers; 35 to 50 percent of the car's content had to be locally produced in 1956, and this was increased to 90–95 percent by the mid-1960s. By the mid-1960s, eight foreign-controlled firms were producing cars in Brazil for sale in the local market, and by 1980 over 1 million cars were being produced annually.

Governments that adopted export-oriented development strategies, such as the East Asian NICs, were relatively more open to foreign direct investment. Singapore and Hong Kong imposed almost no restrictions on inward foreign investment; to the contrary, Singapore based its entire development strategy on attracting foreign investment. South Korea and Taiwan were both less open to investment than Singapore and Hong Kong. In both countries, the government developed a list of industries open to foreign companies, but even proposals to invest in these industries were not automatically approved. Each project had to meet requirements concerning local content, the transfer of technologies, the payment of royalties in connection with these technology transfers, and the impact on imports (Haggard 1990, 199). Still, Taiwan and South Korea did more to attract foreign investment than most governments in Latin America or Africa. Beginning in the mid-1960s and early 1970s, both governments

created export processing zones (EPZs) to attract investment. **Export processing zones** are industrial estates where the government provides land, utilities, transportation infrastructure, and in some cases buildings to the investing firms, usually at subsidized rates (Haggard 1990, 201). Foreign firms based in EPZs are allowed to import components free of duty as long as all of their output is exported. Taiwan created the first EPZ in East Asia in 1965, and South Korea created its first in 1970. These assembly and export platforms attracted a lot of investment from American, European, and Japanese MNCs, and helped fuel the takeoff of East Asian exports during the 1970s. Finally, both countries liberalized foreign investment even further during the mid-1970s in an attempt to attract high-technology firms into the local economies (Haggard and Cheng 1987).

Most developing countries have greatly liberalized foreign direct investment since the 1980s. According to the UNCTAD, of the 1,035 investment policy changes that governments reported making between 1991 and 1999, 94 percent made foreign direct investment easier. Sectors previously closed to foreign investment, such as telecommunications and natural resources, have been opened to foreign investors. Restrictions on one hundred percent foreign ownership have also been lifted in most countries, and restrictions on the ability of foreign investors to repatriate profits have been eased. One can point to two factors that encouraged developing countries to liberalize foreign direct investment. First, developing countries experienced disappointing results under the restrictive investment regimes put in place during the late 1960s (Jones 1996). New foreign direct investment to the developing world fell during the 1970s as the wave of nationalizations and the tight restrictions governing new investment led MNCs to seek opportunities in less risky and constraining markets. Foreign enterprises that operated in developing countries were reluctant to bring in new technologies, and the nationalized sectors performed well below what governments had hoped for at the time of nationalization (Shafer 1983). In short, efforts to foster industrialization by managing MNC activity, either through nationalization or through regulation, yielded disappointing results. Second, the decision to liberalize FDI came as part of the broader shift in development strategies. Under ISI, governments intervened heavily in the economy, and intervention in FDI was part of the overall effort to guide industrialization. As governments adopted market-based development strategies, they intervened less in all segments of the economy, including foreign direct investment. Moreover, liberalization of FDI is fully consistent with the emphasis on trade liberalization, export-oriented production, and integration into the international economy more generally.

Developing countries' governments have not abandoned efforts to control MNC activity. While they have become more open to foreign direct investment, they "continue to look on multinational enterprises from the vantage point of their past experiences. Much as they welcome the contribution of foreign-owned enterprises . . . these countries will have grave doubts from time to time about the long-term contribution of such enterprises, especially as they observe that the grand strategy of the enterprise is built on the pursuit of global sources and global markets" (Vernon 1998, 108).

Advanced industrialized countries. The advanced industrialized countries have been more open to foreign direct investment than developing countries. According to one prominent scholar, only Japan and France enacted regulations that required inward manufacturing investments to receive explicit government approval (Safarian 1993). Most governments have excluded foreign firms from owning industries deemed "critical," but they have not drawn the lists of sectors from which foreign firms are excluded so broadly as to discourage MNC investment (Safarian 1993). In the United States, for example, foreign firms cannot own radio and television broadcasting stations, cannot own a domestic airline, and are prohibited from participation in defense-related industries. American restrictions are not unique, as most advanced industrialized countries prohibit foreign ownership in many of these same sectors.

Japan stood as the clearest exception to this tendency throughout much of the postwar period. Until 1970, Japan tightly regulated inward foreign direct investment (see Safarian 1993; Mason 1992). Japanese government ministries reviewed each proposed foreign investment and approved very few. Proposals that were approved usually limited foreign ownership to less than 50 percent of the local subsidiary. Such restrictions were motivated by the Japanese government's economic development objectives. Japanese officials feared that Japanese firms would be unable to compete with MNCs if foreign direct investment was allowed without restriction. In addition, the Japanese government was concerned that unrestricted foreign direct investment would prevent the development of domestic industries capable of producing the technologies deemed critical for the country's economic success (Mason 1992, 152–153). Regulations on inward investment, in other words, formed an important component of the Japanese government's industrial policy.

Japanese restrictions on inward direct investment were designed to discourage foreign direct investments and to encourage the inflow of foreign technology (Mason 1992, 151). Rather than encourage foreign direct investment, Japanese officials first pressured foreign firms to license their technologies to Japanese firms. If this proved unsuccessful, the Japanese government might consider a direct investment, but in doing so it often attempted to force the foreign firm to create a joint venture with a Japanese firm in order to transfer technology to Japanese firms working in the same industry. Only if a firm was unwilling to license or to form a joint venture, and then only if that firm controlled technologies that were not available elsewhere, did the Japanese government permit the creation of a wholly owned subsidiary in Japan. And even then, the government often attached conditions to the investment. IBM, for example, was forced to license critical technologies to seven Japanese competitors in exchange for being allowed to produce computers in Japan.

Japanese investment restrictions have been greatly liberalized since the late 1960s. In 1967, Japan increased the number of industries open to foreign investment and began to allow 100 percent ownership in some sectors. Additional measures taken in the 1970s and early 1980s further liberalized inward foreign direct investment so that Japan now has no formal barriers to such investments. Many scholars argue, however, that structural impediments continue to pose obstacles to foreign investment in Japan. The cross-holding ownership that characterizes Kereitsu groups makes it difficult for foreign firms to purchase existing Japanese enterprises. The

Japanese distribution system, based on a large number of small retailers, makes it difficult for foreign firms to market their products in Japan. Thus, even though government restrictions on FDI have been eliminated, Japan continues to attract only a small share of the world's foreign investment (see Figure 5.2).

Despite the general tendency toward greater openness, governments in the advanced industrialized countries have been sensitive to foreign control of national economic activity. Two instances illustrate such concerns. During the 1960s, the French government became very concerned about losing national economic autonomy as a result of the large foreign direct investments made by American MNCs following the formation of the European Union (see Servan-Schreiber 1967). The French government was most concerned about foreign ownership in industries subject to rapid technological change, particularly electronics and computers. Along with defense, aerospace, and the nuclear industry, the French government believed these industries were too important to be controlled by foreign corporations (Jones 1996, 277–278). When the American MNC General Electric attempted to acquire France's largest computer company, Machines Bull, it sparked a policy response. The French government instituted a more restrictive policy governing all inward direct investment. Proposed foreign investments were carefully screened, and many were rejected. In cases where a foreign MNC was attempting to purchase an existing French firm, the government would delay a formal decision while it sought a French buyer for the firm. These more restrictive measures were greatly eased beginning in the 1980s, and today France actively seeks MNC investments.

A similar reaction was evident in the United States during the late 1980s in response to a large increase of inward foreign investment. During the 1980s, Japan became a major direct investor in the United States, as did European multinationals. Between 1985 and 1993, the stock of foreign direct investment in the United States more than doubled, rising from $184 billion to $445 billion (Graham 1996, 16). The rapid rise of foreign direct investment, especially by Japanese MNCs, sparked concerns about foreign ownership of critical sectors of the American economy, particularly in computers and semiconductors. Such concerns were most prominent in a proposed sale of Fairchild Semiconductor to the Japanese firm Fujitsu. While Fujitsu ultimately withdrew its bid for Fairchild, this proposed transaction sparked concern that foreign firms were gaining too much control over the American defense industry. Congress responded by passing legislation (the **Exon-Florio Amendment** to the 1988 Omnibus Trade Act) that allows the executive to block foreign acquisitions of American firms for reasons of national security. These concerns diminished greatly during the 1990s as Japanese investment into the United States dwindled (Graham 1996, 20).

Thus, even though the advanced industrialized countries have been much more open to inward foreign direct investment than developing countries, here too, governments have attempted to manage the terms under which MNCs invest in their countries. Where governments used industrial policies, they attempted to protect national firms from MNC competition by restricting foreign investment. Where governments refrained from active industrial policies, they still restricted foreign ownership of sensitive industries, such as those at the forefront of high-technology sectors as well as industries that had close connections to national security.

Accounting for the differences. Why have advanced industrialized countries been less concerned about foreign ownership of the domestic economy than developing countries? For one, the advanced industrialized economies are larger and more diversified than developing countries' economies. Foreign affiliates are therefore more likely to confront competition from domestic firms in the advanced industrialized countries than they are in developing countries. As a consequence, foreign firms are less likely to dominate entire sectors of the economy in the advanced industrialized countries. Moreover, developing countries are sensitive to MNC ownership of natural resources that are held up by politicians as national treasures. In the advanced industrialized countries, MNCs have invested chiefly in manufacturing industries rather than in natural resource industries. As a result, MNCs have been less likely to provoke a nationalist response in the advanced industrialized countries. These varying degrees of economic diversification in conjunction with the different types of FDI that have dominated flows to the two groups of countries have meant that foreign ownership poses less of a threat of economic dominance in advanced industrialized countries than it does in developing countries. As a consequence, governments in the advanced industrialized countries have felt less compelled to regulate MNC activity.

In addition, there appears to be a strong correlation between a country's importance as a home for MNCs and its openness to inward FDI. The United States and the United Kingdom, the two largest foreign investors throughout the twentieth century, have also been the most open to inward foreign investment. Japan's opening to inward investment since 1970 has come as Japanese firms have begun to invest heavily in other advanced industrialized countries. When countries are both host and home to MNCs, they are less likely to adopt policies that reflect purely host country concerns. Attempts by the United States or Great Britain to regulate inward foreign direct investment would invite retaliation from other governments that would make it harder for their own firms to invest abroad. Because developing countries have historically been hosts and rarely home to MNCs, they have no such cross-cutting interests. Their efforts to regulate MNC activity are therefore not tempered by the fear of retaliation against their own MNCs operating abroad.

Finally, there have been fundamental differences in how governments approach state intervention in the national economy. Whereas governments in many developing countries pursued import substitution industrialization strategies that required a high degree of intervention, most governments in the advanced industrialized countries have been more willing to allow domestic economic developments to be driven by the market. These different attitudes about the role that the government can and should play in the national economy have translated into different approaches to foreign direct investment. Whereas governments in developing countries sought to harness FDI to their development objectives, most governments in the advanced industrialized countries had no explicit development plans to which to harness foreign direct investment and were therefore more willing to accord fairly liberal treatment to foreign investment. Even the exceptions to the pattern of nonintervention are consistent with this difference. Efforts to tightly regulate MNCs occurred in those advanced industrialized countries where governments did intervene heavily in conjunction with industrial policies. The two governments that were most restrictive toward foreign direct

investment, Japan and France, were also the two governments that relied most heavily on industrial policies to promote domestic economic activity.

In summary, governments have responded to the dilemma arising from MNC activity by attempting to manage the terms under which MNCs participate in the domestic economy. At a minimum, governments have excluded MNCs from participation in areas of the domestic economy deemed critical for national security and other priority objectives. At a maximum, governments have prohibited foreign investment completely. As a group, developing countries have tended to restrict inward FDI more than the advanced industrialized countries. Different economic structures, different positions in the global economy, and different government roles in the national economy have given rise to different policies toward FDI and MNCs in the two groups of countries.

The Bargaining Relationship

While host countries' governments have tried to harness MNC activity to their domestic economic priorities, this is not always easily achieved. A host countries' government is not always—or even often—in a position to dictate the terms under which multinational corporations enter the local economy. Instead, host country governments and MNCs exist in an interdependent relationship; each holds something of vital importance to the other, and each has the ability to deny this thing of value to the other. The host country government controls access to its market, resources, and labor, all things to which the MNC wants access. The MNC controls investment capital, technology, and links to international markets, all things to which the host country government wants access. This interdependent relationship means that host country governments must often bargain with MNCs, and the terms under which investment occurs are a result of whatever agreement is reached.

Whether investment takes place on terms that meet the host country government's objectives or instead takes place on terms that better suit the MNC's goals is a function of bargaining power. The larger share of the gains from a proposed investment will go to whichever actor has greater bargaining power. The relative bargaining power of the MNC and the host country is in turn determined by two broad considerations. First, how important is the host country to the MNC parent? The specific factors that determine the importance of the host country will depend upon the type of investment in question. If the investment is market oriented, then the size of the host country market will be critical. If the investment is natural resource oriented, then the availability of the resources controlled by this host country elsewhere in the world will be critical. Finally, if the investment is efficiency oriented, then the ability of the MNC to achieve the same efficiency gains in other countries is the critical consideration. While the measure of a country's importance is different for each type of investment, the more important the country in question is—the larger its market, the more it controls resources not available elsewhere, the more it offers clear cost advantages relative to other countries—the more power will shift in favor of the host country government. Conversely, as the importance of the country diminishes, bargaining power shifts in favor of the MNC.

Second, how important is the MNC to the host country government? Here a number of considerations are important. How large is the proposed investment? All

else being equal, large investments are likely to be more important to the host country than small investments. To what extent is the technology controlled by the MNC available elsewhere? The more the MNC exercises exclusive control over a technology that the host country considers essential to industrialization, the greater the power of the MNC. How competitive is the sector in which the MNC operates? Are there multiple MNCs capable of making similar types of investment, or is the MNC in question the only firm willing to make the desired investment? If the host country government can turn to other MNCs for the same type of investment, then any one MNC is less important to that government. Thus, bargaining power shifts in favor of the host country as the importance of a particular MNC decreases, while bargaining power shifts in favor of the MNC as its importance to the host country increases.

In short, the more that one side has monopolistic control over things of value to the other, the greater its bargaining power. Conversely, the less that one side has monopolistic control over things of value to the other, the weaker its bargaining power. Host-country governments have the bargaining advantage when their country is of vital importance to the MNC and a large number of MNCs are interested in investing in their country. In such situations we would expect the host country to be able to capture many of the gains from investment. MNCs have the power advantage when the country is not of critical importance and few other MNCs are present in their sector. In these cases, we would expect the MNC to capture the larger share of the gains from investment. When the country is of critical importance to a particular firm and there are few other MNCs willing and able to invest in this sector in this country, we would expect hard bargaining between the host country government and the MNC. Here we would expect an investment agreement that evenly distributes the gains between the two parties. Finally, the gains would also be evenly distributed when the country is of limited importance to a particular firm and when multiple MNCs are contemplating investment in a particular sector in that country. In such cases neither side has much bargaining power, and the gains should be divided between them relatively equally.

Bargaining does not stop once the initial investment has been made. Instead, the host country government and the MNC continue to bargain over the distribution of the gains from the investment, and each will try to alter the initial agreement in its favor. Bargaining continues in part because the initial balance of bargaining power between the host country government and the MNC can change once the initial investment has been made (Moran 1974). Known as the **obsolescing bargain** model, this argument suggests that bargaining power initially favors the MNC for reasons discussed above—the size of the investment and the availability of the associated technology are beyond the host country's capabilities. Moreover, the returns on the proposed investment are uncertain, and therefore the MNC bears the risk in making the investment—if returns are small the MNC loses from its investment while the host country loses little. The MNC can exploit this power asymmetry to initially capture the larger share of the gains from the investment. Once the investment has been made, however, power begins to shift to the host country government. The MNC cannot easily remove the large fixed investment. The host country government can use this fixed investment to gain a bargaining advantage. In addition, technology transfers occur as the MNC hires and trains the local population. As the local population acquires the technology and management expertise, the technological benefits provided by the MNC diminish.

A Closer Look

Luring the German Luxury Car Producers to the South

The German automaker BMW decided in the early 1990s to create a new assembly plant outside Germany. Such a move represented a real shift for BMW, which had never previously assembled cars outside of Bavaria. BMW's decision to begin assembling cars outside Germany was motivated by a determination to reduce its costs. German automakers were earning about $28 an hour, far greater than the average of $16 an hour that unionized autoworkers make in the United States. In addition, the persistent strengthening of the German mark against the dollar during the late 1980s had further eroded the ability of BMW to compete in the American market. BMW spent three years and looked at 250 different sites in 10 countries before deciding in 1992 to build the plant in Spartanburg, South Carolina (Faith 1993). In late September 1992, BMW began construction of this $400 million assembly plant that would employ some 2,000 people and produce as many as 90,000 cars a year. BMW expanded this production facility in 1998 from 1.2 million square feet to 2.1 million square feet. This facility remains BMW's only American production site (www.BMW.com).

Why did BMW choose Spartanburg over other potential sites? A range of considerations, including financial incentives offered by the state of South Carolina shaped BMW's decision to base production in Spartanburg. Spartanburg had some advantages arising from its location; it is close to a deep-water seaport in Charleston, South Carolina, and it is connected to this port by a good interstate highway. This transportation network would allow BMW to transport the cars destined for overseas markets easily. In addition, labor in South Carolina was relatively cheap—averaging about $10 to $15 an hour—and nonunionized. In addition, the state and local government in South Carolina put together a financial package that offset a substantial share of BMW's investment. Officials advanced about $40 million to purchase the 900 acres of land upon which the plant would be built, and agreed to lease the site to BMW for only $1 per year. In addition, about $23 million was spent preparing the site and improving the infrastructure, including such things as water, sewer, and roads. Another $71 million of tax breaks were offered over a 20-year period. Finally, state, local, and federal money was provided to improve the airport in nearby Greenville (Harrison 1992). All together, the incentives offered by South Carolina to BMW totaled about $135 million, an amount equal to $67,500 for each job BMW would create.

The use of financial incentives to attract an investment from a German automaker reached new heights in Alabama's courtship of Mercedes-Benz in the mid-1990s. Mercedes-Benz decided, for reasons identical to those that motivated BMW, to build an assembly plant outside of Germany (Myerson 1996). It eventually constructed a $300 million plant in Vance, Alabama, employing about 1,200 workers to produce 65,000 sport utility vehicles each year. In its initial search for suitable sights, Mercedes focused on 62 possibilities, none of which were in Alabama. As Andreas Renschler, who led the search for the site remarked, "Alabama was totally unknown" (quoted in Myerson 1996). Government officials in Alabama were determined to attract Mercedes to their state, however. The governor, James E. Folsom, Jr., flew to Mercedes headquarters in Stuttgart three times, and working with other state politicians put

Continued

together a financial package to attract the German firm to Alabama. The package included $92.2 million to purchase and prepare the site for construction, $75.5 million in infrastructure improvements for water, sewage, and other utilities, $5 million each year to pay for employee training, and tax breaks. In addition, the state of Alabama agreed to purchase 2,500 of the sport utility vehicles that Mercedes intended to build in the factory, at a cost of about $75 million. The total package was estimated at between $253 and $300 million, an amount equal to $200,000 to $250,000 for each job Mercedes intended to create (Waters 1996).

While BMW and Mercedes officials publicly deny that the incentive packages they received played an important role in their decisions to invest in Spartanburg and Vance, it is hard to escape the conclusion that these packages did matter. In BMW's case, the incentive probably mattered at the margin. Spartanburg was one of at least two suitable sights in the United States (Omaha, Nebraska, was the other site that BMW considered). The willingness of South Carolina to offer a more generous package of incentives than Nebraska probably tipped the balance in its favor. In the case of Mercedes, it seems clear that Vance, Alabama, held few of the natural advantages enjoyed by sites in North Carolina and South Carolina, the other two finalists in the competition. In fact, the site Mercedes considered in North Carolina enjoyed many of the same characteristics that had attracted BMW to Spartanburg. The willingness of Alabama to offer an incentive package more than twice as large as that offered by North Carolina—which is reported to have offered Mercedes about $109 million in incentives—probably enabled Alabama to overcome its initial disadvantage (Burritt 1994).

Because incentive packages do shape the investment decisions that firms make, governments cannot easily opt out of the incentive game. As the former treasurer of North Carolina, Harlan Boyles, commented following the Mercedes-Alabama deal, "all the competition [for investment] has been forced upon the states" by the MNCs. "Until there is meaningful reform and an agreement between states not to participate, very little will change" (quoted in McEntee 1995). And while Boyles's comment was directed at competition for investment among states within the United States, its logic applies equally well to competition between national governments in the international economy.

Finally, once the investment proves successful, uncertainty about the returns falls. The MNC thus no longer bears the risk it did in the preinvestment period. Unable to threaten to leave the country without suffering substantial costs, and no longer in possession of technology capabilities foreign to the host country population, the MNC finds that its initial bargaining advantage has diminished. The host country can exploit this power shift to renegotiate the initial agreement and extract a larger share of the gains from the project.

The logic of the obsolescing bargain applies most directly to natural resource-oriented investments. These types of investments most often combine large fixed investments with relatively mature, or stable, technologies. The wave of nationalizations that occurred in the 1960s and 1970s, therefore, resulted in part from a shift in bargaining power to host country governments. Investments in manufacturing industries are less susceptible to the logic of the obsolescing bargain. The fixed investment component is smaller,

and technology in many manufacturing industries is complex and rapidly changing. Thus, initial investments in manufacturing cannot easily be held hostage by the host country government, and the value of the technology transferred to the local population at any one point in time is lower because new technologies are constantly introduced. As a result, bargaining power does not shift so easily or so rapidly to the host country government (Kobrin 1987).

As MNCs have increasingly emphasized efficiency-oriented investments, bargaining power may have shifted in favor of MNCs. Evidence in favor of such a shift can be found in the growing competition between host country governments to attract MNCs. Such competition often takes the form of locational incentives. **Locational incentives** are packages assembled by host country governments "specifically designed either to increase the rate of return of a particular FDI undertaking, or to reduce its costs or risks" (UNCTAD 1995, 288–289). By offering such incentives, governments hope to attract MNCs into their economies by offsetting a portion of the cost of the MNC's investment. Two types of incentives dominate the packages that governments offer to MNCs. Most governments—99 out of 103 countries that the UNCTAD surveyed in the mid-1990s—offer tax incentives. Almost all governments offer MNCs a reduced corporate income tax rate. Also important are tax holidays, usually of five years following the investment, exemptions from import duties, accelerated rates of capital depreciations, and deductions from gross income for income tax purposes. According to UNCTAD, developing country governments rely most heavily on tax holidays and exemptions from import duties, while governments in the advanced industrialized countries rely more often on accelerated depreciation schedules and specific tax deductions. A large number of governments also offer direct financial incentives to MNCs. In fact, the UNCTAD reported that 59 out of the 83 governments that it surveyed in the mid-1990s provided such assistance. Direct financial assistance can be provided as a grant from the government to the MNC or as a subsidized loan. Governments in the advanced industrialized countries use this type of incentive more than governments in developing countries because they are better able to afford direct financial assistance (Moran 1999, 95).

The willingness of governments to offer locational incentives to MNCs has grown rapidly during the last 20 years, and the dollar amount of these packages has increased. Across the entire OECD, in 1989 there were 285 incentive programs offering support totaling $11 billion. By 1993—the last year for which comprehensive data is available—there were 362 programs offering incentives totaling $18 billion. Within the United States, the typical package averaged between $50–70 million, but the value of the typical package has been increasing (Moran 1999). Some evidence of the growth of incentives is provided in Table 5.7. Note the rapid growth in the per-job cost of government incentives. In the early 1980s, the largest per-job cost of incentives was just below $50,000 and the average was about $30,000. By the early 1990s the average per-job cost was well over $100,000 for similar types of investment. "All this suggests that competition for FDI with incentives is pervasive, and is even more so now than it was ten years ago. Many countries have increased their incentives in order to divert investment away from competing host countries . . . This has been so regardless of whether the countries involved were large or small, rich or poor, developed or developing" (UNCTAD 1995, 298).

Table 5.7
Host Country Incentive Packages, 1983–1995

Location	Year	Firm	Other Locations Considered	Government Support ($US Millions)	Company's Investment ($US millions)	Employees	Support per Job
Smyrna, Tennessee	1983	Nissan	Georgia	33.0	745–848	1,300	25,384
Flat Rock, Michigan	1984	Mazda	Alabama, Iowa, Kansas, Missouri, Nebraska, North Carolina, Oklahoma, South Carolina, Tennessee	48.5	745–750	3,500	13,857
Georgetown, Kentucky	1985	Toyota	Georgia, Indiana, Kansas, Missouri, Tennessee	149.7	823.9	3,000	49,900
Lafayette, Indiana	1986	Fuji-Isuzu	Illinois, Kentucky	86.0	480–500	1,700	50,588
Setubal, Portugal	1991	Auto Europa Ford Volkswagen	United Kingdom, Spain	483.5	2,603	1,900	254,451
Tuscaloosa, Alabama	1993	Mercedes-Benz	Georgia, Nebraska, North Carolina, South Carolina, Tennessee	250.0	300	1,500	166,667
Northeast England	1994–1995	Samsung	France, Germany, Portugal, Spain	89.0	690.3	3,000	29,675
Spartanburg, South Carolina	1994	BMW	Oklahoma, Nebraska	130.0	450	1,200	108,333
Castle Bromwich, Birmingham, Whitley, United Kingdom	1995	Jaguar	Detroit, Michigan	128.72	767	1,000	128,720
Hambach, Lorraine, France	1995	Mercedes-Benz, Swatch	Belgium, Germany	111.0	370	1,950	56,923

Source: UNCTAD 1995, 296–297.

We see, therefore, that host country governments, whether in the developing world or in the advanced industrialized world, face an identical dilemma in their relationship with MNCs. While foreign direct investment can make important contributions to the host country, foreign ownership means that this contribution is uncertain. As we have seen, all governments have responded to this dilemma by attempting to manage foreign direct investment. Governments in developing countries have sought to exert considerable control over MNC activity. With smaller and less diversified economies that are typically hosts and rarely home to MNCs, and with governments committed to interventionist development strategies, developing countries have sought to harness MNCs to their development objectives. Governments in the advanced industrialized countries have done less to manage MNCs. With large and diversified economies that are both host and home to MNCs, and with governments that have intervened less heavily in domestic markets, the advanced industrialized countries have been willing to give MNCs a much looser rein in their national economies. And while host country governments try to regulate the terms under which MNCs operate in their economies, such control may well elude them. The interdependence between host country governments and MNCs means that the specific terms under which investments occur are more often negotiated than imposed by the host country.

MNCs and Labor in the Global Economy

Multinational corporations have been heavily criticized for the way they are alleged to treat workers in developing and advanced industrialized countries. MNCs are accused of exploiting workers in developing countries by paying low wages and maintaining sub-standard workplaces. MNCs are accused of eliminating large numbers of jobs in advanced industrialized countries by shifting production to low-wage developing countries. As we shall see, developing country workers employed by MNCs receive better wages and enjoy better working conditions than do developing countries' workers employed by local firms. In the advanced industrialized countries, outward investment by MNCs changes the kinds of jobs available in the domestic economy, but does not reduce the total number of jobs available in the domestic economy.

MNCs and Labor in Developing Countries

Critics of globalization in general and of MNCs in particular claim that MNCs exploit workers in developing countries. Most of these critics acknowledge that MNCs bring jobs to developing countries. However, critics allege that the quality of these jobs is very poor. Low wages and unbearable working conditions result in sweatshop conditions in MNC affiliates operating in developing countries. Workers would be better off, critics allege, without MNCs. To what extent are these criticisms supported by evidence on MNC operations in developing countries? We look first at the question of wages and then turn our attention to workplace conditions and the treatment of workers. As we proceed, it is important to bear in mind that our principal question is not whether sweatshops exist, for they clearly do. Our central question is whether MNCs are an important source of sweatshops.

Table 5.8
Annual Compensation by MNC Affiliates (thousands of USD)

	High-Income Countries	Middle-Income Countries	Low-Income Countries
Manufacturing	45.0	14.1	4.9
Petroleum	72.8	30.7	25.4
Food	45.6	13.8	5.9
Primary and Fabricated Metals	38.6	18.0	13.8
Electronic and Electric Equipment	32.0	8.8	3.6

Source: Graham 2000, 92.

MNCs are accused of paying very low wages to workers in developing countries. Critics allege that wages are so low that workers are unable to meet their basic daily needs. To what extent does available evidence support this allegation? It is clear that the wages that MNC affiliates pay to workers in developing countries are substantially lower than the wages they pay to employees in advanced industrialized countries. Table 5.8 illustrates these wage differences for a few industries. In all manufacturing industries, a typical worker employed by an MNC affiliate in an advanced industrialized country earns almost ten times as much as a typical worker employed by an MNC affiliate in a low-income country. This disparity is also apparent within specific manufacturing industries. In the food processing industry, for example, a worker employed by an MNC in the United States or Europe will earn just over $45,000 per year, while a worker employed by an MNC affiliate in a low-income country will earn slightly less than $6,000 per year. Such wage differences, however, are not necessarily evidence that MNCs are "exploiting" workers in developing countries. Instead, we would expect workers in most low-income countries to earn less, simply because labor productivity in low-income countries is substantially lower than labor productivity in advanced industrialized countries.

An alternative way to evaluate the wages that MNC affiliates pay their workers in developing countries is to compare the wages paid by MNC affiliates to the wages paid by local firms that are not controlled by MNCs. Some evidence on this comparison is presented in Table 5.9. Because the wage gap between advanced industrialized countries and developing countries is largest in manufacturing industries, this table focuses

Table 5.9
Compensation By MNCs and Local Firms

	High-Income Countries	Middle-Income Countries	Low-Income Countries
Average Compensation Paid by MNC Affiliate	32.4	9.5	3.4
Average Compensation Paid by Local Manufacturing Firm	22.6	5.4	1.7
Ratio	1.4	1.8	2.0

Source: Graham 2000, 94.

only on manufacturing industries. It presents the average wage paid by MNC affiliates to their manufacturing employees and the average wage paid by local manufacturing firms. We can use these two pieces of information to calculate a ratio between the two wages. A ratio equal to one would indicate that MNC affiliates and local firms pay their workers the same amount. A ratio less than one would indicate that MNC affiliates pay less than local firms. Conversely, a ratio greater than one would indicate that MNC affiliates pay more than local firms. A glimpse at the bottom row of Table 5.9 makes the simple point that in all three groups of countries MNC affiliates pay higher wages than local firms. Thus, workers appear to earn a premium by working for an MNC relative to what they would be paid by a local firm. Moreover, the size of this premium increases as we move from high-income countries to low-income countries. A worker employed by an MNC affiliate in the United States could expect to make 1.4 times what she would make in an American firm. A worker employed by an MNC affiliate in a low-income country could expect to make twice as much as she would make in a firm owned by a local entrepreneur. Thus, even though MNCs pay workers in developing countries less than they pay workers in advanced industrialized countries, they tend to offer higher wages than developing countries' firms. Thus, on simple wage terms, workers in a developing country have every reason to prefer a job in an MNC affiliate to a job in a local firm.

Critics allege, however, that wages are only one part of the problem. MNCs are also accused of maintaining sub-standard working environments. Researchers have documented four objectionable practices during the last 15 years (Graham 2000, 99–104). First, many firms require their workers to work excessively long hours. In one Indonesian factory that produces shoes for Nike, for example, workers reported working 11 hours per day, seven days a week (Connor 2002, 20). Often, such overtime is not compensated at a higher rate of pay. Second, workers are often forced to work in abusive environments that include exposure to toxic chemicals and other health and safety hazards, physical punishment for violation of workplace rules, and sexual harassment. Workers in a Chinese toy factory, for example, reported consistent chemical odors and paint dust in the air, which they suggested caused persistent headaches, dizziness, stomach aches, and nausea (The National Labor Committee 2002, 17). Third, firms sometimes engage in bonded labor schemes under which a person "pledges his or her labor for a specified period of time in return for a loan" (Graham 2000, 103). Finally, many developing country firms employ children. According to the International Labor Organization, more than 250 million children under the age of 14 are currently working.

While there is considerable evidence of such practices in developing countries, two additional questions must be asked. First, how prevalent are such practices? Second, to what extent are MNC affiliates, as opposed to locally owned firms, responsible for such practices? Critics allege, or at least imply, that all foreign affiliates of MNCs operating in developing countries are sweatshops (see e.g., Wallach and Sforza 2000). For this group, therefore, sweatshops are prevalent. Others argue that sweatshops are the exception rather than the rule. It is difficult to evaluate which claim is true because no one has systematically investigated what percentage of factories in developing countries subject workers to the practices described above. The best that we can do is rely upon anecdotal evidence compiled in a rather unsystematic fashion by individual researchers. Such anecdotal evidence suggests two conclusions. First, abuses seem most common in a relatively

limited number of industries, particularly in footwear, apparel, toy making, and sporting goods (Graham 2000, 101). Second, abuses seem more common in locally-owned firms than in MNC affiliates. According to the United Nations Conference on Trade and Development, "working conditions in MNCs are not less favorable than those of comparable national employers; often they rate better than the average in local firms." This same study continues, "large well-established and visible MNCs are likely to comply with international standards and not to undercut the labor standards of their host (and home) countries. They adhere to minimum wage, working hours, overtime, and compensation regulations" (UNCTAD 1999). This suggests that a developing country worker is likely to find better working conditions in an MNC affiliate than in a locally-owned firm.

In general, therefore, MNCs pay higher wages and appear to be less likely to subject workers to terrible working conditions than the local firms against which they compete for workers. This is not to suggest that low wages and poor working conditions are insignificant problems. Nor is it to deny that such practices are abhorrent wherever they occur. In addition, noting that MNCs are less likely to pay low wages and to maintain sub-standard workplaces does not mean that MNCs never engage in such practices. Moreover, in many instances, MNCs will contract work to locally-owned firms who do engage in sweatshop practices and then claim that they are not responsible for how these contract firms treat their workers. Such an attitude seems, at best, disingenuous. Many MNCs have begun to respond to such criticisms by establishing monitoring regimes that inspect working conditions in the developing countries' firms that produce for them. At the same time, however, workers do seem more likely to be subject to sweatshop conditions in local firms than in MNC affiliates. And while it is certainly reasonable to argue that MNCs could do more to prevent the abuse of workers, the evidence suggests that it is an exaggeration to claim that MNCs systematically engage in such practices.

MNCs and Labor in Advanced Industrialized Countries

Critics argue that MNCs also have negative consequences for workers in the advanced industrialized countries. Labor unions and other critics claim that outward investment diverts capital that otherwise could have been invested at home, that overseas production reduces exports from the home country, and that the net result is a loss of production and jobs. American labor unions first began to advance such criticisms of outward investment by American multinationals in the early 1970s. In 1971, the AFL-CIO adopted an Executive Council Statement that called for a new approach to trade and investment policy. Many of the proposals advanced by the AFL-CIO eventually found there way into the Burke-Hartke Bill, which was introduced to the United States Congress in September of 1971. The **Burke-Hartke Bill** called for extensive use of quantitative restrictions to limit imports in order to discourage American MNCs from moving production offshore. In addition, the bill called for restrictions on outward investment by requiring the executive branch to review and approve all outward movements of capital and technology (Black, Blank, and Harrison 1978, 65). While this legislation was defeated, it reflected concerns about how outward investment affects the U.S. economy that have been an important factor in the opposition of American labor to the NAFTA, to the proposed FTAA, and to China's entry into the WTO.

Are American labor unions correct to claim that American MNCs are eliminating jobs in the United States? Existing studies suggest that outward investment has no net effect on the number of jobs available in the home country. To understand why this is the case we need to consider two factors. First, we need to know what would have happened if the firm had not invested abroad. It is certainly possible that, absent foreign investment, the capital that would have been invested abroad will instead be invested at home, that foreign markets will continue to be serviced by exports, and that home country jobs will therefore be maintained. There is, however, an equally plausible alternative scenario. The domestic firm may find it increasingly difficult to maintain its share of the domestic and world markets in the face of intense international competition. The firm will have little incentive to make new investments at home as it loses market share to foreign competitors. At the end of the day, the firm may well go out of business, eliminating the jobs it had provided. For example, American labor unions have been highly critical of Mexico's maquiladora program. Under the **maquiladora program** the Mexican government established an export processing zone in northern Mexico and encouraged American manufacturing MNCs to create assembly operations. Critics claim that this export processing zone has eliminated hundreds of thousands of American manufacturing jobs as MNCs have shifted production to Mexico. According to studies conducted by the United States International Trade Commission, however, most of the jobs that have moved to Mexico in connection with the program would have disappeared even without the maquiladora program. The products imported into the United States from American plants based in Mexico would have been imported from Asia rather than produced in the United States (Ready 1993). To evaluate the impact of outward foreign investment on the home country, therefore, we first need to know what would have happened in the home economy in the absence of such investment. And while some jobs are indeed lost as a direct result of outward investment, the actual number is usually much lower than the simple headline statistic. In other words, using policy to limit outward investment will probably not preserve jobs in the American economy. Limits on outward investment would have to be accompanied by import restrictions as well, as was proposed in the Burke-Hartke Bill.

Second, once we have a reasonably accurate picture of what would have happened in the absence of outward investment, we need to factor in the jobs that the foreign affiliates of MNCs create in the home country. Foreign affiliates can create jobs in the home country in two ways. When an MNC establishes a foreign affiliate, many of the components that comprise the final good are imported from the home country. To the extent that the foreign affiliate gives the MNC a cost advantage that allows it to maintain its current market share or to increase this share, demand for the components produced in the home country will increase. This increased demand will lead to more jobs being created in the home economy. For example, it has been estimated that the assembly plants created in northern Mexico by American MNCs directly support 154,000 jobs in the United States. These jobs would not exist in the absence of the maquiladora program (Ready 1993). Jobs can also be created because MNCs' foreign affiliates raise incomes in the host country, and consequently consumption in the host country should rise. If the home country is an important trading partner with the host country, increased consumption in the host country will translate into increased demand for consumer goods produced in the home country and hence to an increase in home country exports to the host. Increased exports will in turn have a positive impact on job creation in the home country.

When we fit these two factors together, we find that outward investment has no net impact on the number of jobs in the home country economy. The total number of jobs destroyed is approximately equal to the total number of jobs created. What outward investment does alter, however, is the sectoral location of jobs in the home country. The jobs that are destroyed are most often located in the import-competing sector while the jobs that are created are most often located in the export-oriented sector. Such shifts are not to be regretted on an aggregate level. Jobs in the export-oriented sector in the United States tend to be high-skill, and therefore high-paying, jobs. In contrast, jobs in the import-competing sector in the United States tend to be low-skill, and therefore low-paying, jobs. Outward investment therefore replaces low-skill, low-wage jobs with high-skill, high-wage jobs. On an aggregate level, it is hard to argue that replacing low-paying jobs with high-paying jobs is a bad thing.

While the impact of outward investment on jobs in the home country is positive in the aggregate, its impact on the people that lose their jobs and the communities that lose their factories is clearly negative, at least in the short run. When a factory closes, people living in that community lose jobs, incomes, and opportunities. People who have lost jobs due to outward investment often find it difficult to find new jobs that pay as well as their old ones. While new higher-paying jobs are being created, people often find it difficult to move into them. In many cases people must be willing to accept jobs in communities that are new to them. The social networks that we discussed in Chapter 2 in the context of trade adjustment, often make people reluctant to move. These social constraints on labor mobility are often reinforced by industry specific skill sets. A person who has spent 20 years as a welder in an auto plant, for example, cannot easily transfer these skills to investment banking, the law, or the design of integrated circuits for computers. The combination of social networks and industry-specific skills makes labor relatively immobile. When an MNC closes a factory in a community in the United States, and when the displaced workers are unable or unwilling to move to new jobs in other communities, people will have fewer job opportunities and will often be forced to accept a lower standard of living.

In summary, there is little systematic evidence to support the most common criticisms of the impact that multinational corporations have on workers in developing and advanced industrialized countries. There is little evidence that MNCs systematically "sweat" developing country workers. On average, MNCs pay higher wages and maintain better working environments than indigenous firms in developing countries. Nor do MNCs export jobs from advanced industrialized countries. While outward investment does destroy some jobs, it also creates jobs in the home country. The real impact of outward investment in the advanced industrialized countries is to shift jobs from low-skill sectors to high-skill sectors, and this shift in the location of jobs raises substantial adjustment problems. In reflecting upon these conclusions it is important to bear two considerations in mind. The conclusion about the relationship between MNCs and sweatshops is a limited conclusion. The conclusion is not that sweatshops are not a problem, but rather that MNCs do not appear to be the principal culprits. Nor should the fact that outward investment does not reduce the total number of jobs in advanced industrialized countries be taken to mean that the jobs lost by particular

communities are inconsequential. These job losses hurt the communities concerned, and it is the adjustment problem generated by these job losses that drives the contemporary political debate in the United States and other advanced industrialized countries about the role of MNCs in the global economy.

International Regulation of MNCs

What is perhaps most surprising about the activity of multinational corporations is the absence of comprehensive rules governing international investment. It is not the case that governments have made no effort to create such rules. In fact, governments have repeatedly tried to create international rules to govern foreign direct investment during the last 50 years. But to date these efforts have yielded little. There are partial rules, set out within the WTO as well as less binding rules within the OECD. There are also some well-established international rules that apply to a few countries, such as the investment chapter of the North American Free Trade Agreement. As we will see here, however, conflict between the capital exporting advanced industrialized countries and the capital importing developing countries has prevented the creation of more comprehensive investment rules. More recently, the emergence of a political backlash against globalization in general and proposed investment rules in particular has further constrained what governments can achieve in this area.

Historically, the international rules governing foreign direct investment have been based on four legal principles. First, foreign investments are private property to be treated at least as favorably as domestic private property. Second, governments have a right to expropriate foreign investments, but only for a public purpose. Third, when a government does expropriate a foreign investment it must compensate the owner for the full value of the expropriated property, or in legal terminology, expropriation must be accompanied by "adequate, effective, and prompt" compensation (Akehurst 1984, 91–92). Finally, foreign investors have the right to appeal to their home country in the event of a dispute with the host country. Although such principles are designed to protect the property of foreign investors and therefore clearly reflect the interests of the capital exporting countries, capital exporting and capital importing countries alike accepted them throughout the nineteenth century (Lipson 1985). The one exception came from Latin American governments' challenge to the right of foreign governments to intervene in host countries in support of their firms. By the late nineteenth century, Latin American governments were invoking the Calvo Doctrine (named after the Argentinean legal scholar Carlos Calvo who first stated it in 1868). The **Calvo Doctrine** argues that no government has the right to intervene in another country to enforce its citizens' private claims (Lipson 1985, 19). While the Calvo Doctrine challenged the right of governments to use diplomatic pressure and military force to protect their citizens' foreign investments, it did not challenge the rules themselves.

The capital importing countries began to challenge these legal principles during the interwar period (Lipson 1985). The first challenge came in the Soviet Union, where the 1917 revolution brought to power a Marxist-Leninist government that rejected the idea of private property. The comprehensive nationalization of industry that followed "constituted the most significant attack ever waged on foreign capital" and

radically redefined the role of the government in the economy (Lipson 1985, 67). Some Latin American governments also began to expropriate foreign investments during this period, particularly in the extractive industries and public utilities. These acts broadened the notion of "public purpose" that stood behind the internationally recognized right of expropriation, extending it from its traditional association with eminent domain to a much wider association with the state's role in the process of economic development. In addition, such widespread nationalizations also posed a challenge to the principle of compensation. The Soviet government linked compensation of foreign investors, for example, to claims on Western governments for damages caused by their militaries during the civil war that followed the revolution (Lipson 1985, 67).

The United States attempted to reestablish the traditional legal basis for investment protection following the Second World War. As the largest, and in the immediate postwar period the only, capital exporting country, the United States had a clear interest in establishing multilateral rules that provided security for American investments overseas. But U.S. efforts to achieve this goal by incorporating the historical legal protection of foreign investments into the International Trade Organization ran into opposition from the capital importing countries. Governments from Latin America, India, and Australia were able to create a final set of articles that did more to elaborate the right of host countries to regulate foreign investments within their borders than to provide the security that American business was seeking (Brown 1950; Lipson 1985, 87). American business strongly opposed the resulting investment components of the ITO. As the U.S. National Foreign Trade Council commented, "[the investment] article not only affords no protection for foreign investments of the United States but it would leave them with less protection than they now enjoy" (Diebold 1952, 18). Opposition from American business to the investment articles of the Havana Charter proved a major reason for the ITO's failure to gain congressional support.

The ITO experience is important for two reasons. The failure of the ITO meant that there would be no international rules governing foreign direct investment. The GATT became the center of the trade system, and the GATT had little to say about foreign investment. More broadly, the failure of the ITO reflected a basic conflict that has dominated international discussions about rules regulating foreign direct investment regime to this day. Led by the United States, the advanced industrialized countries in their role as capital exporters have placed greatest emphasis on creating international rules that regulate host country behavior in order to protect the interests of their MNCs. Developing countries, in their role as capital importers, have placed greatest emphasis on creating international rules that regulate the behavior of MNCs in order to maintain control over their national economies. This basic conflict between the capital exporting countries and the capital importing countries has carried through more than 50 years of discussions about an international investment regime and has prevented agreement on any international investment rules.

During the 1960s and 1970s, developing countries largely set the agenda for international discussions about foreign direct investment. Working through the United Nations, the developing countries sought to create international investment rules that reflected their interests as capital importers. The effort to regulate MNCs became a central element of the New International Economic Order. Here, developing countries sought two broad objectives that were designed to "maximize the contributions of

TNCs to the economic and social development of the countries in which they operate" (Sauvant and Aranda 1994, 99). Developing countries sought international recognition of their right to exert full control over all economic activity within their territories. To this end, developing countries achieved a **United Nations Resolution on Permanent Sovereignty over Natural Resources** in 1962. This resolution recognized the right of host countries to exercise full control over their natural resources and over the foreign firms operating within their borders extracting these resources. The resolution affirmed the right of host country governments to expropriate foreign investments and to determine the appropriate compensation in the event of expropriation (de Rivero 1980, 92–93; Akehurst 1984, 93). The intent of this resolution, and the others that followed during the 1960s and 1970s was to shift the legal basis for compensation away from payment for the full value of the expropriated property to payment in line with what the expropriating government determined to be appropriate. As Akehurst (1984, 93) points out, this implied that compensation was likely to be quite low.

Developing countries also sought to write a code of conduct regulating MNC behavior. Such a code aimed to regulate MNC activity in five broad areas (Asante 1980, 124; de Rivero 1980, 95–96). First, the code would prevent MNC interference in the internal affairs of their host countries. Second, the code would regulate MNCs' economic activities within host countries to ensure that these activities conformed to governments' stated development objectives. Third, the code would ensure that technology and management skills were transferred to host countries on favorable terms. Fourth, the code would regulate the repatriation of MNC profits. Finally, the code would encourage MNCs to reinvest profits in the host countries. In short, the various components of the code were designed to ensure that MNCs would make as large a contribution as possible to the countries in which they operated. They would do so by ensuring that MNC activities "were compatible with the medium and long-term needs which the governments in the capital importing countries had identified in their development plans" (de Rivero 1980, 96).

The developing countries' efforts to write a code of conduct for MNCs, like the broader NIEO of which it formed one part, met opposition from the advanced industrialized countries. Whereas the developing countries wanted the code to be binding, the advanced industrialized countries pushed for a voluntary code. And whereas the developing countries wanted only to regulate MNCs, the capital exporting governments insisted that any code that regulated MNC behavior be accompanied by a code that regulated the behavior of host countries as well (Sauvant and Aranda 1994, 99). Governments worked on both codes throughout the late 1970s and early 1980s, completing drafts of both by 1982. The resulting codes were never implemented, however, but they were never formally rejected either. Instead, the codes remained in limbo for ten years until in 1992 a U.N. committee recommended that governments seek an alternative approach (Graham 1996, 78–79).

By the early 1980s, bargaining power in international negotiations was shifting back toward the advanced industrialized countries. The advanced industrialized countries, led by the United States, used this advantage to shift the agenda back toward regulations on host country government behavior. Some initial steps were taken during the Uruguay Round. Under pressure from the United States, Trade Related Investment Measures (TRIMs) were placed on the Uruguay Round agenda. A **Trade**

Related Investment Measure is a government policy toward foreign direct investment or MNCs that has an impact on the country's imports or exports. For example, domestic content or trade balancing requirements would force a firm to import fewer of its inputs or export more of its output than it would in the absence of such regulations. The result would be a distortion of international trade. In placing TRIMs on the GATT agenda, the United States sought to limit the ability of host country governments to use such measures. The United States sought a very expansive agreement that addressed 13 types of government policies that affected foreign investments, including domestic sales requirements, exchange restrictions, export requirements, investment incentives, licensing requirements, remittance restrictions, technology transfer requirements, and trade balancing requirements (Croome 1996). Such rules would restrict virtually all aspects of host country governments' efforts to manage inward investment. Many of the other advanced industrialized countries supported the U.S. effort, though they did not all share the American desire for such a far-reaching agreement. Japan most strongly supported the U.S. objectives. The EU proposed a shorter list of policy restrictions, and the Scandinavian countries wanted to restrict the agreement to domestic content and export performance requirements.

The developing countries, even those that were trying to attract foreign direct investment, strongly opposed the scope of American objectives. Most were reluctant to see TRIMs incorporated into the GATT at all. Developing countries' opposition was strongest among a group of large developing countries led by Argentina, Brazil, China, Egypt, India, and Nigeria. This group argued that "development considerations outweighed whatever adverse trade effects TRIMs might have, and that no new GATT provisions to regulate them were needed" (Croome 1995, 258). In contrast to the broad objectives sought by the advanced industrialized countries, this group wanted to restrict any final agreement to measures that addressed "the direct and significant adverse trade effects" of investment policies (Croome 1995, 259). Even there, the group wanted to limit the effect of such measures. They put forward a list of 13 development objectives that they claimed justified the use of investment measures. The only international restriction they proposed was a nonbinding approach that would encourage governments to "seek to avoid" using TRIMs in a way that distorted trade or caused injury to another GATT member.

A final, and somewhat limited agreement was eventually reached. Two changes made a final agreement possible. On the one hand, the advanced industrialized countries scaled back the scope of their demands, agreeing to focus on four investment measures: domestic content rules, trade-balancing measures under which a firm's input imports must be matched by exports, restrictive foreign exchange practices, and weak constraints on the ability to link investment incentives to export performance requirements. On the other hand, the attitudes of developing countries toward foreign direct investment had also changed greatly since the early 1980s. As we saw above, the late 1980s brought the progressive liberalization of developing countries' policies toward foreign direct investment, and a decrease of the nationalist, passionate, and anti-MNC feelings that had prevailed throughout the 1970s. This reduction of developing countries' governments' perceived need to regulate MNC activity at home translated into a greater willingness to accept international rules governing their behavior as host countries.

A Closer Look

Protecting Investment in NAFTA

The North American Free Trade Agreement contains the most fully developed rules of any international investment agreement. These rules are embodied in Chapter 11 of the free trade agreement and are based on five central principles (Graham 1996, 82–83). The principle of national treatment requires all political authorities—federal, state, provincial, and local—to treat all investors from other NAFTA countries no less favorably than they treat domestic investors. The principle of most favored nation ensures that no NAFTA government treats an investor from another NAFTA country less favorably than it treats investors from outside NAFTA. In addition, Chapter 11 prohibits new performance requirements and requires governments to phase out existing performance requirements. Governments are also prohibited from restricting the ability of a domestic affiliate of a foreign firm from converting its profits and other revenues into any currency it desires at the prevailing market rate of exchange. Finally, the agreement allows member governments to expropriate foreign investments only for a public purpose and in the event of such expropriation the investor must be compensated at fair market value.

Chapter 11 also establishes a mechanism to settle investment disputes. What is most distinctive about the settlement of investment disputes under NAFTA is that private investors can seek arbitration of a dispute with a NAFTA government. In most international economic agreements, disputes must be initiated and pursued by governments; private investors have no standing. In NAFTA, a corporation has the right to pursue a claim against a member government if a government policy that violates the rules embodied in Chapter 11 harms the investor's interests. In advancing a claim against a member government, an investor must first attempt to resolve the dispute through consultations. It may then pursue relief through the country's domestic courts or use binding arbitration under the United Nations Commission on International Trade Law (UNCITRAL) or the World Bank's International Centre for the Settlement of Investment Disputes (ICSID). Arbitration panels can award monetary compensation to the corporation or require the government to restore any property that has been expropriated. In no instance, however, can an arbitration panel require a government to rescind a policy measure.

Critics have pointed to substantive and procedural problems with NAFTA's Chapter 11 (see Public Citizen 2001; Bottari 2001). Considerable criticism has been directed at Article 1110, which requires governments to compensate investors for acts of expropriation. Controversy arises because the broad language of Article 1110 requires governments to compensate investors for policies that are "tantamount to" expropriation. "Corporations have used this provision to challenge or seek compensation for what are called 'regulatory takings'" (Bottari 2001, 4). A regulatory taking refers to cases in which a government regulation designed to protect the environment or promote some other public goal also substantially reduces the value of a property. Suppose, for example, that a landowner is prohibited from developing her property because it provides a habitat for a species protected by the Endangered Species Act. She might claim that the Endangered Species Act is "tantamount to expropriation" because it greatly reduces the market value of her land and restricts her

Continued

ability to use her property. Article 1110 allows corporations to seek monetary compensation from governments in such cases.

An American firm called the Ethyl Corporation initiated the first such case under NAFTA in 1996. The Ethyl Corporation produces a chemical called methylcyclopentadienyl manganese tricarbonyl, or MMT, that is added to gasoline to improve engine performance. The Ethyl Corporation exports MMT to Canada where Canadian refineries add it to gasoline sold in the Canadian market. In 1996, the Canadian parliament began debating legislation that would ban the import and inter-provincial transportation of MMT. If passed, this legislation would end Ethyl Corporation's exports to Canada. In September of 1996 the Ethyl Corporation notified the Canadian government that it was suing for $251 million compensation under Chapter 11. Ethyl Corporation claimed that the proposed ban violated Chapter 11 in many ways. Most important, Ethyl argued that by preventing Ethyl from continuing to profit from its exports to Canada the law would be tantamount to an expropriation of Ethyl's assets. An arbitration panel was created in UNCITRAL, but before this panel could issue a ruling the Canadian government settled the dispute. It opted not to ban MMT and paid Ethyl Corporation $16 million in legal fees and damages (Public Citizen 2001). Critics argue that this case shows how private corporations can use the "tantamount to" expropriation clause to reverse government regulations that promote public health and protect the environment.

Chapter 11 has also been criticized for the lack of accountability and transparency in its arbitration panels. The typical arbitration panel is composed of only three people selected in part by the parties to the dispute. In the ICSID, for example, the investor bringing the claim and the national government each select an arbitrator, and these two then select a third. The arbitration process is closed to public participation and little detail about the cases is provided. Moreover, there is no regularized process of appeal. "The almost complete lack of transparency and public participation . . . combined with the vast power of tribunals to grant an infinite amount of taxpayer dollars to corporations that successfully bring NAFTA suits, raise questions as to whether it is an appropriate venue for the arbitration of such significant issues of public concern" (Public Citizen 2001, 7).

The failure to achieve a more extensive agreement in the Uruguay Round led the advanced industrialized countries to begin negotiation on a **Multilateral Agreement on Investment** (MAI) in the OECD in May 1995. The OECD appeared to offer at least three advantages over the WTO as a forum for an investment agreement. Because OECD membership is restricted to the advanced industrialized countries, all of which shared a commitment in principle to a liberal regime for foreign direct investment, negotiations in the OECD seemed less likely to be blocked by conflicts among the participants than would negotiations in the WTO. Moreover, because about 65 percent of the world's FDI occurs within the advanced industrialized world, an agreement reached in the OECD would create rules that governed the majority of international investment. Finally, an OECD-based agreement would not preclude participation by developing countries. The agreement was envisaged as an instrument to which non-OECD governments could accede if they desired. The MAI was intended to promote further liberalization of foreign direct investment and to provide

greater security to foreign investors. Liberalization was to be achieved by basing the agreement on two central principles. The first was national treatment, which requires governments to treat foreign-owned firms operating in their economy no differently than domestic firms. The second principle was most favored nation, which required governments to treat the foreign firms from each party to the agreement on the same terms it accorded to firms from all other parties to the agreement. The two principles implied that governments could not discriminate against firms from any country in favor of domestic firms or foreign firms from other countries. To provide greater security to foreign investors, the agreement incorporated the historical standard governing expropriation, thereby codifying the right to prompt, effective, and adequate compensation. In addition, the draft agreement restricted the ability of governments to limit the ability of firms to remit profits, dividends, and proceeds from asset sales. The agreement was also to provide for a dispute settlement mechanism patterned on the NAFTA, which would allow for both state-to-state claims and firm-to-state claims.

Negotiations proved fruitless, however, due to conflict among OECD governments and to strong and vocal opposition from groups outside the process. Conflict among OECD governments slowed the negotiating process greatly, as governments first established the guidelines and then busied themselves writing exceptions to the general rules. The treaty's preamble contained 17 footnotes registering the concerns and qualifications of the governments (Kobrin 1998). By 1997, several hundred pages of exceptions had been attached by OECD governments covering the sale of farmland, cultural industries—film and television in particular—and government-sponsored investment promotion agencies (*The Economist* March 14, 1998, 81). The Clinton Administration pressed for the inclusion of labor and environmental standards, despite opposition from other OECD governments. Developing countries also began to express opposition to the emerging agreement. Developing countries' concerns echoed those they had advanced throughout the previous 30 years. The emerging treaty sought to regulate host country behavior and did nothing to regulate the behavior of the MNCs. Moreover, developing countries were concerned that a completed MAI would subsequently be used as a template for a wider investment agreement negotiated within the WTO. They would then be forced to accept in broad terms an investment regime that they had played no role in negotiating.

Perhaps the strongest opposition to the MAI came from an unexpected source: a large and vocal coalition of interest groups from across the world. Public opposition was sparked by the posting of the draft of the MAI on a website belonging to Public Citizen in February 1997 (Public Citizen is a nonprofit pubic interest group founded by Ralph Nader). The posting of the treaty was followed by the rapid emergence of a transnational coalition of interest groups opposed to the MAI. As Stephen Kobrin notes, "a coalition of strange bedfellows arose in opposition to the treaty, including the AFL-CIO, Amnesty International, Australian Conservation Foundation, Friends of the Earth, Public Citizen, Sierra Club, Third World Network, United Steelworkers of America, Western Governors' Association, and World Development Movement" (Kobrin 1998, 98). In all, it has been estimated that some 600 organizations in almost 70 countries spoke out against the proposed treaty (Kobrin 1998, 97). Interest group opposition focused on specific components of the proposed treaty and on broader concerns about globalization (Kobrin 1998). The specific concerns about the treaty included claims that while the MAI provided considerable rights to MNCs and imposed obligations on host countries, it provided no rights to host countries and imposed no obligations on MNCs concerning workers, consumers, or the environment. In addition, opponents argued that the treaty imposed too many constraints on the ability of national and local governments to regulate economic activity. Finally, opponents claimed that the dispute settlement mechanisms that were to be created as part of the agreement shifted power away from democratically elected national politicians to international bureaucrats with little accountability to the public. More broadly, opponents argued that the MAI was yet another development in the larger phenomenon of globalization that gave too much power to large corporations at the expense of labor and national sovereignty.

The combination of conflict among OECD governments about the specific contents of the treaty, opposition from developing countries outside the negotiations, and public opposition proved fatal. As opposition grew, progress in the negotiations slowed. In April 1997, the OECD announced that there would be a six-month pause. When negotiations resumed in October, the deadline for completion was pushed forward to May 1998. When this deadline passed without a completed treaty, the deadline was pushed forward again to May 1999. Meanwhile, opposition began to affect the negotiating governments. The New Zealand government stated that it would refuse to sign the treaty, and governments in France and the United Kingdom either withdrew their support completely or began to reconsider their position (Warkentin and Mingst 2000). Negotiations ceased in December 1998 without a final treaty.

Thus, although governments have spent almost 30 years negotiating rules to govern foreign direct investment—within the UN, within the GATT, and within the OECD—they have yet to conclude an extensive set of regulations. Conflict between the capital-exporting countries and the capital-importing countries over the basic purpose of such a regime is the primary reason for this lack of success. The two groups of countries have been unable to agree whether any such regime should regulate the behavior of host country governments, or the behavior of the MNCs. The obvious compromise, that international rules might usefully regulate both, has yet to materialize in a meaningful way. The more recent emergence of the antiglobalization campaign has added another obstacle on the already crowded path to the successful negotiation of a set of international rules through which to regulate foreign direct investment.

Conclusion

Multinational corporations are perhaps the most controversial aspect of the international economic system. Controversy over the role that MNCs play in the international economy arises from their size and from the nature of their managerial structure. As we have seen here, MNCs are very large firms that extend managerial control across borders and make decisions in reference to global strategies. This managerial and decision-making framework coexists somewhat uneasily with an international political system that remains organized around national governments controlling exclusive territorial domains. Because multinational corporations and governments pursue

independent objectives, there are times when the global strategies of these large firms come into conflict with the economic objectives of the governments that host them. MNCs, therefore, highlight the tensions between an emerging global economy and a fragmented international political system that continues to be organized around sovereign nation states.

Without exception, governments have responded to the challenges posed by MNCs by attempting to regulate their activities. As we have seen, governments have tried in some cases to harness multinationals to their development objectives, and in others have attempted to prevent foreign control of critical sectors of the national economy. And while developing countries have exerted greater energies in this effort than have governments in the advanced industrialized world, few advanced industrialized countries have been willing to abandon all efforts to regulate what foreign firms can and cannot own. Since the mid-1980s, the trend throughout the world has been toward greater liberalization, particularly in the developing world. Only time will tell if this trend is permanent, or if instead it represents yet another swing of the pendulum that seems to characterize developing countries' governments' relationship with the international economic system.

Perhaps the most surprising aspect of the political economy of multinational corporations, if not of the international economic system more broadly, is the absence of an international investment agreement. Unlike trade, there is no comprehensive set of multilateral rules governing foreign direct investment. As we have seen, this gap reflects a basic conflict between the capital-exporting countries and the capital-importing countries over what is to be regulated. Is it most important to regulate the behavior of host country governments towards the multinationals that invest in their countries, or is it most important to regulate the behavior of MNCs toward labor, the environment, local practices, and local politics in the host country? The inability of the advanced industrialized countries and the developing countries to agree upon an answer to this question, and the apparent unwillingness to compromise by regulating both, have thus far prevented the creation of comprehensive rules to regulate international investment.

Key Terms

Burke-Hartke Bill
Calvo Doctrine
Crowding Out
Exon-Florio Amendment
Export Processing Zones
Foreign Direct Investment
Horizontal Integration
Intangible Asset
Intra-firm Trade
Locational Advantages
Locational Incentives
Maquiladora Program
Market Imperfection
Multilateral Agreement on Investment
Nationalization
Obsolescing Bargain
Performance Requirement
Positive Externalities
Specific Asset
Trade Related Investment Measures
United Nations Resolution on Permanent Sovereignty over Natural Resources
Vertical Integration

Web Links

General information about MNCs: The United Nations Conference on Trade and Development publishes an annual volume, called *World Investment Report* that surveys trends in foreign direct investment. The full text of this publication, as well as other UNCTAD publications related to MNCs can be found at *http://www.unctad.org/wir/contents/wir01content.en.htm.*

The monthly periodical *Multinational Monitor* maintains a website from which you can access many of their articles. *http://www.essential.org/monitor/.*

The Electronic Development and Environment Information System (ELDIS), based at the Institute of Development Studies in Sussex, England, maintains a website with good links to information about MNCs. This page can be found at *http://www.ids.ac.uk/eldis/transnat/tnc_lele.htm.*

Information about the aborted Multilateral Agreement on Investment can still be found on the web at a few sites. Try:

Put together by students for a course at University of California, Irvine *http://darwin.bio.uci.edu/~sustain/issueguides/MAI/index.html.*

The Council of Canadians maintains a site with old press releases from their anti-MAI campaign in 1998–1999 as well as links and some publications at *http://www.canadians.org/campaigns/campaigns-mai.html.*

Public Citizen maintains a website dedicated to NAFTA's Chapter 11 and its possible extension to the Free trade Area of the Americas at *http://www.citizen.org/trade/nafta/CH_11/.*

A large amount of information about Chapter 11 cases as well as links to recent papers analyzing investment protection under NAFTA can be found at *http://www.naftaclaims.com.*

Suggestions for Further Reading

For a good introduction to the economics of multinational corporations see Richard E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge: Cambridge University Press, 1996).

The best single source on the history of multinational corporations is Geoffrey Jones, *The Evolution of International Business: An Introduction* (London: Routledge, 1996).

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CHAPTER 6

THE INTERNATIONAL MONETARY SYSTEM

The international monetary system facilitates international economic transactions. It does so by enabling people living in different countries to conduct trade and financial transactions with each other. In order to engage in international trade and finance, people must be able to determine international prices. Before purchasing foreign products, a person living in the United States must be able to determine what, for example, a good produced in Germany and priced in euros will cost in dollars. People must also be able to pay foreigners for the goods, services, and financial assets that they purchase from them. To purchase German goods, an American who earns dollars must have a way to pay a German producer in euros. Such international payments involve not only the physical transfer of money from one country to another, but also the exchange of one currency into another. Unless these functions are performed well, people will be unable to conduct international economic transactions.

Like the international trade system, the international monetary system is a political system—it provides rules governing exchange rates and other aspects of international monetary relations. The rules governing the international monetary system have changed greatly over the last 100 years. These changes are embodied in the shift from fixed exchange rates to floating exchange rates. Until the 1930s, the international monetary system was based on fixed exchange rates under the gold standard. Governments established a fixed price for their currencies in terms of gold and were committed to maintaining this gold price. Governments abandoned the gold standard following World War II, replacing it with a system of "fixed-but-adjustable" exchange rates. In the Bretton Woods system, as this postwar system was called, governments fixed their currencies to gold, but the rules allowed them to change these gold prices under a set of mutually agreed circumstances. The Bretton Woods system, therefore, added flexibility to the gold standard. But governments abandoned the Bretton Woods system as well, and since the mid-1970s, governments have selected whatever exchange rate arrangements best suit their needs. As a consequence, the world's principal currencies currently float against each other. Currencies have no fixed price against gold, and governments make only occasional attempts to influence their relative values. During

the last 100 years, therefore, the international monetary system has evolved from fixed to floating exchange rates.

This chapter explores the causes and consequences of this shift from fixed to floating exchange rates. In examining the *cause* of this shift, we place greatest emphasis on how governments have responded to an economic constraint imposed by the international monetary system. This constraint takes the form of a tradeoff between fixed exchange rates and domestic economic autonomy: governments must choose between maintaining a fixed exchange rate and managing domestic economic activity. In examining the *consequences* of the shift to floating exchange rates, we focus on the tremendous increase of international capital flows during the last 20 years. Capital flows have affected the operation of floating exchange rates in unexpected ways, with potentially harmful consequences for some elements of the international economy, and have complicated the prospect for reforming this system. As we will see, these two themes suggest that the shift from fixed to floating exchange rates has resulted from governments' unsuccessful efforts to reconcile exchange rate stability with domestic economic autonomy. When ultimately forced to choose between the two, governments opted for domestic economic autonomy and allowed their currencies to float. And while the contemporary system of floating exchange rates has not functioned smoothly, capital flows have further tightened the tradeoff, making systemic reform less likely.

THE INTERNATIONAL MONETARY SYSTEM

The international monetary system is a political system comprised of rules governing exchange rate arrangements and balance of payments adjustment. The international monetary system is also a network of economic relationships that limits the kinds of rules that governments can create and implement. To understand this constraint, imagine an architect who must heed the laws of physics when designing a building. If the architect elects to ignore these laws in pursuit of some aesthetic vision, the building will look beautiful on paper but will collapse under its own weight once built. The laws of physics thus limit the types of buildings that architects can successfully build. The same is the case with the international monetary system. Exchange rates and balance of payments adjustment obey economic laws. If governments elect to ignore these economic laws when creating an international monetary system, the system will collapse around them.

To understand international monetary systems, therefore, we must explore the underlying economic relationships that limit what governments can successfully create. We first examine the economics of exchange rate arrangements and describe how these arrangements have changed over the last 100 years. We then examine balance of payments adjustment and describe how the adjustment process has changed as well during the last century. Finally, we examine the link between exchange rates and balance of payments adjustment to highlight a tradeoff between exchange rate stability and domestic economic autonomy. This discussion highlights two historical trends within the international monetary system. First, during the last 100 years the international monetary system has moved progressively from fixed to flexible exchange rate arrangements, and from domestic to external balance of payments adjustment. Second, these changes

have resulted from changes in the way that governments have responded to the tradeoff between exchange rate stability and domestic economic autonomy.

The Exchange Rate System

An exchange rate is simply the price of one currency in terms of another. As I write this, for example, the dollar-yen exchange rate is 133.64, which means that one dollar will purchase 133.64 Japanese yen. A currency's exchange rate is determined by the interaction between the supply of and the demand for currencies in the **foreign exchange market,** the market in which the world's currencies are traded. When an American business needs yen to pay for goods imported from Japan, for example, it will go to the foreign exchange market and buy them. Thousands of such transactions undertaken by individuals, businesses, and governments each day—some looking to buy yen and sell dollars and others looking to sell yen and buy dollars—determine the price relationship between the dollar and the yen and among all of the world's currencies. Imbalances between the supply of and the demand for currencies in the foreign exchange market cause a currency's exchange rate to change. If more people want to buy than sell yen, for example, this excess demand will cause the yen to gain value, or appreciate. Conversely, if more people want to sell yen than buy yen, this excess supply will cause the yen to lose value, or depreciate.

An **exchange rate system** is a set of rules governing how much governments can allow their currencies to appreciate and depreciate in the foreign exchange market. There are two prototypical systems, a fixed exchange rate system and a floating exchange rate system. In a **fixed exchange rate system,** governments can allow only very small changes in their currency's exchange rate. In such a system, governments establish a fixed price for their currencies in terms of some external standard, such as gold or another country's currency. Under post-World War II arrangements, for example, the United States fixed the value of the dollar at $35 per ounce of gold. The government then maintains this fixed price by buying and selling currencies in the foreign exchange market. In order to engage in these transactions, governments will hold a stock of **foreign exchange reserves,** a term that refers to a government's holdings of other countries' currencies. If the dollar is selling below its fixed price against the yen in the foreign exchange market, for example, the U.S. government will sell yen that it is holding in its foreign exchange reserves and purchase dollars. These transactions will reduce the supply of dollars in the foreign exchange market, causing the dollar's value to rise. If the dollar is selling above its fixed price against the yen, the U.S. government must sell dollars and purchase yen. Such dollar sales increase the supply of dollars in the foreign exchange market, causing the dollar's value to fall. The yen it acquires then become part of the U.S. government's foreign exchange reserves. Such government purchases and sales of currencies in the foreign exchange market are called **foreign exchange market intervention.** In a fixed exchange rate system, the government must prevent its currency from changing value, and it does so by buying and selling currencies in the foreign exchange market.

In a **floating exchange rate system,** there is no rule limiting how much an exchange rate can move in the foreign exchange market. Governments do not maintain a fixed price for their currencies against gold or any other standard. Nor are governments

required to engage in foreign exchange market intervention to influence the value of their currency. Instead, the value of one currency in terms of another is determined purely by the interaction between supply and demand in the foreign exchange market. If demand for a currency in the market falls, that currency's exchange rate is allowed to depreciate. Conversely, if demand for a currency in the market increases, that currency's exchange rate is allowed to appreciate. In contrast to a fixed exchange rate system, therefore, a floating exchange rate system calls for very little government involvement in influencing the value of one currency in terms of another.

Fixed and floating exchange rate systems are not the only types of exchange rate system. Instead, each represents one end of a continuum between completely rigid and perfectly flexible exchange rates. Other types of exchange rate systems lie between these two extremes. Some are essentially fixed exchange rate systems that provide a bit of exchange rate flexibility. In a **fixed-but-adjustable exchange rate system,** the system that lay at the center of the post-World War II monetary system and the European Union's regional exchange rate system between 1979 and 1999, currencies are given a fixed exchange rate against some standard and governments are required to maintain this exchange rate. However, the rules allow governments to change this fixed price occasionally, usually under a set of well-defined circumstances. Other systems lie closer to the floating exchange rate end of the continuum, but provide a bit more stability to exchange rates than a pure float. In a **managed float,** which perhaps most accurately characterizes the current international monetary system, governments do not allow their currencies to float freely. Instead, they intervene in the foreign exchange market to influence their currency's value against other currencies. However, there are usually no rules governing when such intervention will occur, and governments do not commit themselves to maintaining a specific fixed price against other currencies or an external standard. Because all exchange rate systems fall somewhere between the two extremes, one can usefully distinguish between exchange rate systems on the basis of how much exchange rate flexibility or rigidity they entail.

During the last 100 years the arrangements governing the international monetary system have shifted along this continuum from rigidly fixed exchange rates to more flexible exchange rates. In the nineteenth and early twentieth century, governments maintained rigidly fixed exchange rates under the gold standard. In this system governments established a fixed price for their currency in terms of gold and intervened in the foreign exchange market to maintain this price. Following World War II, governments abandoned the fixed exchange rates of the gold standard in favor of fixed-but-adjustable exchange rates. Known as the **Bretton Woods system,** this system required each government to establish a fixed price for their currency in terms of gold (called a central parity). Each government then committed itself to allowing its currency to move no more than 1 percent above or below this central parity. Governments were allowed to alter their central parity—to reduce or raise the value of their currency in terms of gold—when they faced a particular set of economic conditions (that we will study later in this chapter). Governments abandoned the Bretton Woods system in the early 1970s and since that time they have been allowed to choose almost any exchange rate arrangement they desire (the one exception is that governments are prohibited from fixing their currency to gold) (Dam 1982, 271). As a result, the contemporary international monetary system is characterized by a combination of floating

exchange rates, managed floats, fixed-but-adjustable exchange rates, and permanently fixed exchange rates. However, the world's most important currencies—the dollar, the yen, and the euro—float against each other.

Balance of Payments Adjustment

Balance of payments adjustment refers to policy measures and economic processes that eliminate imbalances in countries' international trade and financial positions. Understanding precisely what this means requires some prior knowledge about a country's balance of payments and the characteristics of balance of payments imbalances. We begin our discussion therefore by looking in some detail at the balance of payments, and then we examine the three principal mechanisms through which balance of payments imbalances can be eliminated.

The **balance of payments** registers a country's transactions with all other countries in a given year. Table 6.1 presents the United States' balance of payments for 2000. The balance of payments is divided into two broad categories: the current account and the capital account. The **current account** records all current payments made by and to the country in connection with international transactions. The current account divides these international transactions into four sub-categories. The *trade account* registers all payments made in connection with imports and exports of goods such as manufactured items and agricultural products. The *service account* registers all payments made in connection with imports and exports of service sector activities such as banking services, insurance, consulting, transportation, tourism, and construction. The *income account* registers all payments coming into and going out of the United States in connection with royalties, licensing fees, interest payments, and profits. Finally, the *unilateral transfers account* registers all unilateral transfers from the United States to other countries and vice versa. This account includes such things as wages earned in the United States by immigrants that are sent to families in the home country, gifts, and foreign aid expenditures by the U.S. government. Payments in any of these categories by the United States to the rest of the world are recorded as debit items, while payments by the rest of the world to the United States are recorded as credit items. Debit items are balanced against credit items to produce a *current account balance*. In 2000, the United States ran a current account deficit of almost $444.7 billion. In other words, payments by American residents to foreigners were $444.7 billion greater than foreigners' payments to American residents.

The **capital account** registers financial flows between the United States and the rest of the world. Any time an American resident purchases a financial asset—a foreign stock, a bond, or even a factory—in another country, this expenditure is registered as a capital outflow. Each time a foreigner purchases an American financial asset the expenditure is registered as a capital inflow. Capital outflows are registered as negative items while capital inflows are registered as positive items in the capital account. In 2000, American residents other than the U.S. government purchased almost $580 billion worth of foreign financial assets, while foreigners purchased more than $1 trillion of American financial assets. Capital outflows are set against capital inflows to produce a capital account balance. In 2000, the U.S. capital account balance was

Table 6.1
U.S. Balance of Payments, 2000
(Millions of U.S. Dollars)

Current Account	
Trade in Goods	
Imports	–1,224,417
Exports	772,210
Trade in Services	
Net Military Transactions	500
Net Travel and Transportation Receipts	3,180
Other Services, net	72,788
Balance on Goods and Services	**–375,739**
Income Receipts	352,866
Income Payments	–367,658
Balance on Income	**–14,792**
Unilateral Transfers, net	–54,136
Balance on Current Account	**–444,667**
Capital Account	
Total U.S. Owned Assets Abroad	**–580,952**
U.S. Official Reserve Assets	–290
Other U.S. Government Assets	–944
U.S. Private Assets	–579,718
Foreign Owned Assets in the United States	**1,024,218**
Foreign Official Assets	37,619
Other Foreign Assets	986,599
Balance on Capital Account	**443,266**
Overall Balance (Statistical Discrepancy)	**–1,401**

Source: Economic Report of the President 2002.

$443.3 billion. A country's overall balance of payments position is determined by adding the current account and the capital account together to produce a net external position. In 2000, the United States ran an overall balance of payments deficit of $1.4 billion.

Any country's current and capital accounts should be mirror images of each other. That is, when a country runs a current account deficit it must run a capital account surplus. Conversely, when a country runs a current account surplus it must run a capital account deficit. Grasping why this relationship must exist is easiest in the case of a country with a current account deficit. The presence of a current account deficit means that a country's total expenditures in a given year—expenditures on goods and services, on investments in factories and houses, and on all other domestic as well as

foreign products—are larger than its total income in that year. In the case of the United States, this means that in 1999 American residents as a group spent $331.5 billion more than they earned in income. Residents of one country can spend more in a given year than they earn only if residents of other countries are willing to lend them a portion of their income. The capital account surplus that accompanies the current account deficit, in other words, finances the deficit country's expenditures in excess of income. If people in other countries are unwilling to advance loans, the country will be unable to spend more than it earns and thus cannot have a current account deficit. To understand why a country that has a current account surplus must have a capital account deficit, imagine that there are only two countries in the world: the United States, which has a current account deficit, and the World which, by definition, has a current account surplus with the United States. The World can have a current account surplus with the United States only if it is willing to lend money to American residents. Otherwise, Americans can't buy the World's goods, and the World's current account surplus will disappear. Thus, a country that has a current account surplus must also have a capital account deficit. Because the current and capital accounts must be mirror images of each other, the emergence of a large current account imbalance in one country will always be accompanied by large offsetting imbalances in other countries. During the last 20 years, for example, large American current account deficits have been accompanied by large current account surpluses in Japan and, for part of the period, Germany.

While the current and capital accounts must balance each other, there is no assurance that the hundreds of thousands of uncoordinated international transactions that private individuals and businesses conduct every year will necessarily produce this balance. When they don't, the country will face a balance of payments imbalance. Such an imbalance can take the form of a balance of payments deficit, in which the current account deficit is greater than the capital account surplus, or it can take the form of a balance of payments surplus, which occurs when the current account surplus is less than the capital account deficit. When such imbalances arise, countries must undergo **balance of payments adjustment.** Balance of payments adjustment entails using government policies to correct a balance of payments deficit or surplus. Governments can adjust their balance of payments position in three different ways. The simplest approach is to restrict international transactions. A government facing a deficit can reduce imports by raising tariffs or imposing quotas, for example. Using trade barriers to eliminate an external imbalance is inconsistent with the spirit of the WTO, though GATT rules do allow governments to suspend trade-liberalizing measures when confronting a large balance of payments deficit. Ideally, however, the international monetary system should promote balance of payments adjustment through other channels.

Two other channels are available. Countries can adjust by changing their exchange rate. A country with a deficit can devalue its currency, that is, it can reduce the price of its currency in terms of other currencies. Currency **devaluation** reduces the price of the devaluing country's goods in foreign markets and raises the domestic currency price of foreign goods in the devaluing country's market. A 10 percent devaluation of the dollar against the euro, for example, will reduce the price that EU residents pay for goods produced in the United States by 10 percent and it will raise the price that Americans pay for EU goods by 10 percent. By making American products

cheaper and EU goods more expensive, devaluation should cause American imports from the EU to fall and American exports to the EU to rise. Conversely, a country with a surplus can revalue is currency. Currency **revaluation** raises the price of a currency in terms of other currencies. Revaluation raises the foreign price of domestic goods and lowers the domestic price of foreign goods. In this case, imports will rise and exports will fall. While less disruptive than trade restrictions, frequent exchange rate changes can heighten uncertainty and depress international trade and investment.

Finally, countries can adjust by changing domestic economic activity. This method of adjustment requires a government to use macroeconomic policy to influence domestic economic conditions. **Macroeconomic policy** refers to efforts by the government to influence aggregate economic activity in the national economy, such as the rate of economic growth, the rate of inflation, and the level of unemployment. Governments use two principal policy instruments, fiscal policy and monetary policy, to try to influence these elements of national economic performance. **Fiscal policy** refers to the tax and spending measures the government adopts. An expansionary fiscal policy, such as a tax cut or additional spending, can raise the rate of growth and reduce unemployment. A restrictive fiscal policy, such as a reduction in government expenditures or a tax increase, will most often slow the rate of economic growth and raise unemployment. **Monetary policy,** which is conducted by the nation's central bank, influences the country's money supply and interest rates. An expansionary monetary policy, which reduces interest rates and increases the money supply, can boost economic growth and reduce unemployment, but will also raise inflation. A restrictive monetary policy will have the opposite effect, slowing economic growth, raising unemployment, and lowering the rate of inflation.

In order for domestic adjustment to work, governments must use macroeconomic policy to alter domestic economic activity in ways that eliminate a balance of payments imbalance. If the country has a balance of payments deficit, the government must tighten monetary and fiscal policy. Interest rates must rise and the government must spend less or tax more in order to restrain economic growth. By slowing domestic economic activity, restrictive macroeconomic policies will reduce the country's demand for imports, increase the amount of goods available for export, and attract foreign capital into the country. These dynamics will eliminate the balance of payments deficit. Conversely, if the country has a balance of payments surplus, the government must expand monetary and fiscal policy. Interest rates must fall and the government must spend more or tax less in order to boost economic growth. More rapid growth will increase the domestic demand for imports, reduce exports, and encourage domestic capital to flow abroad. These dynamics will eliminate the surplus. While using macroeconomic policies to promote adjustment has few negative consequences for the international economy, it does have a substantial impact on the domestic economy. Countries with balance of payments deficits will have to accept higher unemployment as they adjust while countries with surpluses will be forced to accept higher inflation as they adjust.

Two final points about the politics of balance of payments adjustment are worth emphasis. First, deficit and surplus countries face asymmetric economic pressures to adjust. As we saw above, a balance of payments deficit means that a country's residents are spending more than the sum of their total income and the loans they can attract

from other countries. Because it is impossible for a country to spend more than its income and available credit, countries with balance of payments deficits face inescapable pressures to eliminate the imbalance. Surplus countries face less pressure to adjust. A balance of payments surplus means that the country as a whole is spending less than its total income. A surplus thus does not erode a country's foreign exchange reserves, and the country will face less economic pressure to eliminate its surpluses. Second, because a surplus in one country or in a group of countries is the necessary counterpart of a deficit in another country, the adjustment of one imbalance will eliminate its counterpart as well. Any time an imbalance arises, therefore, the question of who should bear the cost of adjustment—the country with the deficit or the country with the surplus—arises as well. This can generate political conflict in the international monetary system as governments with deficits seek to push the burden of adjustment onto surplus countries, while governments with surpluses try to push the burden onto deficit countries. As we shall see, conflict over who adjusts has been at the center of the international monetary system throughout the last 100 years.

The principal adjustment mechanism at the center of the international monetary system has changed substantially during the last 100 years. In the gold standard of the nineteenth and early twentieth centuries, exchange rates were permanently fixed to gold and adjustment could only occur through changes in domestic economic activity. In the Bretton Woods system, balance of payments adjustment was supposed to occur through a combination of changes in domestic economic activity and changes in exchange rates. In the contemporary monetary system, the advanced industrialized countries rely primarily upon exchange rate changes to promote balance of payments adjustment, and only in extreme cases do they alter domestic economic activity to eliminate external imbalances. During the last 100 years, therefore, the balance of payments adjustment mechanism has shifted from one based almost exclusively on changes in domestic economic activity to one based almost exclusively on changes in exchange rates.

The Tradeoff between Exchange Rate Stability and Domestic Autonomy

The international monetary system has thus shifted during the last century from a system based on fixed exchange rates and domestic adjustment to one based on floating exchange rates and exchange rate adjustment. These two components of the international monetary system have changed together because the choice of how to adjust balance of payments imbalances and the choice between a fixed or floating exchange rate are inextricably linked. If a government wants a fixed exchange rate it must adjust by using macroeconomic policy to induce changes in the domestic economy. If the government is unwilling to use macroeconomic policy to eliminate a balance of payments imbalance, it will not be able to maintain a fixed exchange rate for any extended period of time. Governments thus face a tradeoff between the ability to maintain a fixed exchange rate on the one hand and the ability to use macroeconomic policy to manage the domestic economy on the other. This tradeoff has been central to the evolution of the international monetary system. It is important, therefore, to understand why this tradeoff exists.

The tradeoff originates in the way that balance of payments imbalances affect exchange rates in the foreign exchange market. As we saw above, people living in one

country buy foreign currencies to pay for the goods, services, and financial assets they buy from foreigners. As a consequence, a balance of payments imbalance between two countries necessarily gives rise to an imbalance between the supply of and the demand for these two currencies in the foreign exchange market. To make this less abstract, let's imagine there are only two countries in the world, the United States and Japan, and to simplify further let's assume that there are no international capital flows. Suppose then that the United States has purchased 800 billion yen worth of goods from Japan, while Japan has purchased $4 billion worth of goods from the United States. Moreover, the two countries are trying to maintain a fixed exchange rate: $1 equals 100 yen. In this example, then, American residents need 800 billion yen to pay Japanese firms for all of the goods they have imported from Japan. To acquire this many yen, they must sell $8 billion. Japanese residents need $4 billion to pay American firms for all of the goods they have imported from the United States, which they can acquire by selling 400 billion yen. The imbalance in U.S.-Japanese trade has thus given rise to an imbalance in the foreign exchange market: American residents are selling more dollars than Japanese residents are willing to buy, and Japanese residents are selling fewer yen than American residents need to buy. This imbalance puts pressure on the dollar to depreciate against the yen.

When the yen-dollar exchange rate is fixed, however, as it is in our example, then either the United States or the Japanese government must intervene in the foreign exchange market to prevent this imbalance from causing the currencies to change in value. Who should intervene is unclear—the Japanese government could prevent the yen from appreciating by selling yen and buying dollars, or the U.S. government could prevent the dollar from depreciating by buying dollars and selling yen. Thus, just as it is unclear which country should adjust to eliminate a balance of payments imbalance, it is unclear which government should intervene in support of the fixed exchange rate. Suppose the U.S. government intervenes, selling yen it holds in its foreign exchange reserves and buying dollars. This intervention eliminates the imbalance in the foreign exchange market as the U.S. government provides the 400 billion yen that American residents need and removes the $4 billion that Japanese residents do not want. This intervention also initiates the domestic economic adjustments that will eliminate the American current account deficit. By intervening in the foreign exchange market, the United States is using monetary policy, and the effect in this case is to reduce the U.S. money supply. In selling the 400 billion yen, the United States acquires $4 billion from American residents. These dollars go into the Federal Reserve Bank's coffers and are therefore taken out of circulation. This reduction in the money supply causes interest rates to rise, and this in turn causes economic growth to slow. As economic growth slows, the United States will import less from Japan, thereby correcting the balance of payments deficit. Foreign exchange market intervention in support of a fixed exchange rate thus sets in motion the domestic economic adjustments necessary to eliminate the underlying balance of payments imbalance.

A government will be unable to maintain a fixed exchange rate if it is unwilling to accept the domestic economic adjustments caused by foreign exchange market intervention. Suppose the U.S. government does not allow foreign exchange market intervention to alter the American money supply. Suppose instead that it engages in a

practice called sterilized intervention. In **sterilized intervention** a government first intervenes in the foreign exchange market and then reverses these operations in the domestic securities market. In our example, this means that the United States first buys $4 billion in the foreign exchange market and then buys $4 billion worth of Treasury securities from individuals in the securities market in order to inject $4 billion back into the American money supply. The net effect of these two central bank operations on the U.S. money supply is zero. Since sterilized intervention does not reduce the money supply economic growth remains strong. Consequently, American residents continue to purchase large numbers of Japanese goods, and the United States continues to run a current account deficit. This deficit continues to create an imbalance in the foreign exchange market that the United States must correct through further intervention that is again sterilized. Now, clearly at some point the U.S. government must run out of yen that it can use to buy dollars in the foreign exchange market. When it does, it will have to suspend its intervention and allow the dollar to depreciate. So we see that if the United States is unwilling to allow foreign exchange market intervention to alter its money supply, it can maintain a fixed exchange rate for only as long as its foreign exchange reserves last. More broadly, we see that a government will not be able to maintain a fixed exchange rate for any extended period of time if it is unwilling to accept the domestic economic adjustments needed to eliminate a balance of payments imbalance.

Governments thus face a tradeoff between exchange rate stability and domestic economic autonomy in the international monetary system. If a government wants to use macroeconomic policy to manage domestic economic activity, it will be unable to maintain a fixed exchange rate. Conversely, if a government wants to maintain a fixed exchange rate, it will be unable to use macroeconomic policy to manage the domestic economy. This tradeoff between a fixed exchange rate and the ability to use macroeconomic policy to manage the domestic economy has been central to the changes in the international monetary system that have occurred over the last 100 years. We turn now to look more closely at these changes.

The Bretton Woods System

Governments embarked on an ambitious and ultimately unsuccessful attempt to create an innovative international monetary system following the Second World War. Drawing lessons from their experiences during the interwar period, governments made exchange rates a matter of international cooperation and regulation for the first time in history. Here we examine this effort, focusing on why governments attempted to alter the international monetary system, how this system differed from earlier monetary systems, and why this system ultimately failed. American and British policymakers began planning for the postwar monetary system in the early 1940s. Harry Dexter White, an economist working at the United States Treasury, developed an American plan, while John M. Keynes, an economist who was advising the British Treasury, developed a British plan. Bilateral consultations yielded a joint U.S.-British plan that was published in 1943. This "Joint Statement," as the plan was called, served as the basis for the Articles of Agreement that emerged from a multilateral conference attended

by 44 countries in Bretton Woods, New Hampshire, in 1944. The international monetary system they created, called the Bretton Woods system, was based on an explicit code of conduct for international monetary relations and an institutional structure centered on the International Monetary Fund (IMF).

The Bretton Woods system had a relatively short life. It was not fully implemented until 1959, and by the early 1960s it was beginning to experience the stresses and strains that brought about its collapse in the early 1970s. While many factors contributed to its disintegration, the most important weakness was its failure to promote balance of payments adjustment. The Bretton Woods system was supposed to promote adjustment through a combination of exchange rate changes and domestic economic adjustment. In practice, however, governments proved reluctant to use either adjustment mechanism. As a result, large balance of payments imbalances, particularly in the United States, placed mounting stress on the system of fixed exchange rates. The stress ultimately proved too much for the system to bear, and currencies were torn from their fixed exchange rates in the early 1970s in a wave of crises.

Creating the Bretton Woods System

In creating the Bretton Woods system, American and British policymakers faced a fundamental challenge. They sought to create a system of fixed exchange rates in a world in which governments were unwilling to use macroeconomic policy to eliminate balance of payments imbalances. Governments first became reluctant to correct balance of payments imbalances through changes in domestic economic activity during the 1920s. This reluctance stemmed from a shift in the balance of political power within European political systems following the First World War. We will explore these developments in greater detail in Chapter 7 when we focus on the domestic politics of exchange rate policy. For now we note only that the growing strength of labor unions and the emergence of mass-based democracies throughout Europe made governments reluctant to accept the higher unemployment caused by domestic adjustment to a balance of payments deficit. In this new political environment, a government's ability to maintain political power came to depend in part on its ability to deliver strong economic performance: causing unemployment to rise in order to eliminate a balance of payments deficit was a sure recipe for being thrown out of office. Thus, when governments confronted large balance of payments deficits that required them to choose between devaluing their currency and accepting higher unemployment, domestic politics created powerful incentives to devalue. When faced with just this choice in the early 1930s, most European governments abandoned the gold standard and floated their currencies.

The emergence of domestic political constraints on balance of payments adjustment meant that returning to a system of rigidly fixed exchange rates like the gold standard following World War II was impossible. But floating exchange rates were no more acceptable. American and British officials believed that the experiment with floating exchange rates following the collapse of the gold standard in the 1930s had been disastrous and their dissatisfaction was shared by the broader international community. As an influential study published by the League of Nations in 1944 summarized, "If there is anything that the interwar experience has demonstrated, it is that

[currencies] cannot be left free to fluctuate from day to day under the influence of market supply and demand" (quoted in Dam 1982, 61). In creating the Bretton Woods system, therefore, American and British officials worked to design a system that would both provide a high degree of exchange rate stability *and* minimize the need for domestic economic adjustment. To these ends, the Bretton Woods system included four innovative features: greater exchange rate flexibility, capital controls, a stabilization fund, and the International Monetary Fund.

The first innovation over previous international monetary systems was the decision to explicitly incorporate exchange rate flexibility into the Bretton Woods system. Unwilling to embrace freely floating exchange rates, and yet also aware that most governments were unwilling to accept the domestic adjustments necessary to sustain a system of rigidly fixed exchange rates, American and British planners sought middle ground in a system of fixed-but-adjustable exchange rates. In the fixed-but-adjustable exchange rate system each government established a central parity for its currency against gold, but could change this gold price when facing a fundamental disequilibrium. A **fundamental disequilibrium** was the term applied to cases of extremely large balance of payments imbalances. While the precise criteria of a fundamental disequilibrium were never defined, it was generally accepted that the term referred to balance of payments imbalances that were so large that pursuing domestic adjustment alone would be inordinately painful. In such instances, governments would be allowed to devalue their currency. Thus, exchange rates would be fixed on a day-to-day basis, but governments would be able to devalue or revalue when they needed to correct a large external imbalance. Incorporating exchange rate flexibility in this manner would reduce the need for domestic adjustment while still providing very stable exchange rates.

The second innovation of the Bretton Woods system was the decision to allow governments to limit international capital flows. During the nineteenth and early twentieth centuries, governments had made little effort to control international capital movements. In theory, capital flows are an important component of the international economy. They allow countries to finance current account imbalances and to use foreign funds to finance productive investment. Many governments believed, however, that capital flows had destabilized exchange rates during the interwar period. Large volumes of capital had crossed borders, only to be brought back to the home country at the first sign of economic difficulty in the host country. This resulted in "disequilibrating" capital flows in which countries with current account deficits shipped capital to countries with current account surpluses rather than the "equilibrating" flows from surplus to deficit countries that were required to finance the underlying current account deficits. Governments were unwilling to maintain fixed exchange rates in the face of these capital outflows because they generated large balance of payments deficits that called for large domestic economic adjustments. Following the collapse of the gold standard in the early 1930s, most governments had adopted exchange restrictions to limit capital flows. **Exchange restrictions** are government regulations on the use of foreign exchange. In the most restrictive regimes, the central bank will establish a monopoly on foreign exchange. Any private actor wanting to acquire foreign currencies or wanting to exchange foreign currency into the domestic currency must go through the central bank. The central bank can then restrict the types of transactions for which it is willing to exchange currencies. It might, for example, refuse to supply foreign currency to a domestic resident who wants to buy financial assets in a foreign country. It might refuse to supply domestic currency in exchange for a foreign currency to a person who wants to buy domestic financial assets. By controlling purchases and sales of foreign exchange in this manner, governments can limit financial capital flows into and out of the domestic economy.

In planning the Bretton Woods system, the question was whether to allow governments to retain such exchange restrictions following the war. American policymakers wanted most such restrictions eliminated in order to restore liberal international capital markets. Most other governments wanted to retain restrictions on capital flows. Keynes, for example, believed that it was "vital" to "have a means . . . of controlling short-term speculative movements of flights of currency" (cited in Dam 1982, 98). In the absence of such controls, Keynes argued, exchange rates would be vulnerable to speculative attacks that would drive governments to float their currencies, just as had happened in the interwar period. In other words, Keynes believed that maintaining the system of fixed-but-adjustable exchange rates required governments to restrict international capital flows. Keynes' position carried the day. While the Articles of Agreement required governments to remove all restrictions on their residents' ability to convert the domestic currency into foreign currencies in order to settle current account transactions, they allowed (but did not require) governments to restrict the convertibility of their currency for capital account transactions. Most governments elected to take advantage of this right, and as a consequence international capital flows were tightly restricted until the late 1970s.

The decision to create a stabilization fund was the third innovation in the Bretton Woods system. A **stabilization fund** is a credit mechanism consisting of a pool of currencies that can be loaned to governments facing balance of payments deficits. Each country that participated in the Bretton Woods system was assigned a share of the total fund (called a quota), the size of which corresponded to its relative size in the global economy. Each country then contributed to the fund in the amount of its quota, paying 25 percent in gold and the remaining 75 percent in its national currency. These contributions produced a pool of credit that member governments could draw from when they faced balance of payments deficits. As the world's largest economy, the United States had the largest quota, with a contribution of $2.75 billion. Britain had the second largest quota, with a contribution of $1.3 billion. Other governments had much smaller quotas; France, for example, had a quota of only $450 million, while Panama's was only $0.5 million. In 1944, the stabilization fund held a total of $8.8 billion. When a government's foreign exchange reserves were insufficient to cover a small deficit, it could draw the currencies it needed from the stabilization fund. This credit mechanism would make it unnecessary for governments to respond to small balance of payments deficits by devaluing their currency or by imposing barriers to imports (De Vries and Horsefield 1969, 23–24).

The final innovation of the Bretton Woods system was an international organization, the International Monetary Fund (IMF). Governments established the IMF to monitor member countries' macroeconomic policies and balance of payments positions, to decide when devaluation was warranted, and to mange the stabilization fund. Governments needed the IMF to monitor each other's behavior in order to limit two kinds of opportunistic behavior in the Bretton Woods system. First, the exchange rate

system created the potential for competitive devaluations. Because devaluation reduces the price of a country's goods in world markets, it was feared that a government would devalue its currency to enhance the competitiveness of its exports. If one government devalued in an attempt to boost exports, other governments would be likely to devalue in response. This concern was generated by the interwar period, during which governments were believed to have pursued competitive devaluations in an attempt to capture export markets from other nations (Dam 1982, 63–64). Thus, governments wanted to determine collectively when devaluation by a particular country was warranted and when it was not.

Second, governments had incentives to abuse the stabilization fund. Easy access to the credit available in the fund might encourage governments to run large balance of payments deficits. Governments could stimulate the domestic economy, import more than they export, and then turn to the stabilization fund to finance the balance of payments deficit that resulted. If all governments pursued such policies, the stabilization fund would be quickly exhausted and governments would be left with large external deficits that they could no longer finance. Governments would then abandon fixed exchange rates and perhaps restrict imports. Thus, the successful operation of the stabilization fund required some way to prevent governments from continuously financing external deficits with fund resources.

Governments attempted to limit the possibilities for these two kinds of opportunistic behavior by giving the International Monetary Fund (IMF) some authority over exchange rate changes and full control over access to the stabilization fund. For exchange rate changes, the Articles of Agreement specified that governments were to devalue or revalue their currencies only after consultation with the IMF. The IMF was to evaluate the country's balance of payments position and express either agreement with or opposition to the government's claim that it was facing a fundamental disequilibrium. If the IMF opposed the proposed devaluation, the government could still devalue, but it would not be allowed to draw from the stabilization fund (Dam 1982, 90). The IMF also controlled access to the stabilization fund. The IMF's rules limited the total amount that a government could borrow to 25 percent of its quota per year, up to a maximum of 200 percent of its quota at any one time. It was agreed, however, that governments would not have automatic access to these funds. Each member government's quota is divided into four *credit tranches* of equal size, and drawings from each *tranche* require approval by the IMF's Executive Board. Approval for drawings on the first *tranche* is automatic, as they represent borrowings against the gold that each member has paid into the stabilization fund. Drawing on the higher credit *tranches*, however, is subject to something called conditionality. **Conditionality** requires a member government to reach agreement with the IMF on the measures it will take to correct its balance of payments deficit before it can draw on its higher credit *tranches*. Conditionality agreements typically require governments to reduce the growth of the money supply and to reduce government spending. Conditionality thus forces governments to correct the domestic economic imbalances that cause their balance of payments problems. The practice of IMF conditionality is controversial, and we will return to it in greater detail in Chapter 8.

The Bretton Woods system thus represented an attempt to create an international monetary system that would reconcile fixed exchange rates and domestic

A Closer Look

The International Monetary Fund

The International Monetary Fund is based in Washington, D.C. It has a staff of about 2,300, most of whom are professional economists, a membership of 183 countries, and controls $272 billion that it can lend to member governments facing balance of payments deficits. Two ruling bodies, the Board of Governors and the Executive Board, make decisions within the IMF. The **Board of Governors** sits at the top of the IMF decision-making process. Each country that is a member of the IMF appoints one official to the Board of Governors. Typically, the country's central bank president or finance minister will serve in this capacity. The Board of Governors meets only once a year, however, and therefore almost all IMF decisions are actually made by the Executive Board. The **Executive Board** is composed of 24 executive directors, each of which is appointed by IMF member governments. Eight countries (the United States, Great Britain, France, Germany, Japan, China, Russia, and Saudi Arabia) appoint an executive director to represent its interest directly. The other 16 executive directors represent groups of IMF member countries. For example, Pier Carlo Padoan (an Italian) is currently the executive director representing Albania, Greece, Italy, Malta, Portugal, and Spain. Vijay L. Kelkar (from India) is currently the executive director representing Bangladesh, Bhutan, India, and Sri Lanka. The countries belonging to each group jointly select the executive director who represents them. A managing director appointed by the Executive Board chairs the Executive Board. Traditionally, the managing director has been a European (or at least non-American).

Voting in the Board of Governors and the Executive Board is based on a weighted voting scheme. The number of votes each country has is based on the size of its quota in the stabilization fund. The United States, which has the largest quota, currently has 371,743 votes (17.16 percent of total votes). Palau, which has the smallest quota, currently has only 272 votes (.002 percent of total votes). Many important decisions require an 85 percent majority. As a result, both the United States, with 17 percent of total votes, and the EU (when its member governments can act jointly), with more than 16 percent of the total vote, can veto important IMF decisions. As a block, developing countries also control votes sufficient to veto IMF decisions. Exercising this developing-country veto requires a level of collective action that is not easily achieved, however. In contrast with other international organizations, therefore, the IMF is not based on the principle of "one country, one vote." Instead, it is based on the principle that the countries that contribute more to the stabilization fund have a greater say over how this fund is used. In practice, this means that the advanced industrialized countries have much greater influence over IMF decisions than developing countries.

IMF lending is based on a practice called conditionality. **Conditionality** means that the ability to borrow is conditional upon the government's willingness to agree to and implement a package of policy reforms. The precise content of these reforms is formulated by the borrowing government in consultation with IMF officials, and then presented to the Executive Board in what is called a **letter of intent.** The Executive Board must then approve the letter of intent. Once such approval has been given, the loan is released in phased installments as the borrowing government implements the economic program embodied in the letter of intent.

Continued

The IMF lends to its members under a number of different programs, each of which is designed to address different problems and carries different terms for repayments.

- Stand-by Arrangements are used to address short-term balance of payments problems. This is the most widely used IMF program. The typical stand-by arrangement lasts 12–18 months. Governments can take as long as five years to repay loans under this program, but the expectation is that loans will be repaid within two to four years.
- The Extended Fund Facility was created in 1974 to help countries address more protracted balance of payments problems with roots in the structure of the economy. The typical arrangement under this program is thus twice as long as a stand-by arrangement (three years). Moreover, governments can take as long as ten years to repay loans under this program, but the expectation is that the loan will be repaid within 4.5 to 7 years.
- The Poverty Reduction and Growth Facility (PRGF) was established in 1999. Until that time, the IMF had provided financial assistance to low-income countries through a program called the Enhanced Structural Adjustment Facility (ESAF). It was this program that the IMF used to finance the structural adjustment reforms we examined in Chapter 4. In 1999, however, IMF member governments agreed to focus more on poverty reduction, and to do so they replaced the ESAF with the PRGF. Loans under this program are based on a Poverty Reduction Strategy Paper (PRSP), which is prepared by the country in cooperation with civil society and other development partners, in particular the World Bank. The interest rate levied on PRGF loans is only 0.5 percent, and governments can take as long as ten years to repay loans under this program.
- Two new programs were established in the late 1990s in response to currency and financial crises in Asia and other parts of the developing world. These programs, the Supplemental Reserve Facility and the Contingent Credit Line, provide additional financial resources for governments that are either experiencing or threatened by a currency crisis that creates the need for short-term financing on a very large scale. Countries must repay loans under both programs within 2.5 years, but are expected to repay within 1.5 years. Both loans carry a substantial charge on top of the interest rate in order to discourage governments from using them except in true crisis situations.

The role played by the IMF the international monetary system has been highly controversial. IMF conditionality has been criticized throughout the postwar period, particularly as the IMF has applied this practice to developing countries. In addition, the IMF has been heavily criticized for the way it responded to the financial crisis that struck Asia and other developing countries in the late 1990s. We will examine these criticisms in greater detail in Chapter 8.

economic autonomy. The rules and institutions that governments created sought to achieve this reconciliation through four innovations. The stabilization fund would enable governments to maintain fixed exchange rates in the face of small and temporary external imbalances. Controlling capital flows would ensure that balance of payments imbalances were small and relatively slow to develop rather than large and

driven by sudden shifts in capital flows. Devaluing or revaluing their currency in the event of a large external imbalance would shield governments from having to accept substantial domestic economic adjustments. The IMF would ensure that governments did not abuse the system. We turn our attention now to why these innovations failed.

The Operation and Collapse of the Bretton Woods System

The effort to reconcile stable exchange rates and domestic economic autonomy proved unsuccessful. The Bretton Woods system failed largely because governments were unwilling to make the adjustments necessary to eliminate large and persistent balance of payments imbalances. The most important imbalance was in the United States—it ran balance of payments deficits throughout this period, though this imbalance was accompanied by balance of payments surpluses in other countries, particularly in Germany. The adjustment problem was complicated by the central role played by the dollar in the system. Governments had not intended the dollar to play a prominent a role in the Bretton Woods system, but the U.S. currency quickly became the system's primary reserve asset. As the **primary reserve asset,** the dollar became the currency that other governments held as their foreign exchange reserves in order to make their international payments and to intervene in foreign exchange markets. This was reasonable; the United States was the largest economy in the world, and at the end of the Second World War, the United States held between 60 and 70 percent of the world's gold supply. The dollar was fixed to gold at $35 per ounce, and other governments were willing to hold dollars as foreign exchange reserves because dollars were "as good as gold." As a consequence, the stability of the Bretton Woods system came to depend upon continued confidence that the U.S. government would maintain its commitment to exchange dollars held by foreigners for gold at $35 an ounce. But persistent American balance of payments deficits eroded this confidence. As it became ever more apparent that the United States would not take steps to eliminate its balance of payments deficit, confidence in the dollar collapsed completely and the Bretton Woods system was swept away in a series of crises in the late 1960s and early 1970s. We examine these developments here, focusing first on the dollar's central role in the system and then on the crises that brought about the collapse of the system between 1971 and 1973.

From dollar shortage to dollar glut. American balance of payments deficits initially played a very constructive role in the Bretton Woods System. Governments had planned to implement the Bretton Woods system immediately following the Second World War. This proved impossible, however, because no European government held dollars or gold, the other important reserve asset, in any appreciable amount. Moreover, economic weakness prevented them from running current account surpluses with the United States in order to earn dollars. Because European governments held so few dollars, they were unwilling to allow domestic residents to freely convert the domestic currency into gold, dollars, or other gold-backed currencies. Governments needed foreign exchange in order to import food, capital goods, inputs, and many of the other critical components needed to reconstruct their economies following the devastation of the Second World War. Allowing people and businesses to freely exchange the domestic

currency for dollars or gold, as the rules of the Bretton Woods system required, would produce a run on and quickly exhaust the limited foreign exchange reserves that governments held. Governments would then have to reduce imports and slow the pace of economic reconstruction. An aborted British attempt to restore the convertibility of the pound in 1947 starkly illustrated the threat (Eichengreen 1996, 103). Under pressure from the United States, and with the support of a $3.75 billion American loan, the British government allowed holders of the British pound to purchase gold and dollars for current account transactions. Those who held pounds rushed to exchange them for dollars, and in doing so consumed the American loan and a large share of Britain's other foreign exchange reserves in only six weeks. As its reserves dwindled, the British government once again suspended the convertibility of the pound. Convertibility, and therefore the implementation of the Bretton Woods system, would have to wait until European governments had accumulated sufficient foreign exchange reserves and reconstructed their economies.

In order for European governments to accumulate foreign exchange reserves, however, dollars had somehow to be transferred from the United States to other governments. The United States' balance of payments deficit was the mechanism through which this transfer was achieved (see Figure 6.1). Initially, the United States exported dollars to Europe and other parts of the world through foreign aid and military expenditures. The Marshall Plan, initiated in 1947 and implemented between 1948 and 1952, is the most prominent example of this American policy. By the late 1950s, however, private capital was also flowing out of the United States and into Europe (Block 1977). These American balance of payments deficits meant that more dollars flowed out from the United States each year than flowed in. These dollars were in turn accu-

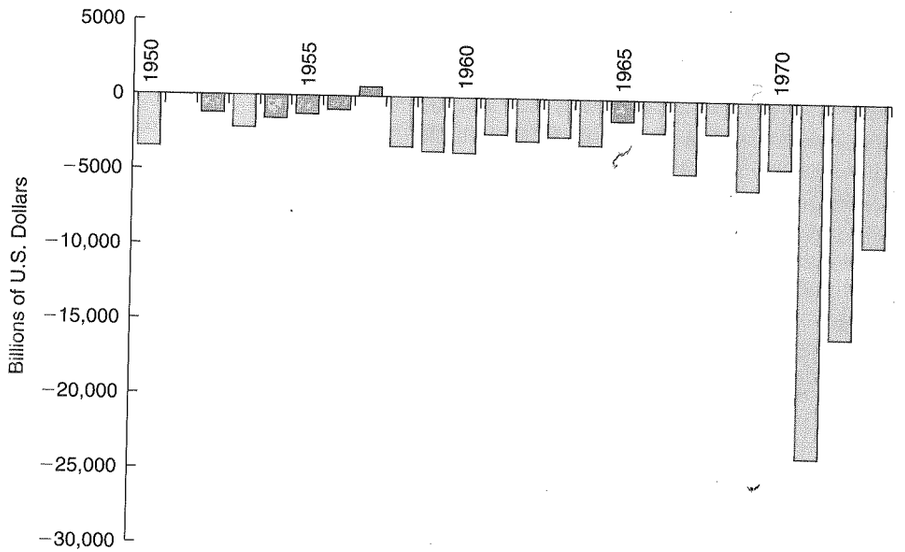

Figure 6.1 U.S. Balance of Payments, 1950–1973.
Source: Economic Report of the President 2001.

mulated by European governments, who held them as foreign exchange reserves and used them to pay for imports from the United States and other countries. Those governments who wanted to do so could exchange whatever dollars they held into gold at the official price of $35 an ounce. By 1959, this mechanism had enabled European governments to accumulate sufficient dollar and gold reserves to feel confident about allowing their residents to freely convert the national currency into other currencies in order to settle current account transactions with relatively few restrictions. In 1959, therefore, the Bretton Woods system was finally implemented, almost 15 years after it had been created.

Over the next few years, however, the postwar dollar shortage was transformed into an over-abundance of dollars, called the **dollar glut,** that contributed to the system's collapse in the early 1970s. The dollar glut emerged largely as a consequence of the continuation of American balance of payments deficits during the 1960s (see Figure 6.1). Between 1958 and 1970 the United States ran average annual balance of payments deficits of $3.3 billion. These deficits remained fairly stable during the first half of the 1960s, but then began to grow after 1965. Deficits were caused by U.S. military expenditures in connection with the Vietnam War and expanded welfare programs at home, and by the unwillingness of the Johnson and Nixon Administrations to finance these expenditures with higher taxes. The result of these policies was an expansionary macroeconomic policy in the United States that sucked in imports and encouraged American investors to send capital abroad. The dollars accumulated by governments in the rest of the world as the inevitable result of these American balance of payments deficits represented foreign claims on American gold holdings. The rising volume of foreign claims led in turn to what has been called **dollar overhang:** foreign claims on American gold greater than the amount of gold that the United States actually held. The emergence and subsequent worsening of dollar overhang can be seen in the evolution of foreign dollar holdings and the U.S. gold stock during the 1950s and 1960s. In 1948 foreigners held a total of $7.3 billion against U.S. gold holdings of $24.8 billion. In this period, therefore, there was no uncertainty regarding the American ability to redeem all outstanding foreign claims on U.S. gold. By 1959, foreign dollar holdings had increased to $19.4 billion while U.S. gold holdings had fallen to $19.5 billion, of which $12 billion had to be reserved as backing for domestic claims and therefore could not be used to satisfy foreign demands for gold. By 1970, American gold holdings stood at $11 billion, while foreign claims against this gold had risen to $47 billion. Thus, persistent balance of payments deficits reduced the ability of the United States to meet foreign claims on American gold reserves at the official price of $35 an ounce.

Dollar overhang threatened the stability of the Bretton Woods system (see Triffin 1960). As long as the dollar remained the system's primary reserve asset, the growth of dollars circulating in the global economy would have to keep pace with the expansion of world trade. This meant that dollar overhang would worsen. Yet, as dollar overhang worsened, people would lose confidence in the ability of the American government to exchange dollars for gold at $35 an ounce. Once this confidence had evaporated, people and governments would rush to sell whatever dollars they held before the dollar was devalued or American gold reserves were exhausted. Declining confidence in the dollar, in other words, would encourage foreign dollar holders to begin betting against the dollar's fixed exchange rate with gold, leading to crises that would ultimately

A Closer Look

Dollar Overhang and the Confidence Problem

In early May of 1962, James Tobin wrote a memo to President John F. Kennedy in which he explained the reasons for and the consequences of dollar overhang. The memo, extracts of which are reproduced below, not only provides an excellent explanation of the central problem the United States faced, but also highlights how dollar overhang generated political problems for the Kennedy Administration.

MEMORANDUM FOR THE PRESIDENT, 5 MAY, 1962

The United States Operates a Bank for the World

This "Bank" is not a formal institution. It has no legal existence, no physical address, no clearly defined balance sheet. Nevertheless it is this Banking function which dominates our gold problem and magnifies our balance of payments difficulties. Some "deposits" in this Bank are the dollar bank deposits and short-term securities owned by foreign *central banks and governments.* We permit these depositors to exchange their dollars for gold whenever they please. At present these "deposits" amount to $10.3 billion, compared to $4.6 billion ten years ago.

In addition, there are $10.8 billion of dollar deposits (compared to $4.3 billion in 1952) and liquid securities owned by foreign *private* banks, business firms, and individuals, and by international lending institutions. These foreign owners cannot exchange their dollars for our gold. But they can sell them to their central banks, and thereby increase the official "deposits" in the Bank, which can be cashed for gold.

The reserves of the Bank are the U.S. gold stock. At the end of January these amounted to $16.8 billion, of which $11.4 billion are legally committed as backing for the U.S. domestic money supply. (Ten years ago, this Bank had gold reserves of $23.1 billion, of which $11.4 billion were needed to cover the domestic money supply.)

The Deposits of the Bank are Uninsured

A foreign central bank which holds dollars instead of converting them into gold runs the risk that we will choose to, or be forced to, lower the gold value of the dollar or stop paying out gold for dollars on demand. This is why our official depositors do not want to have too big a part of their own reserves in the form of uninsured deposits. That is why they from time to time cash dollars into gold. If any large part of the $10.8 billion private (and international) foreign dollar holdings were sold to foreign central banks, the central banks would almost surely turn most of them into gold.

Before the days of deposit insurance in the U.S., an ordinary commercial bank was in this same situation. Its depositors could ask for cold cash—coins and currency, including gold. No bank had enough reserves to pay its depositors if all of them wished to withdraw their deposits at the same time. A depositor was always running the risk that the bank would "fail." And whenever enough depositors thought this risk was too great, they made the bank fail. The only way we got out of this was to institute government deposit insurance, which guaranteed to the depositors that $1 of bank deposit will always be worth a dollar bill.

Continued

The same danger—a run on the Bank—is what we are now up against in the international sphere. But so far we haven't advanced to the obvious solution, a way of guaranteeing the Bank's depositors against loss.

The U.S. Balance of Payments and the Bank

A U.S. balance of payments deficit adds to the dollars in foreign hands, private and official. If foreign banks and individuals get more dollars than they want, they sell them to their own central banks for their local currencies. If the central banks thus acquire more dollars than they want, they use them to buy gold from us. In 1961

The deficit was	$2.5 billion
But private foreign holders only wished to hang on to	$1.3 billion
Hence they sold	$1.2 billion to foreign central banks.
But central banks only wished to hang on to	$0.5 billion
Hence they cashed	$0.7 billion in for gold,
The rest of the deficit	$1.8 billion remains outstanding

Adding to the dollar claims (or claims but one step removed) on our gold stock.

The Overhang of Dollar Liabilities, and "Confidence"

Ending the payments deficit will stop the growth of our Bank's liabilities. But even when we have no balance of payments deficit, the $21.1 billion of dollar liabilities resulting from the past will still be hanging over our heads—claims or potential claims against our gold which could be exercised at any moment. Even without payments deficits, we can lose gold as these claims move between depositors. Dollars may move from private stocks to official holders who by tradition prefer gold, or from a central bank that willingly holds dollars to one that likes gold.

Furthermore, it is this overhang which places us at the mercy of the "confidence" which foreign central bankers, private bankers, and financial pundits have in the dollar. The state of "confidence" is a funny thing—fragile, irrational, contagious, political, unpredictable . . . So long as we have to worry about "confidence," we are not masters in our own house. Domestic policy is perpetually inhibited by what this or that measure may do—or by what someone thinks it may do—to confidence in the dollar. In particular, measures to stimulate employment and growth are inhibited—even though in the long run unemployment and economic stagnation also weaken confidence. Worse yet, foreign confidence is heavily dependent upon the views of our natural political opponents at home—the financial community and the conservative press. Their views of the dollar are colored by their political and ideological opposition to any and all active government policy for economic expansion. These vocal financial conservatives weaken foreign confidence in the dollar. Then they can use the issue of confidence as a weapon to oppose domestic policies they have always opposed anyway.

Source: James Tobin, "Memorandum for the President," 5 May, 1962. Record Group 56. Records of the Under Secretary of State for International Affairs, Box 117. National Archives and Records Administration, Archives II, College Park, Maryland.

undermine the system. Heading off these crises was complicated by the central role the dollar played in the system. To eliminate dollar overhang, the United States would have to reverse its balance of payments position. Rather than run deficits that pumped dollars into the international economy, the United States would have to run balance of payments surpluses that pulled dollars back into the United States. Yet, because the dollar served as the system's primary reserve asset, reducing the number of dollars in circulation in the global economy would reduce the liquidity that financed world trade. As governments defended their fixed exchange rates in face of this contraction of liquidity, the world economy could be pushed into a deflationary spiral (Eichengreen 1996, 116). The Bretton Woods system therefore faced a dilemma: the dollar's role as the primary reserve asset would eventually undermine the system of fixed exchange rates, but measures to strengthen the dollar could trigger global deflation that could also destroy the system.

This liquidity problem, as it came to be called, was not simply an obscure technical matter. It was also a source of political conflict, particularly between France and the United States. The French argued that the United States gained considerable advantages from the dollar's role as the system's primary reserve asset. No other country could run persistent balance of payments deficits because they would eventually run out of foreign exchange reserves and be forced to eliminate the deficit. But the United States did not face this reserve constraint—it could run deficits as long as other governments were willing to accumulate dollars. The French argued, with some merit, that this enabled the United States to pursue an "imperialistic" policy. In the economic arena, the United States could buy French companies, and in the geostrategic arena, the United States could expand its activities with few constraints, as it was doing in Vietnam (Dam 1982, 144). The French government decried this as an "exorbitant privilege" and advocated the creation of an alternative reserve asset to provide liquidity to the Bretton Woods system. In the mid-1960s, the French even advocated a return to the gold standard in order to eliminate the benefits the United States realized from the dollar's role in the system. Efforts to solve the liquidity problem, therefore, became inextricably linked to how systemic reform would affect American power in the international monetary system and in the wider global arena.

Governments did respond to the liquidity problem by creating a new reserve asset to supplement the dollar. Working in conjunction with the IMF, governments created the Special Drawing Right (SDR). The Special Drawing Right is a reserve asset managed by the International Monetary Fund and allocated to member governments in proportion to the size of their quotas. The SDR is not backed by gold or any other standard, cannot be used by private individuals, and is not traded in private financial markets. Its sole purpose is to provide a source of liquidity that governments can use to settle debts with each other arising from balance of payments deficits. The intention was that SDRs would supplement dollars as a source of liquidity in the international monetary system. The first allocation of SDRs occurred in 1970. By this time, however, the Bretton Woods system was moving toward its ultimate demise and the SDR never played an important role in the system.

Crises and collapse. By the mid-1960s, therefore, governments were confronting the problems that would undermine the Bretton Woods system in the early 1970s. The

continued viability of the system depended upon restoring confidence in the dollar, and this in turn required adjustment to eliminate the underlying balance of payments imbalances. Adjustment could be achieved through one of three paths: devalue the dollar against gold, restrain economic activity in the United States in order to reduce American imports, or expand economic activity in the rest of the world in order to increase American exports. But governments proved unwilling to adopt any of these measures. Instead, they were paralyzed by political conflict over who should bear the costs of the adjustments necessary to eliminate the imbalances that were weakening the system.

The simplest solution would have been to devalue the dollar against gold. Devaluation was not easily achieved, however. American policymakers believed that they could not change the dollar's exchange rate unilaterally. If the United States devalued against gold unilaterally, American policymakers believed, European governments and Japan would devalue as well. As a consequence, the only way to devalue the dollar was to convince European and Japanese governments to revalue their currencies. Europe and Japan were unwilling to revalue their currencies against the dollar, however, because they believed that such a currency realignment would remove any incentive the United States might have to undertake balance of payments adjustment of its own (Solomon 1977, 170). Realignment, in other words, would let the United States off the hook.

With a currency realignment off the table, only two other solutions were left: adjustment through economic contraction in the United States or adjustment through economic expansion in other countries. In the United States, neither the Johnson nor the Nixon Administrations were willing to adopt the domestic economic policies required to eliminate the U.S. balance of payments deficit. As U.S. Treasury Secretary Henry Fowler spelled out in a memo to President Johnson in mid-1966, the United States could eliminate its imbalance in one of two ways: "Reduce the deficit by cutting back U.S. commitments overseas," a choice that would entail "major changes in [U.S.] foreign policy," or "reduce the deficit by introducing new economic and balance of payments measures at home" (United States Department of State). Neither option was attractive. The Johnson Administration was not willing to allow the balance of payments to constrain its foreign policy goals, and restricting domestic economic activity to correct the deficit was politically inconvenient. Richard M. Nixon, who assumed the presidency in 1969, was no more willing to adopt policies to eliminate the American deficit. Instead, the Nixon Administration blamed the exchange rate and trade policies pursued by other governments for the strains emerging in the international monetary system (Dam 1982, 186). The dollar's weakness was not a result of the American balance of payments deficit, the Nixon Administration claimed, but was instead caused by balance of payments surpluses in Germany and Japan. As Eichengreen notes, the United States acted "like a bull in a china shop," threatening to wreck the international trade and financial system unless other governments supported the dollar in the foreign exchange market and took measures to stimulate imports from the United States (Eichengreen 1996, 130).

Most governments in Western Europe and Japan were initially willing to support the dollar. They did so "because [the dollar] was the linchpin of the Bretton Woods system and because there was no consensus on how that system might be reformed or replaced" (Eichengreen 1996, 130). But there were clear limits to their willingness to continue to do so, as the case of Germany illustrates. By 1970 Germany had done

more to support the dollar than any other European government. The German government had agreed not to demand gold from the United States; this stood in stark contrast to the French, who had adopted a policy of demanding gold from the United States for the dollars they acquired. In addition, Germany had negotiated a series of "offset payments" with the Johnson Administration through which a portion of American military expenditures in Germany were offset by German expenditures on American military equipment. Such payments reduced the extent to which American military expenditures in Europe contributed to its balance of payments deficit. Germany's willingness to support the dollar, however, was limited by Germany's aversion to inflation. Germany had experienced hyperinflation during the 1920s, with prices rising at the rate of 1,000 percent per month in 1923. This experience had caused German officials and the German public to place great value on price stability (see Emminger 1977; Henning 1994). Supporting the dollar's fixed exchange rate threatened to raise German inflation. As confidence in the dollar began to erode, dollar holders began to sell dollars and buy marks. Foreign exchange market intervention to prevent the mark from appreciating expanded the German money supply and created inflation in Germany. The inflationary consequences of foreign exchange market intervention made Germany reluctant to support the dollar indefinitely. Continued support would be based on clear evidence that the U.S. was adopting domestic policies that were beginning to reduce its balance of payments deficit.

During the 1960s, therefore, governments adopted a variety of measures to try to shore up the Bretton Woods system, but they were unwilling to take the steps that were necessary to correct the fundamental source of weakness in the system. As a consequence, the American balance of payments deficit continued to export dollars into the system, dollar overhang continued to worsen, and confidence in the dollar's fixed exchange rate with gold began to erode. **Speculative attacks,** large currency sales sparked by the anticipation of an impending devaluation, began to occur with increasing frequency and mounting ferocity. By 1970, the United States held only $11 billion in gold, while foreign claims against this gold had risen to $47 billion. Another $8 billion was added in the first six months of 1971 as the U.S. balance of payments position deteriorated further (see Figure 6.1). As foreign claims on U.S. gold mounted, confidence in the dollar's fixed exchange rate eroded, giving rise to a series of speculative attacks. In the first six months of 1971, private holdings of dollars fell by $3 billion, a sign that people were expecting the dollar to be devalued (Dam 1982, 187). Massive sales of the dollar forced European governments to purchase more than $5 billion in defense of the dollar's fixed exchange rate. The speculative attacks reached a new high in May 1971. In only two days Germany purchased $2 billion, supporting the dollar, a record amount at that time (Kenen 1994, 500). The need for such massive intervention breached the limits of German willingness to support the dollar and the German government floated the mark. Speculative attacks on the dollar resumed in the summer of 1971 and in August the Nixon Administration suspended the convertibility of the dollar into gold and imposed a 10 percent surcharge on imports (see Gowa 1984). The United States had abandoned the central component of the Bretton Woods system; it would no longer redeem foreign governments' dollar reserves for gold.

Governments made one final attempt to rescue the Bretton Woods system. During the fall of 1971, they negotiated a currency realignment that they hoped would reduce

the U.S. payments deficit and stabilize the system. The realignment was finalized in a December meeting held at the Smithsonian Institution in Washington, D.C. The dollar was devalued by 8 percent against gold, its value falling from $35 per ounce to $38 per ounce. European currencies were revalued by about 2 percent, thus producing a total devaluation of the dollar of 10 percent. In addition, the margins of fluctuation in the exchange rate system were widened from 1 percent to 2.25 percent to give the system a bit more exchange rate flexibility. But the United States did not restore the ability to convert dollars into gold. While Nixon hailed the Smithsonian realignment as "the greatest monetary agreement in the history of the world," the realignment solved neither the economic imbalances nor the political conflicts that were the cause of the system's weakening. The United States continued to refuse to adopt measures that would reduce its balance of payments deficit. Rather than tighten monetary policy to slow imports and support the new exchange rate, the Nixon Administration loosened monetary policy, "triggering the greatest monetary expansion in the postwar era" (Emminger 1977, 33). German officials remained unwilling to accept the inflation that would result from continual intervention to support the mark's exchange rate against the dollar. With neither government willing to adjust policy to support the new exchange rates, new speculative crises quickly emerged. A massive speculative crisis in late January and early February 1973 brought the system down, as most advanced industrialized countries abandoned their fixed exchange rates and floated their currencies.

Governments initially viewed the shift to floating exchange rates in early 1973 as temporary. At the time, most finance ministers and central bankers were hostile to floating exchange rates (Dam 1982, 224; Kenen 1994, 501). The IMF had begun studying possible reforms in the late 1960s and the crises of the early 1970s gave fresh impetus to this effort. A committee composed of representatives from ten advanced industrialized countries and ten developing countries was created in July 1972. Called the Committee of Twenty (C-20), this group was charged with developing reform proposals that would restore "stable but adjustable" exchange rates. But the ongoing conflict over who should bear the costs of adjustment blocked agreement in the C-20 (Dam 1982). The United States advocated a system that would force countries with current account surpluses to adopt expansionary policies to eliminate their imbalance. European governments advocated a system that would deny the United States the ability to pay for its current account deficits with nonconvertible dollars. Unable to resolve this conflict, the advanced industrialized governments accepted floating exchange rates as a fact of life. Meeting in Rambouillet, France, in November 1975, governments agreed to amend the Articles of Agreement to the IMF, which still required governments to maintain fixed central parities, to legitimize floating exchange rates. This second amendment to the IMF allowed governments to choose their own exchange rate arrangements. Those who wanted to float could do so; those who wanted to maintain some sort of pegged exchange rate were allowed to do so. This amendment came into effect in 1978.

The postwar attempt to create an international monetary system that could provide both exchange rate stability and domestic economic autonomy was therefore relatively short-lived and ended in failure. The reasons for this failure are not hard to find. Some argue that the Bretton Woods system was undermined by dollar overhang. Others suggest that the Bretton Woods system was destroyed by the reemergence of

international capital flows that generated the speculative attacks that ultimately drove governments off of fixed exchange rates. While these factors were important, the fundamental cause of the system's collapse lay in the adjustment problem. To sustain a system of fixed exchange rates, governments must accept the domestic economic costs associated with balance of payments adjustment. Governments were unwilling to accept these costs. The United States was unwilling to accept the rising unemployment required to eliminate its deficit, and Germany was unwilling to accept the higher inflation required to eliminate its surplus. It was this unwillingness to adjust which aggravated the problem of dollar overhang, and it was the problem of dollar overhang that gave international financial markets the incentive to launch speculative attacks against the fixed exchange rate system. The creation and collapse of the Bretton Woods system therefore highlights two important conclusions of this chapter. Even though governments would like to maintain stable exchange rates and at the same time preserve their ability to use macroeconomic policy to manage the domestic economy, no one has yet found a way to reconcile the two. And when confronted with the need to choose between stable exchange rates and domestic economic autonomy, governments have opted for domestic economic autonomy. As a result, the contemporary international monetary system is characterized by considerable exchange rate flexibility. We turn now to examine the operation of this system.

Contemporary International Monetary Arrangements

Since the collapse of the Bretton Woods system, governments have been free to choose whatever exchange rate arrangements they desire. The contemporary international monetary system therefore features a mixture of exchange rate arrangements. No one type of arrangement dominates. At the end of 1999, 45 countries had fixed exchange rates, 63 countries maintained some form of a fixed-but-adjustable regime, and 77 countries allowed their currencies to float (Fischer 2001). The operation of these exchange rate arrangements has been greatly influenced by a dramatic increase in the volume of international capital flows during the last 25 years. While no single statistic can capture this tremendous growth, one figure is illustrative: daily business in the foreign exchange market averages between $1 and $1.5 trillion per day. These capital flows have caused the contemporary international monetary system to operate in ways that governments had not expected, and they have made it more difficult for governments to move back toward a system of fixed-but-adjustable exchange rates. We look at the contemporary system here, focusing first on international financial integration, and then examining the impact of international capital flows on exchange rates and balance of payments adjustment.

International Financial Integration

The growth of international finance represents perhaps the greatest change in the global economy during the last 25 years. Whereas most governments attempted to restrict international capital flows under the Bretton Woods system, since the collapse of this

system all of the advanced industrialized countries have dismantled practically all such restrictions. The growth of international financial flows that followed has profoundly influenced the operation of the contemporary international monetary system. Capital flows have altered the nature of current account adjustment, determine currency values, and increasingly complicate governments' efforts to manage exchange rates. Because capital flows are so important, we begin our investigation by examining this process of international financial integration.

The financial system's purpose is to bring savers and borrowers together. For savers, those people and firms in society that spend less than the income they earn, the question is what to do with the portion of their income that they do not consume. While these savings could be kept at home in a Mason jar or in a shoebox under the bed, it is also possible to put savings to work—to make them available to someone who is willing to pay a fee to use them. For borrowers, those people and firms that spend more than the income they earn, the question is how to acquire funds needed to pay for expenditures larger than their incomes. These expenditures could be investment related, such as the construction of a new factory, or they could be consumption related, such as the purchase of a new car. In either case, a borrower might be willing to pay someone to use her savings to undertake his desired expenditures. The financial system brings these two groups of people together, allowing people with savings to earn a return in exchange for making their savings available to those who want to borrow them.

International financial integration describes the elimination of government policies that limit the ability of savers and borrowers residing in different countries to engage in financial transactions with each other. To what extent do government policies allow a French firm to draw on Japanese or German savings to fund the construction of a factory in Malaysia, or a French resident to buy stocks traded on the Tokyo Stock Exchange or corporate bonds traded in the American bond market? In the Bretton Woods system, governments used a number of policies to make it difficult for their residents to engage in such cross-border financial transactions. Exchange restrictions limited the ability of domestic residents to use foreign exchange to purchase foreign financial assets. Capital controls raised the cost of borrowing from and lending to foreigners. In most instances, such restrictions were designed to prevent domestic savings from flowing abroad, though in some cases, such as Germany in the late 1960s and early 1970s, they were used to discourage capital inflows. Throughout the early postwar period these controls segmented national financial systems into distinct "reservoirs" (Bryant 1987). Individuals and corporations in the same country could borrow and lend to one another, but it was difficult to borrow from or to lend to residents of other countries.

This system of dikes began to crumble during the 1960s. Erosion began with the creation of Eurodollars in the 1950s. **Eurodollars,** which literally refer to dollar-denominated bank accounts and loans managed by banks outside of the United States, were an innovation of British banks. British banks dominated international finance prior to the First World War but had subsequently seen this dominance greatly diminish in the face of American competition. In the immediate postwar period, British banks were therefore looking for some way to continue international lending in face of the tight restrictions the British government had imposed on the convertibility of the pound. At the same time, the Soviet Union needed to hold dollars in order to purchase goods from the West. For understandable reasons, the Soviet Union wanted to place

these dollars in interest bearing accounts that were outside of the reach of the American government. Eurodollars solved both problems in an innovative way. British banks allowed the Soviet government to open dollar-denominated accounts in London, and British banks used these dollars to make dollar-denominated loans. Thus was born what has come to be known as Eurocurrency banking. The emergence of Eurocurrency banking, which quickly spread beyond London and then began to incorporate currencies other than the dollar as well, did not reflect a change in the controls governments used to restrict capital flows into and out of domestic financial systems. Instead, Euromarkets represented a kind of parallel financial universe. In London, for example, foreigners were allowed to deposit and borrow dollars, but domestic residents were not. By preventing domestic residents from having easy access to the Euromarkets based in London, the British regulatory authorities maintained a barrier between international and domestic financial transactions. The Euromarkets allowed British banks to compete with American banks without seeming to interfere with the British government's desire to control capital flows (Helleiner 1994, 84).

The Euromarkets nevertheless complicated the efforts of governments to insulate their national financial systems from international financial flows. As telecommunications and computer technologies improved during the 1970s and 1980s, it became easier for banks and other financial institutions to evade capital controls (Herring and Litan 1995, 13). As a result, international lending began to grow rapidly. Between the early 1960s and 1985, international credit extended by banks grew at an annual rate of 26 percent and total international credit rose from about $12 billion in 1964 to almost $1.5 trillion in 1985 (Bryant 1987, 20–23). As cross-border lending grew, governments found themselves under increasing pressure from capital flows seeking to profit from interest rate differentials between deposits in domestic markets and in Euromarkets. For example, when the interest rate paid on French francs deposited in the Euromarket rose relative to the interest rate in France, francs would flow out of France into the Euromarket. Conversely, if a higher return was available in France than in the Euromarket, financial capital would flow into the French economy. By the late 1960s and early 1970s, the dikes that governments had maintained to prevent capital flows since the Second World War were becoming increasingly porous.

By the late 1970s governments faced a choice between adopting additional capital controls to stem these movements or eliminating capital controls completely (Goodman and Pauly 1993). Over the next ten years all advanced industrialized countries opted for liberalization. The decision to liberalize was shaped in part by changing perceptions of the role governments should play in the market (Helleiner 1994, 146–68; Cohen 1996). In the early 1980s, governments that were determined to reduce the state's involvement in the economy came to power in many advanced industrialized countries. These governments liberalized domestic financial markets and dismantled capital controls. One of the first to do so was Great Britain. In the spring of 1979, the British Conservative Party led by Margaret Thatcher gained a parliamentary majority. In October of that year, Thatcher eliminated all of Britain's capital controls. It has even been reported that Thatcher instructed the Treasury to destroy all documents relating to capital controls so that a future government could not easily reimpose them. Overnight, therefore, Britain abandoned its 40-year effort to insulate its national financial system from international financial flows. Other EU governments followed in the

mid-1980s, dismantling capital controls as part of the single market project (Story and Walter 1997, 254–257). By the early 1990s, few governments in the advanced industrialized world placed any restrictions on cross-border capital flows.

International financial integration has not been limited to the advanced industrialized countries. Many developing countries have also become more deeply integrated into the international financial system since the late 1980s. The World Bank (1997) estimates that only two developing countries were "highly integrated" with the international financial system in the late 1980s. But by 1994, 13 developing countries were highly integrated into the international financial system and 24 more had reached a moderate level of integration. As a consequence, financial capital began to flow to developing countries. In 1996, $240 billion of foreign capital flowed into developing countries, more than three times the amount that had flowed there in the late 1970s. By the end of the decade, developing countries were receiving about 30 percent of total global equity capital flows, compared to only about 2 percent in the late 1980s. Capital flows to the developing world have been concentrated on a small number of countries. Twelve developing countries account for about 80 percent of all private capital flows to the developing world. These countries should look familiar by now; they include the East Asian economies and China, as well as a few Latin America countries, Brazil, Mexico, and Argentina. We will examine capital flows to developing countries in greater detail in Chapter 8.

The volume of international financial transactions has risen dramatically since the mid-1970s. New international bank loans and bond issues grew from $100 billion in 1975 to almost $900 billion in 1998 (see Figure 6.2). Between 1986 and 1998, the average *daily* turnover in foreign exchange markets grew from $850 billion to $1.5 trillion (see Figure 6.3). Many have argued that these capital flows have greatly reduced

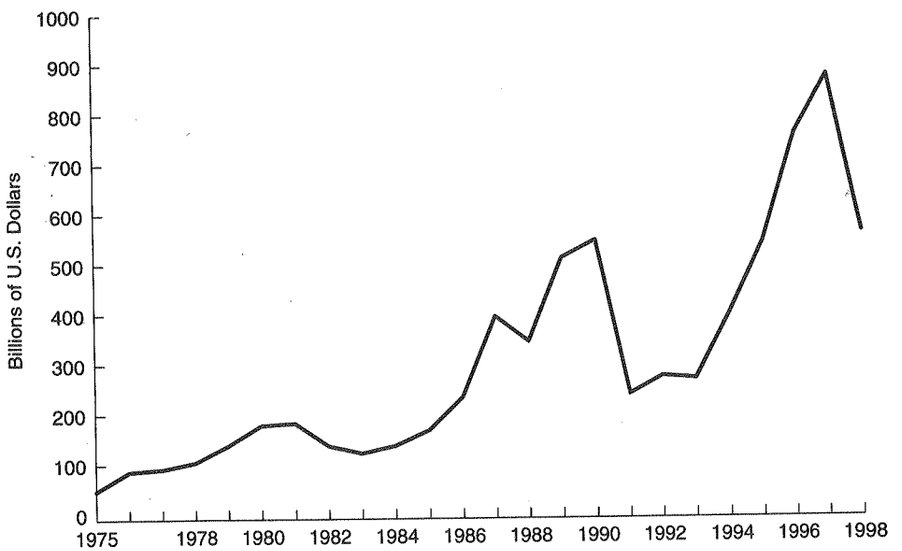

Figure 6.2 International Bank Loans and Bonds.
Source: Bank for International Settlements.

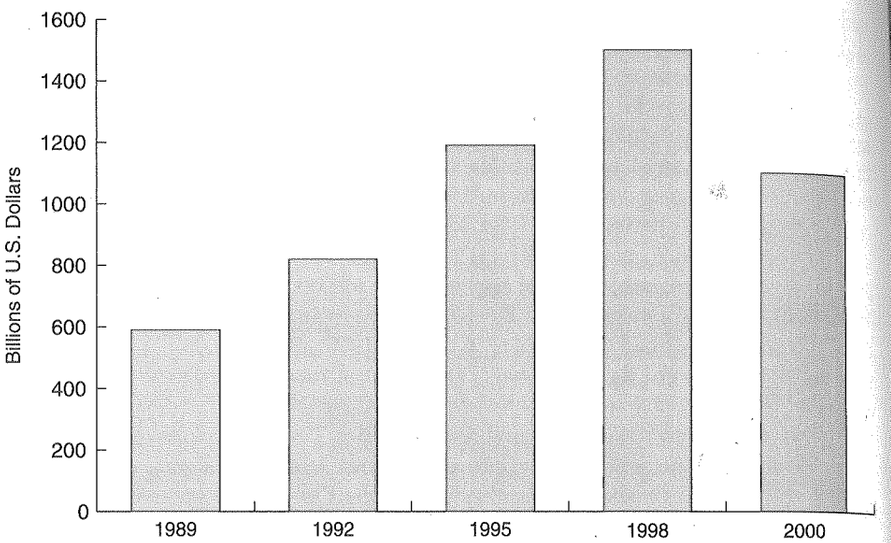

Figure 6.3 Daily Turnover on Foreign Exchange Markets.
Source: Bank for International Settlements.

national economic autonomy, as governments must make policy decisions under the watchful eye of international financial markets. If a government develops a large budget deficit or if its rate of inflation begins to rise, financial markets will sell financial assets denominated in that country's currency, forcing the government to reduce its deficit and bring inflation down. Such claims are exaggerated to some extent. As we saw above, governments face a tradeoff between domestic economic autonomy and exchange rate stability even without capital flows. International financial integration has tightened this constraint, however, in ways that have had a profound impact on the operation of the international monetary system and on the prospects for its reform.

Exchange Rate Arrangements in a World of Mobile Capital

The post-Bretton Woods system of floating exchange rates has not operated as governments had expected it would, in large part because of international financial integration. Large current account imbalances in the United States, in Japan, and in the EU have persisted since the early 1980s because international capital flows have allowed governments to finance rather than eliminate them. The cross-border capital flows that finance these imbalances have in turn affected exchange rates, generating considerable exchange rate volatility and contributing to larger currency movements called misalignments. As we will explore below, current account imbalances and large exchange rate movements pose formidable challenges to the global economy. Concern about these problems has led governments in the advanced industrialized countries to attempt to manage exchange rates. Among the **Group of Five** (G5), which includes

the United States, Japan, Germany, Britain, and France, such cooperation has been occasional and informal. In the EU, exchange rate cooperation has been institutionalized within a regional exchange rate system. As we will see, however, international financial integration is making exchange rate cooperation increasingly difficult.

Floating exchange rates. The world's principal currencies, including the dollar, the yen, the mark, the British pound, and now the euro, have been allowed to float against each other since 1973. The system has not been a pure floating exchange rate system, however, but can instead best be characterized as a managed float. Governments in the countries issuing the world's principal currencies have not adopted any specific price for their currencies against each other, but they have intervened periodically in the foreign exchange market to influence currency values. In some instances a government will intervene unilaterally to try to alter the value of its currency, while in other instances all of the G5 governments coordinate their intervention to affect currency values. We will look at one particularly important instance of this coordinated intervention below.

Many governments initially had high expectations about how this system of floating exchange rates would operate. In particular, governments believed that floating exchange rates would automatically adjust current account imbalances (see Friedman 1953). Current account adjustment would occur automatically from the exchange rate movements that would result from changes in countries' current account positions. A current account deficit in one country would generate an imbalance in the foreign exchange market that would cause that country's currency to depreciate. The corresponding current account surplus in another country would generate an imbalance in the foreign exchange market that would cause that country's currency to appreciate. This exchange rate change would in turn alter the prices of goods produced in the deficit and surplus countries. Goods produced by the deficit country would become cheaper as its currency depreciated while goods produced in the surplus country would become more expensive as its currency appreciated. As a consequence, the deficit country's exports would rise and its imports would fall, bringing the current account back towards balance. The surplus country's exports would fall while its imports would rise, bringing its current account back into balance. In short, current account adjustment would occur automatically as exchange rates moved in response to current account imbalances.

These initial expectations have been disappointed, however, as currency movements have in practice failed to promote current account adjustment. As the figures presented here make clear, the United States, Japan, and Germany have run large current account imbalances for more than 20 years (see Figures 6.4–6.6). The United States has run a current account deficit almost every year since 1982 (with the sole exception of 1991). Japan and Germany have run large current account surpluses that together account for about 80 percent of the American deficit (Solomon 1999, 31). The Japanese current account moved into surplus in the mid-1970s, was pushed into deficit in the late 1970s, but after recovering in 1981 remained in surplus throughout the 1980s and 1990s. The German current account was in surplus throughout the 1970s and 1980s, with the exception of the period 1978–1982. German current account deficits during the 1990s reflect the impact of German unification on the German economy. Currency movements have done little to eliminate these imbalances. Figure 6.7 graphs the dollar's **effective exchange rate,** an overall measure of the

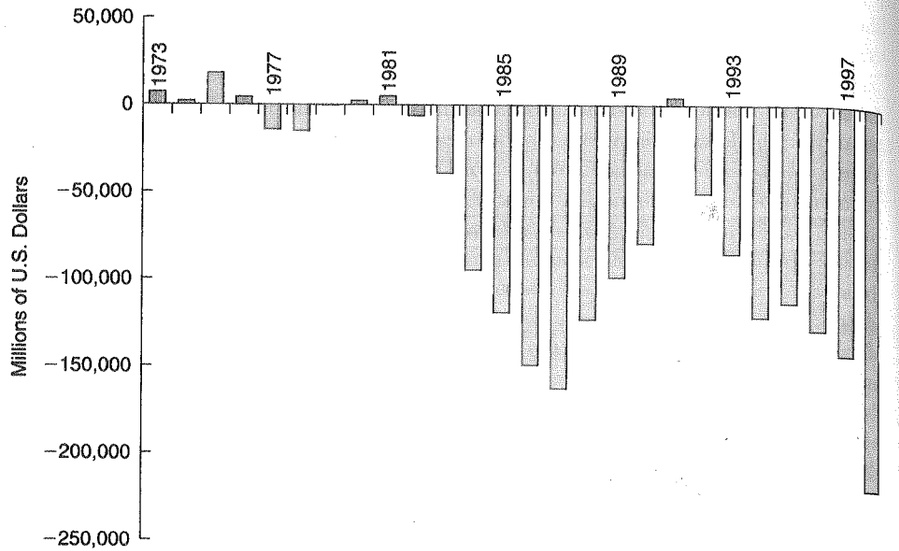

Figure 6.4 U.S. Current Account Balance, 1973–1998.
Source: Economic Report of the President 2002.

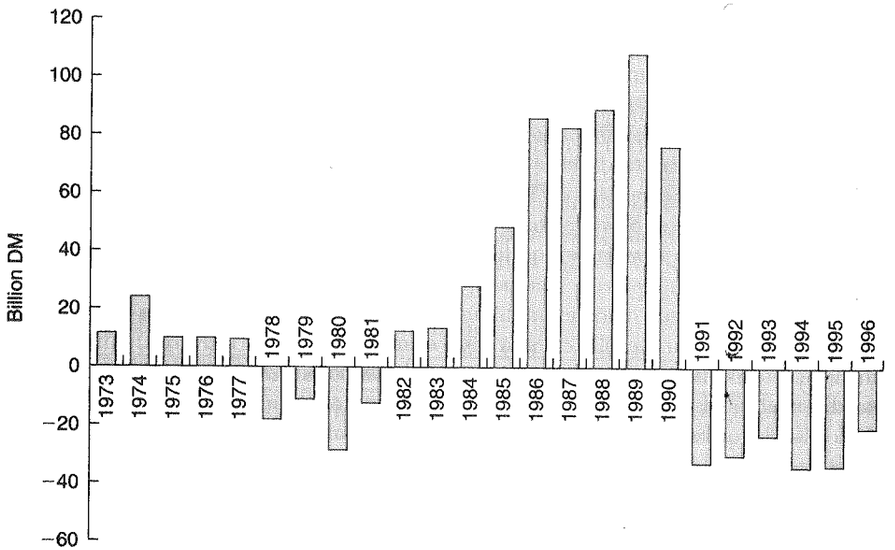

Figure 6.5 Germany's Current Account Balance, 1973–1996.
Source: OECD.

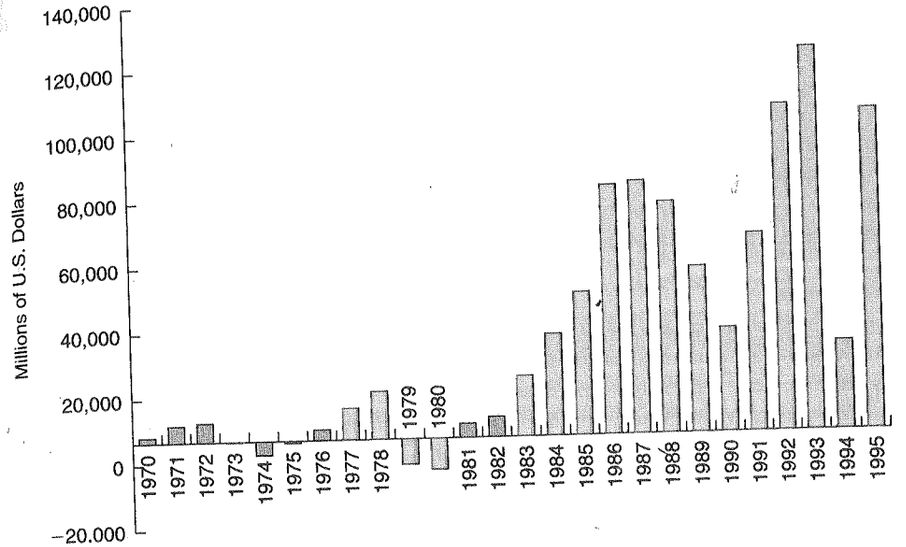

Figure 6.6 Japan's Current Account Balance, 1970–1995.
Source: OECD.

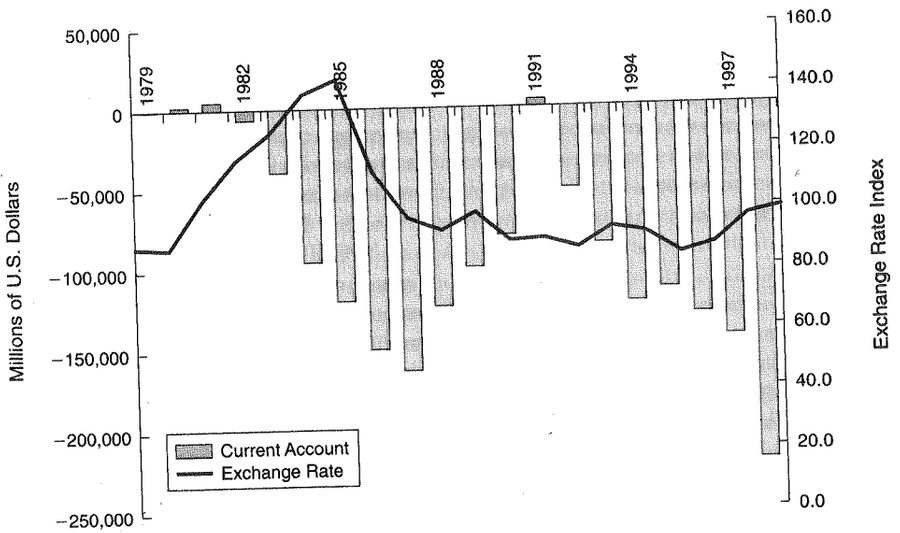

Figure 6.7 U.S. Current Account and Dollar Exchange Rate.
Source: Economic Report of the President.

dollar's exchange rate against the United States' most important trading partners, and the U.S. current account. The two trends indicate some relationship between changes in the dollar's value and the U.S. current account deficit during the 1980s. As the dollar strengthened in the early 1980s, the current account deficit widened, and as the dollar weakened after 1985, the current account deficit narrowed. Yet, the dollar did not depreciate as the current account balance deteriorated in the early 1980s, and the current account has never been brought fully into balance. Even the partial relationship between dollar movements and the current account imbalance disappears during the 1990s. Thus, the last 25 years yield little evidence that exchange rate movements can eliminate current account imbalances.

Exchange rate movements have not promoted current account adjustment in large part because international financial markets have enabled the United States to finance its deficits. International financial markets have channeled funds from countries with current account surpluses, particularly Japan and Germany, to the United States. The ability to finance its current account deficit by attracting capital inflows from abroad has enabled the United States to avoid adjustment, but this has come at the cost of a growing stock of foreign debt. This foreign indebtedness is reflected in America's international investment position. A country's **international investment position** tells us whether the country is a net creditor or debtor nation by subtracting all the foreign assets that its residents own from all of the domestic assets owned by foreigners. A debtor nation owes more to the rest of the world than the rest of the world owes to it; a creditor nation has the reverse position. The American international investment position has worsened steadily during the last 30 years. Excluding direct investment, which does not generate an obligation to repay a debt, total foreign claims on the United States in 1999 stood at $5.8 trillion, while American claims on foreign countries stood at only $4.6 trillion. This produced a net international investment position for the United States of approximately −$1.2 trillion, an amount equal to almost 14 percent of U.S. gross domestic product (Economic Report of the President 2001, 397).

This debt must eventually be repaid. In the meantime, the United States must pay interest to the foreigners who hold this debt. These interest payments may reduce the American standard of living, depending upon how Americans use the funds that they borrow. If the funds borrowed from foreign countries finance consumption expenditures, then interest payments on a growing foreign debt will consume a larger and larger share of U.S. income. This must cause the standard of living in the United States to fall. If the foreign funds finance projects that increase national income, however, by building new factories or developing new technologies, then the American standard of living need not fall. Instead, the interest and principal attached to foreign debt can be repaid from the larger national income that the foreign debt has helped create. Whether foreign debt reduces the standard of living in the United States, therefore, depends upon how these funds are used. While foreign debt need not reduce the American standard of living, continued dependence on capital inflows does render the United States vulnerable to sudden changes in market sentiment. If foreigners suddenly become unwilling to lend to the United States for some reason, (another terrorist attack, for example), the United States will have to reduce its current account deficit quickly. Such a rapid adjustment could have severe consequences for the American economy and bring about a sudden deterioration of the American standard of living.

Thus, while capital flows have eased the pressures for current account adjustment, the resulting accumulation of debt by the United States does raise long-term concerns and renders the American economy vulnerable to developments in the international economic system.

The need for large capital flows to finance current account imbalances has also had an impact on exchange rates, generating exchange rate volatility in the short run and exchange rate misalignments over the longer run. **Exchange rate volatility** refers to short-run exchange rate movements; a currency will appreciate by one or two percentage points in one month and depreciate by the same amount the next. Volatility is caused by short-term imbalances between the supply of and demand for individual currencies in international financial markets. If people wanting to purchase American financial assets, for example, are seeking more dollars than other people are willing to sell, the dollar will appreciate. If people want to sell more dollars than other people are willing to buy, the dollar will depreciate. Volatility, therefore, emerges from short-term imbalances that necessarily arise in foreign exchange markets conducting between $1 trillion and $1.5 trillion of business per day. Such volatility can discourage international trade and investment because it makes it difficult for firms to predict the profitability of international trade. Suppose you are an American producer who exports to the EU and is paid by the importer in euros. You sign a contract establishing the euro price you will receive for your goods, send the goods and expect payment in 60 days. Say that the dollar is trading for one euro on the day you ship your goods, but has fallen to 1.05 euros on the day you receive payment. The dollar amount of your sale, and therefore your profit, has fallen by 5 percent between the time the contract is signed and the payment is made. It is not hard to see why volatility may make businesses reluctant to engage heavily in international trade. The actual impact of exchange rate volatility on international trade and investment is lessened, however, because businesses can purchase options to buy currencies 30, 60, or 90 days in the future at today's exchange rate. This allows firms to protect themselves against short-term exchange rate movements.

Exchange rate misalignments, meaning large changes in exchange rates over a longer period of time, pose bigger problems. Figure 6.8 illustrates misalignments of the dollar, the yen, and the German mark between 1979 and 1998. In this 20-year period the dollar rose from 219 yen in 1979 to 238 yen in 1985, before falling to 128 yen by 1988. The dollar then began to appreciate again, rising to 145 by 1990. From this peak, the dollar again depreciated in the early 1990s, reaching a low of 94 yen in 1995, and then appreciating again to 131 by the end of 1998. The dollar's value against the German mark exhibited almost the identical pattern during the same period. These exchange rate movements represent changes in the value of the dollar, yen, and mark by as much as 50 percent in only one or two years. Misalignments arise from the responses of financial markets to the macroeconomic and current account imbalances at the center of the international economy. The appreciation of the dollar in the first half of the 1980s, for example, was caused by two interacting factors. First, in the early 1980s, the Reagan Administration cut taxes and increased spending, causing the budget deficit and the current account deficit to widen sharply. The widening current account deficit required larger capital inflows, and U.S. interest rates rose sharply to attract the required capital inflows. As capital responded to the high American interest rates, the

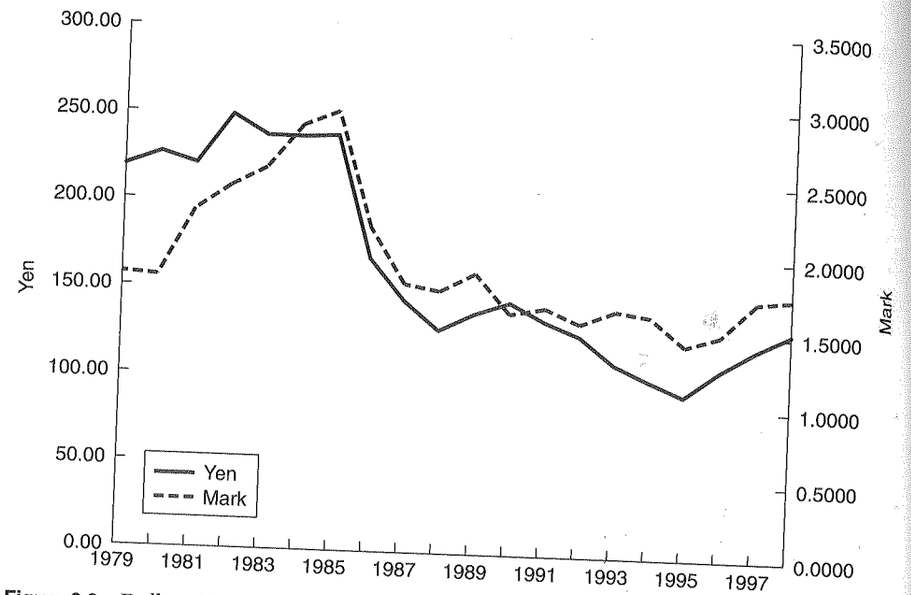

Figure 6.8 Dollar's Value Against the Yen and the Mark.
Source: Economic Report of the President.

demand for the dollar rose substantially and caused the dollar to appreciate against the yen and the mark. The sharp appreciation of the dollar was therefore a result of the inflows of capital required to finance the widening U.S. current account deficit. More broadly, exchange rate misalignments are driven by the international financial flows that result from underlying macroeconomic and current account imbalances.

Misalignments can damage the international economy. Businesses cannot insure themselves against misalignments because financial markets do not provide insurance against currency movements for more than one year in the future. As a result, the businesses that engage in international trade and investment are fully exposed to any large and persistent changes in exchange rates. Exposure to exchange rate movements can discourage investment. Imagine, for example, that you are contemplating building a factory in the United States. Exchange rate movements will influence the amount that you will be able to export and the amount of import competition that you will face. If the dollar is weak, then the investment will be profitable; you will be able to export your goods and you will face little competition from imports in the domestic market. If the dollar is strong, however, the investment may not be profitable. Your goods will be uncompetitive on international markets, and imports will crowd your goods out of the domestic market. The profitability of your contemplated investment, therefore, depends in part on what happens to the dollar's exchange rate during the productive life of your factory. Given the changes in the dollar's value over the past 20 years, can you confidently predict what will happen to the dollar over the next ten? If not, will you make the investment, or is it too risky? Thus, a reduction of investment is one possible consequence of the uncertainty generated by currency misalignments.

Misalignments can also spark political processes that damage the international trade system. The strong dollar of the early 1980s, for example, harmed American producers in the traded goods sectors. Manufacturing industries began to confront intense import competition. To take just one case, Caterpillar, the American producer of earth moving machines, saw its exports fall from $3.5 billion in 1981 to $1.6 billion in 1983 (Funabashi 1988, 71). American agricultural producers also suffered, as their export surplus fell by $8.5 billion between 1981 and 1985 (Funabashi 1988, 69). Manufacturing industries and agricultural producers turned to the political system for relief, pressuring Congress to protect them from imports. Congress was responsive to these pressures. In April of 1985, the U.S. Senate unanimously passed an anti-Japan resolution that accused the Japanese of being closed to American exports, and other protectionist legislation began making its way through the House of Representatives (Funabashi 1988, 73). The appreciation of the dollar therefore spilled over into trade politics, where it sparked demands for "fair trade" and strengthened congressional support for protectionist legislation.

The contemporary international monetary system has thus not operated in the way that governments had anticipated. International financial integration has limited the extent to which exchange rate movements adjust current account imbalances by enabling governments to finance these imbalances. In addition, international financial integration has generated exchange rate volatility and contributed to large exchange rate misalignments. Such exchange rate movements can have a corrosive effect on the global economy, either by directly discouraging international trade and investment, or by sparking political processes that lead to protectionist barriers that make international trade and investment more difficult.

Managing exchange rates. The problems caused by exchange rate volatility and misalignments have spurred governments in the advanced industrialized countries to make attempts to manage exchange rates. This exchange rate cooperation has taken two forms. Among the broader Group of 5, cooperation has focused on periodic and ad hoc efforts to correct misalignments among the dollar, the yen, and the mark (now the euro). Within the EU, governments have engaged in regularized and institutionalized cooperation to minimize misalignments and volatility. We look first at cooperation among the G5 and then turn our attention to the EU.

Exchange rate cooperation in the Group of 5. The high point of cooperation to correct exchange rate misalignments among the Group of 5 occurred in the late 1980s. Pressure for exchange rate cooperation emerged in 1985 following an extended period during which the United States pursued a policy of **benign neglect** toward the dollar's exchange rate. Under this policy of benign neglect, the first Reagan Administration of the early 1980s did nothing as the U.S. budget and current account deficits widened and capital inflows caused the dollar to appreciate sharply. Rather than viewing the dollar's appreciation with alarm, the Reagan Administration championed the strong dollar as a symbol of American economic strength and made no effort to reverse the dollar's ascent. But the harm that the strong dollar caused American manufacturing industry soon became apparent and protectionist forces consequently gained strength in the U.S. Congress. This propelled the Reagan Administration to reevaluate its dollar policy. In the first year of Reagan's second term in office, the administration considered what steps it

could take to stop the dollar's climb and engineer a gradual depreciation. Of particular importance was the decision to appoint James A. Baker III as secretary of the treasury, and one of Baker's first objectives as treasury secretary was to reduce the dollar's value.

The moment looked favorable. The dollar's appreciation appeared to have peaked and in the spring of 1985 the dollar actually began to depreciate. Baker initiated discussions with the German, Japanese, British, and French governments to see whether they would be willing to put together a strategy that could bring about a substantial realignment of the dollar, yen, and mark (Funabashi 1988). These initial discussions led to a meeting of finance ministers from the G5 countries at the Plaza Hotel in New York City on September 22, 1985. In an agreement known as the **Plaza Accord,** the five governments agreed to try to reduce the value of the dollar against the Japanese yen and the German mark by 10 to 12 percent. To achieve this realignment, governments agreed to intervene in the foreign exchange markets whenever it appeared that the markets were pushing the dollar up. In other words, rather than trying to push the dollar down, the G5 would try to prevent the market from pushing the dollar up. Governments agreed to allocate $18 billion to these interventions, with the United States, Germany, and Japan each bearing 25 percent, and Britain and France each bearing 12.5 percent of the total costs. Over the next 15 months, the G5 governments intervened in the foreign exchange markets whenever the dollar's depreciation appeared to be slowing or threatening to reverse. By early 1987, the dollar had fallen almost 40 percent from its peak.

The Plaza agreement was followed by discussion among the G5 governments about deeper exchange rate cooperation. The G5 governments discussed the creation of a variant of fixed-but-adjustable exchange rates called a target zone. In a **target zone,** all currencies would have a central parity surrounded by wide margins—one prominent proposal advocated margins of plus or minus 10 percent—within which the exchange rate would be allowed to fluctuate (Williamson 1983; Solomon 2000). When a currency moved outside the margins, governments would be obligated to intervene in the foreign exchange market or alter domestic interest rates in order to bring it back inside. G5 governments also discussed coordinating macroeconomic policy to promote current account adjustment in the United States, Germany, and Japan. The United States pressured Germany and Japan to adopt more expansionary fiscal policies, largely by reducing taxes, in order to spur domestic demand and increase imports. For its part, the U.S. would adopt a more restrictive fiscal policy to reduce the size of the government budget deficit, thereby reducing domestic demand and U.S. imports. In conjunction with the dollar's depreciation, the coordination of fiscal policies would promote current account adjustment. Neither proposal brought concrete results. Both proposals required governments to use macroeconomic policy to manage the exchange rate, and G5 governments were no more willing to accept such constraints on their domestic economic autonomy in the late 1980s than they had been in the early 1970s.

Interest in exchange rate cooperation among the Group of Five has declined substantially since the late 1980s. In large part this reflects a belief, held most strongly in the United States and somewhat less strongly in Japan and Western Europe, that foreign exchange market intervention can do little to influence exchange rates. Governments do not possess large enough foreign exchange reserves to be important actors in foreign exchange markets. Given the volume of activity in the foreign exchange market, governments must use monetary policy to affect currency values, raising interest

rates when their currency depreciates and lowering interest rates when their currency appreciates. But none of the G5 governments has been willing to use monetary policy to manage the relationship among the dollar, yen, and euro. As a consequence, only a few episodes of coordinated foreign exchange market intervention have occurred since 1990. These coordinated interventions have been much less ambitious than the Plaza Accord, and generally have been undertaken in response to market instabilities. The rapid depreciation of the dollar in late 1994 and early 1995, for example, prompted coordinated intervention by 13 central banks. Only two episodes of coordinated intervention have occurred since 1995, the most recent coming in 2000, to slow the depreciation of the euro (Schwartz 2000; 1996).

Exchange rate cooperation in the European Union. Members of the European Union have been much more willing to manage exchange rates among themselves than have the G5 governments. Since the late 1970s, EU governments have pursued formal and institutionalized exchange rate cooperation within the European Union. Finding some way to stabilize intra-European exchange rates was attractive to EU governments for two reasons. First, EU countries are highly open to trade, and the largest share of each country's trade is with other EU countries. As a result, exchange rate volatility and misalignments within the EU are much more disruptive to individual EU countries than are equivalent movements in the broader international monetary system for the G5 countries (see Frieden 1996). Second, many EU governments were battling high inflation because the shift to floating exchange rates had removed an important constraint on monetary policy. When they do have a fixed exchange rate, governments must restrict the rate at which they allow the domestic money supply to grow. If the money supply grows too rapidly, the economy begins to experience inflation and in many instances a balance of payments deficit emerges which causes the currency to depreciate in the foreign exchange market. The need to intervene in the foreign exchange market to maintain the fixed exchange rate reverses the initial monetary expansion. A fixed exchange rate thus acts as a constraint on monetary policy. Following the collapse of the Bretton Woods system, however, governments could expand the money supply without constraint. Many EU governments did, generating a rapid increase in inflation throughout much of Western Europe during the 1970s. A European-wide exchange rate system would solve both of these problems. Such a system would stabilize each country's exchange rate against its most important trading partners, and keep inflation in check by forcing governments to pursue monetary policies that maintain the fixed exchange rate.

European governments first attempted to create a regional exchange rate system in 1973. This system was short-lived, however, as France, Italy, and Britain had all withdrawn their currencies from the system by 1976. A second attempt, the **European monetary system** (EMS), began operation in 1979. The EMS was a fixed-but-adjustable exchange rate system in which governments established a central parity against a basket of EU currencies called the European Currency Unit (ECU). Central parities against the ECU were then used to create bilateral exchange rates between all EU currencies. EU governments were required to maintain their currency's bilateral exchange rate within 2.25 percent of its central bilateral rate. In practice, however, the EMS quickly evolved into an exchange rate system centered upon Germany. The German mark was the strongest currency in the EU and inflation was lower in Germany than in the other EU countries. Moreover, the German central bank, the Bundesbank,

was the most reluctant participant in the EMS. The Bundesbank was concerned that it would need to continually intervene in foreign exchange markets to support the weaker European currencies, and that this intervention would raise German inflation. The Bundesbank was thus quite reluctant to engage in foreign exchange market intervention or otherwise use German monetary policy to maintain the German mark's exchange rate against the other EU currencies. Instead, the Bundesbank used monetary policy to maintain low inflation in Germany, and the other EU governments adjusted monetary policy and engaged in foreign exchange market intervention to maintain their exchange rate against the mark. The burden of maintaining fixed exchange rates, therefore, fell principally upon the EU governments with high inflation. For the EMS to succeed, these high inflation countries would have to adopt more restrictive monetary policies and reduce their rates of inflation.

Few observers initially gave the EMS much chance of success. Inflation rates averaged just above 10 percent in EU countries, while in Germany inflation was below 5 percent. Such divergent rates of inflation, reflecting substantially different monetary policies, could easily pull the system apart. And indeed, the EMS got off to a rocky start. Currency realignments were quite frequent in the system's first years of operation and a conflict between France and Germany almost destroyed the system in 1981–1983. Conflict arose when newly-elected French president Francois Mitterrand adopted an expansionary macroeconomic policy in 1981. This expansion caused French inflation to rise, the French balance of payments to deteriorate, and the French franc to weaken in the EMS. Mitterrand blamed the franc's weakness on the restrictive macroeconomic policies pursued in Germany (and the other EU countries), refused to alter French policy, and demanded that Germany loosen its policy in line with France. After 18 months of uncertainty about whether Mitterrand would remove the franc from the system or accept the system's constraints, Mitterrand reversed course and adopted restrictive macroeconomic policies. The EMS stabilized in the following years. During the next five years inflation rates in EU countries converged and currency realignments became infrequent. The EMS had defied its critics' expectations.

The EU began to plan for monetary union in 1988. In a **monetary union,** governments permanently fix their exchange rates and introduce a single currency. The EU's push for monetary union emerged from two aspects of the EU. On the one hand, European governments reinvigorated the process of economic integration during the 1980s. New integration projects had been rare during the 1970s as the oil shock, the collapse of the Bretton Woods system, and the ensuing economic stagnation made few governments willing to further open their economies to international trade. In the mid-1980s, EU governments relaunched integration by agreeing to eliminate the remaining barriers to intra-EU trade and capital flows. The Single European Act, as this agreement was called, was directly linked to monetary union because many EU officials believed that the gains from a single market could only be realized with a single currency (see Emerson 1992). In addition, for reasons we explore in greater detail below, governments were concerned that the EMS would become vulnerable to speculative attacks once all restrictions on capital flows had been eliminated. The completion of the single market, therefore, created strong pressures for a shift from the EMS to monetary union.

At the same time, many EU governments were becoming dissatisfied with the asymmetry at the center of the EMS. When they were striving to reduce inflation, most governments were content to place Germany at the center of the EMS and to relieve the Bundesbank of the need to engage in foreign exchange intervention. They were less content with this asymmetry once inflation had fallen. As inflation rates throughout the EU fell toward the German rate of inflation, EU governments began to question why the Bundesbank should continue to set monetary policy for the system as a whole. Instead, many governments argued, the Bundesbank should be required to conduct at least a share of the foreign exchange market intervention required to stabilize the mark. In addition, because German monetary policy was transmitted by the EMS throughout the EU, the other EU governments argued that they should have some influence over the monetary policy adopted by the Bundesbank. By 1987, France and Italy, along with some officials in the European Commission, were suggesting that the time had come to reform the system in order to reduce Germany's privileged role in the EMS (Oatley 1997). Monetary union thus emerged from the broader project of completing the single market and from the narrower concerns about the asymmetry of the EMS.

European governments spent most of the 1990s preparing the way for monetary union. The treaty establishing monetary union, the Maastricht Treaty, was completed in December 1991. Over the next eight years, EU governments completed the task of economic convergence, giving particular attention to maintaining low inflation, reducing government budget deficits, and trying to reduce government debt. In addition, governments created the infrastructure for monetary union. A new European Central Bank (ECB) was created, the accounting systems in the private and public sectors were altered, and the new currency unit was designed and produced. On January 1, 1999, governments took the penultimate step toward monetary union by permanently fixing their exchange rates, transferring authority over monetary policy to the ECB, and introducing the electronic euro. Governments took the final step in January 2002, introducing euro bills and coins and removing national currencies from circulation. At present, EMU does not incorporate all EU member countries: Great Britain, Denmark, and Sweden have opted out of the project. Each retains the right to adopt the single currency at a later date, but at present none have indicated when, or even if, they will do so.

Governments in the advanced industrialized countries have therefore responded to the problems created by exchange rate volatility and misalignments by engaging in exchange rate cooperation. Such cooperation has progressed furthest within the EU, where the desire to minimize exchange rate fluctuations and to contain inflation led governments to create a regional monetary system that during the 1990s was transformed into a full monetary union. Exchange rate cooperation has been much less extensive among the Group of 5. Governments in the broader international monetary system have been willing only to engage in periodic cooperation to manage the relationship among the dollar, the yen, and the mark. Even this minimalist approach has fallen out of favor since the early 1990s.

Capital flows and the prospect for reform. While the managed float has not performed as governments had initially hoped, there is little prospect that the Group of 5 governments will move toward more extensive forms of exchange rate cooperation in the near future. In fact, the process of international financial integration is making such cooperation less rather than more likely. Many prominent observers of the international monetary system, such as former First Deputy Managing Director, of the IMF Stanley Fischer, and Lawrence Summers, former secretary of the treasury in the Clinton Administration,

have argued that fixed-but-adjustable exchange rate systems are increasingly unworkable in a world of mobile international capital (Fischer 2001; Summers 2000).

Fixed-but-adjustable exchange rate systems are increasingly unworkable because they are vulnerable to speculative attacks. A speculative attack can be defined as the sudden emergence of very large sales of a currency sparked by the anticipation of devaluation. In the Bretton Woods system, for example, market participants sold large volumes of dollars in anticipation of devaluation of the dollar against gold. In the early 1990s, market participants sold large volumes of British pounds, Italian lira, French francs, and other currencies in anticipation of devaluations within the EMS. Speculative attacks create large imbalances between the supply of and the demand for the currency being attacked in the foreign exchange market, and large balance of payments deficits for the country being attacked. These imbalances force the government facing such an attack to intervene in the foreign exchange market to defend the exchange rate. The government will rarely hold sufficient foreign exchange reserves to correct the imbalance. In most instances, therefore, the government will have to raise domestic interest rates and impose domestic economic adjustments in order to support its exchange rate.

Fixed-but-adjustable exchange rates are particularly vulnerable to speculative attacks because they are based on the premise that governments can and will periodically realign exchange rates. The recognition that governments can alter exchange rates creates a perverse dynamic in financial markets. Financial market participants will try to anticipate devaluations in order to sell the currency likely to be devalued before devaluation actually occurs. The belief that devaluation is impending can in fact be sufficient to spark a speculative attack that prompts currency sales on such a scale that governments are unable (because they lack sufficient foreign exchange reserves) or unwilling (because they are not willing to raise interest rates high enough) to defend the exchange rate. Devaluation thus takes place whether planned by the government or not. Indeed, speculative attacks make it difficult for governments to arrange orderly exchange rate realignments. Thus, the central premise of fixed-but-adjustable exchange rate systems—that governments should periodically realign exchange rates—appears to be sufficient to generate speculative attacks that make it impossible to maintain such systems for extended periods of time.

A crisis in the EMS in 1992–1993 illustrates this dynamic at work. The crisis developed in the wake of German economic unification in 1990. Unification caused German inflation to rise, and the Bundesbank responded by raising interest rates. To maintain fixed exchange rates against the mark, the other EU governments had to match German interest rate increases. As European interest rates rose, European economies were pushed into recession. Financial markets began to question whether EU governments would be willing to endure protracted recessions simply to maintain their exchange rate with the German mark. Growing doubts about governments' willingness to endure recessions for the sake of maintaining a fixed exchange rate that could in fact be devalued caused market participants to sell the currencies they believed were most likely to be devalued. The size of the capital flows and the amount of foreign exchange market intervention was unprecedented. The British government spent $20 billion—about half of its foreign exchange reserves—in a single day in an unsuccessful attempt to defend the pound (Eichengreen and Wyplosz 1993). The Swedish central bank spent $26 billion—an amount roughly equal to 10 percent of Sweden's GNP, or about $3,500 per Swede—in its unsuccessful defense of the krona's peg. The French government spent $32 billion in a single week during September 1992 to defend the franc (Eichengreen 1996 173–174). Speculative attacks on the system continued periodically into 1993. They ended only after EU governments widened the margins within which currencies were allowed to fluctuate from 2.5 percent to 15 percent. The EMS crisis is not unique. Similar crises have occurred in developing countries. We will examine these in Chapter 8.

Such speculative attacks appear to be eliminating fixed-but-adjustable exchange rates as a viable policy option. Between 1991 and 1999 the number of countries maintaining fixed-but-adjustable exchange rates fell by about one-third, from 98 to 63, while the number of countries with floating or permanently fixed exchange rates has increased greatly (see Figure 6.9). In percentage terms, 62 percent of the world's countries maintained a fixed-but-adjustable exchange rate in 1991, while only 34 percent did in 1999. There has thus been a clear shift away from fixed-but-adjustable exchange rates toward floating and permanently fixed exchange rates. Many observers attribute this change to the growing difficulty of maintaining fixed-but-adjustable exchange rates in a world of internationally mobile capital. If the Group of 5 wants to stabilize exchange rates, therefore, they will probably not be able to do so by moving back toward a Bretton Woods type system. Instead, they will have to adopt some type of permanently fixed exchange rates, as achieved by the EU through monetary union. There are no signs, however, that they are willing to consider a single currency for the international monetary system.

The alternative, of course, is to combine exchange rate reform with new efforts to limit international capital flows. There have been recent proposals, particularly by antiglobalization groups, to introduce a Tobin tax on international currency transactions

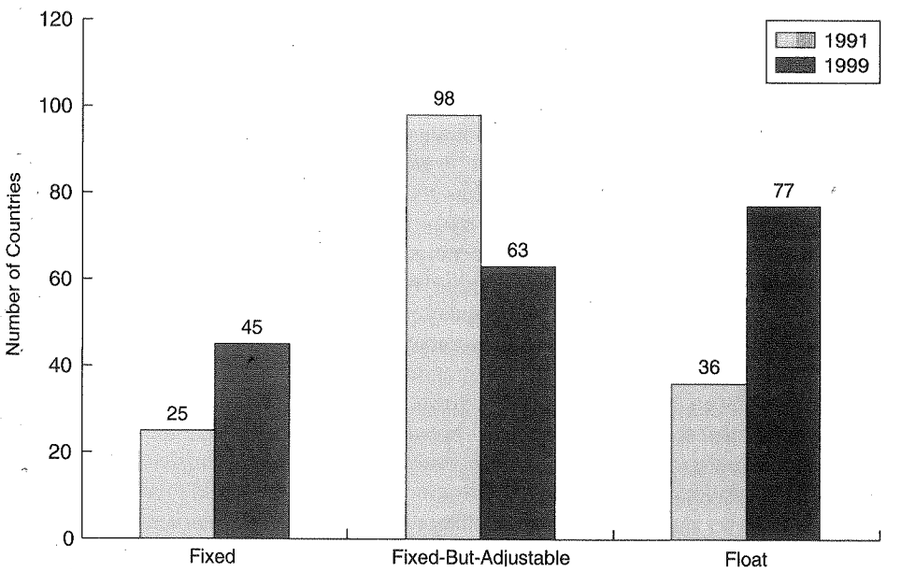

Figure 6.9 Change in Exchange Rate Arrangements, 1991–1999.
Source: Fischer 2001.

in order to stem speculative attacks. A **Tobin tax,** named after Nobel Prize winning economist James Tobin who first proposed the idea in 1972, is a small tax on foreign exchange market transactions. In Tobin's proposal, this tax would be high enough to discourage short-term capital flows, but not high enough to discourage long-term capital flows or international trade. Such a tax, in Tobin's own words, would "put sand in the wheels of international finance" by slowing cross border capital flows rather than ending them altogether. The revenues generated by this tax, the antiglobalization groups suggest, could be used to fund antipoverty programs in developing countries. However, few advanced industrialized countries have expressed support for the Tobin tax, or for any other form of capital control. The EU created a working group in the fall of 2001 to examine the Tobin tax and speculative activity in financial markets more generally. Given skepticism about such measures in many of the large EU countries, however, little is likely to come from this initiative. In the wider international community, the United States has expressed no interest, and the IMF's Managing Director Horst Koehler has questioned the feasibility of implementing a Tobin tax. There is little indication, therefore, that the advanced industrialized countries are willing to re-introduce capital controls. Consequently, they will be unlikely to embark on any far-reaching effort to provide greater exchange rate stability in the international monetary system.

Conclusion

The shift from fixed to floating exchange rates has been shaped by governments' responses to the tradeoff between exchange rate stability and domestic economic autonomy. The shift from the fixed exchange rates of the gold standard to the fixed but adjustable exchange rates of the Bretton Woods system reflected an attempt by governments to reconcile stable exchange rates with domestic economic autonomy. By allowing governments to change their exchange rate when facing a large balance of payments deficit, governments hoped that they would be able to maintain a high degree of exchange rate stability and simultaneously use monetary and fiscal policy to manage domestic economic activity. The Bretton Woods system collapsed in the mid-1970s because these two goals could not be reconciled. And while the collapse of Bretton Woods was influenced by the dollar's central role in the system, what undermined the system was the unwillingness of governments to eliminate balance of payments imbalances through domestic economic adjustments. Ultimately this refusal to accept domestic economic adjustment proved incompatible with fixed exchange rates.

Practically all aspects of the contemporary international monetary system have been influenced by international financial integration. Capital flows have affected the adjustment process by enabling governments to finance current account imbalances. These imbalances, and the accumulating financial imbalances that accompany them, generate a number of vulnerabilities, particularly concerning the continued willingness of foreigners to finance the American deficit. Meanwhile, the churning of the world's foreign exchange markets has generated exchange rate volatility that can discourage international trade and investment. The cross-border capital flows needed to finance current account imbalances have contributed to large exchange rate misalignments that can discourage investment and spark political processes that lead to higher protectionism. In combination with underlying macroeconomic imbalances, financial integration has caused the contemporary international monetary system to operate in ways governments had not expected.

Governments in the advanced industrialized countries have responded to these developments by cooperatively managing exchange rates. There has been considerable variation, however, in their willingness to institutionalize such cooperation. EU governments have gone furthest, establishing a regional exchange rate system in the late 1970s and moving to full monetary union in the first decade of the twenty-first century. The Group of Five governments have been much less willing to engage in exchange rate cooperation. Because foreign exchange market intervention is no longer a highly effective tool for influencing currency movements, exchange rate stability requires governments to embrace deeper forms of cooperation. This includes fiscal policy coordination to eliminate current account imbalances and monetary policy coordination to maintain exchange rates within narrow bands. There is little indication that the Group of Five governments are willing to embrace such coordination. And even if they were, it is not clear that it would be sufficient. The middle ground between floating and fixed exchange rates that governments first tried to establish in the Bretton Woods system appears to have disappeared. Thus, exchange rate stability among the G5 currencies requires governments either to create a monetary union for the dollar, yen, and euro, or to re-impose controls on international capital flows. There is no indication that governments are willing to entertain either idea at present.

Key Terms

Balance of Payments
Balance of Payments Adjustment
Benign Neglect
Board of Governors
Bretton Woods System
Capital Account
Conditionality
Current Account
Devaluation
Dollar Glut
Dollar Overhang
Effective Exchange Rate
Eurodollars
European Monetary System
Executive Board
Exchange Rate Misalignments
Exchange Rate System
Exchange Rate Volatility
Exchange Restrictions
Fiscal Policy
Fixed Exchange Rate System
Fixed-but-adjustable Exchange Rate System
Floating Exchange Rate System
Foreign Exchange Market
Foreign Exchange Market Intervention
Foreign Exchange Reserves
Fundamental Disequilibrium
Group of Five
International Investment Position
Letter of Intent
Macroeconomic Policy
Managed Float
Monetary Policy
Monetary Union
Plaza Accord
Primary Reserve Asset
Revaluation
Speculative Attacks
Stabilization Fund
Sterilized Intervention
Target Zone
Tobin Tax

Web Links

Visit the International Monetary Fund at *www.IMF.org*.

The Bank for International Settlements publishes an annual report in which it surveys developments in international financial markets. This report can be found at *www.BIS.org*.

You can learn more about the EU's economic and monetary union at the website maintained by the European Central Bank: *http://www.ecb.int/*.

Suggestions for Further Reading

Perhaps the most readable account of the evolution of the international monetary system during the last 100 years is Barry J. Eichengreen, *Globalizing Capital: a History of the International Monetary System* (Princeton: Princeton University Press, 1996).

For further exploration of the Bretton Woods System, see Robert Solomon, *The International Monetary System, 1945–1976: an Insiders View* (New York: Harper & Row Publishers, 1977) and Joanne Gowa, *Closing the Gold Window: Domestic Politics and the End of Bretton Woods* (Ithaca: Cornell University Press, 1983).

For those interested in the European Monetary System, see Peter Kenen, *Economic and Monetary Union in Europe: Moving Beyond Maastricht* (Cambridge: Cambridge University Press, 1995), Kathleen MacNamara, *The Currency of Ideas* (Ithaca: Cornell University Press, 1997); Thomas Oatley, *Monetary Politics: Exchange Rate Cooperation in the European Union* (Ann Arbor: University of Michigan Press, 1997).

For the evolution of the international financial system since the Second World War see Eric Helleiner, *States and the Re-emergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994) and Robert Solomon, *Money on the Move: the Revolution in International Finance Since 1980* (Princeton: Princeton University Press, 1999).

CHAPTER 7

Domestic Politics and Exchange Rate Policy

During the last 100 years, governments in the advanced industrialized countries have shifted from the rigidly fixed exchange rates that characterized the gold standard to exchange rate arrangements that offer much greater flexibility. Despite this generalized shift to greater exchange rate flexibility, however, some governments have been more willing to maintain fixed exchange rates than others. Most EU governments, for example, maintained fixed-but-adjustable exchange rates throughout the 1980s, and have now adopted permanently fixed exchange rates within monetary union. At the same time, however, some EU governments refused to participate in the European Monetary System, while others participated but devalued their currencies frequently within the system. Moreover, even though most EU countries have embraced monetary union, some, most notably Great Britain, have thus far refused to participate. To take another example, the Reagan Administration refused to take action during the early 1980s to slow the dollar's sharp appreciation. In 1985, however, the Reagan Administration initiated a multilateral process to reduce the dollar's value and began to explore the merits of international monetary arrangements that could provide greater exchange rate stability. Thus, the more generalized shift to greater exchange rate flexibility has been accompanied by considerable variation in exchange rate policies, both across countries and across time within countries. This chapter explores how the interaction between domestic interests and institutions shapes these exchange rate policy decisions.

Our exploration of domestic exchange rate politics is structured around two central questions. First, how have domestic interests and institutions shaped and reinforced governments' decisions to abandon rigidly fixed exchange rates in favor of greater exchange rate flexibility? Second, how do domestic interests and institutions account for the different exchange rate policies adopted by different governments? Why do some governments maintain fixed exchange rates while others seek greater exchange rate flexibility? Why do some governments value strong currencies while others value weak currencies? The chapter develops two approaches to these two questions, using the same organizing framework we used to explore the domestic politics of trade policy.

The society-centered approach asserts that exchange rate policies reflect politicians' responses to the demands made by domestic interest groups. The state-centered approach, which might be more accurately characterized as an institution-centered approach in this context, asserts that political institutions, particularly central bank institutions, can sometimes allow policymakers to act independently from societal pressures when making exchange rate policy. While the two approaches are often seen as alternative explanations, this chapter argues that both are required to fully understand the historical evolution of exchange rate policies. The society-centered approach highlights the societal pressures to which elected officials must respond when making exchange rate policy. The state-centered approach helps us understand how domestic institutions mediate these societal interests and thereby shape exchange rate policies. We begin, however, by looking at how the interaction between changes in domestic political institutions and changes in economic theory encouraged governments to abandon rigidly fixed exchange rates in the early twentieth century.

Domestic Politics, Monetary Policy, and the Exchange Rate

As we saw in Chapter 6, the shift toward greater exchange rate flexibility began in the early twentieth century and was first codified in the Bretton Woods system established at the end of the Second World War. We begin our investigation of the domestic politics of exchange rate policy by examining this initial shift toward greater flexibility. The shift to greater exchange rate flexibility was motivated by some important changes in domestic political institutions and in the economic theories that informed government attitudes about their proper role in the economy. Changes in electoral institutions in the 1920s produced mass-based democratic elections for the first time in history in many European countries. As a consequence, governments were forced to respond to a set of domestic interests that they had previously been able to ignore, with clear consequences for economic policy. In addition, during the 1930s a revolutionary approach to economic policy began to influence government economic policy. This revolution, sparked by the work of British economist John M. Keynes, provided a compelling intellectual justification for governments to use monetary policy to manage the domestic economy. Institutional change and economic theory combined to push governments to seek greater exchange rate flexibility.

Electoral Politics, the Keynesian Revolution, and Monetary Policy

The shift to greater exchange rate flexibility embodied in the Bretton Woods system was driven by two far-reaching changes in the domestic politics of economic management. The first change stemmed from the transformation of electoral systems—the rules governing who has the right to vote—throughout Western Europe. Prior to the First World War, electoral systems in most West European countries were extremely restrictive. The right to vote was generally limited to males, usually 25 years or older, who met explicit property or income conditions. In European countries with parliamentary

governments, less than one-quarter of the total male population in the relevant age group met these conditions. In Great Britain, for example, only 3.3 percent of the population could vote until 1884, while reforms enacted in 1884 extended the right to vote to only about 15 percent of the population. Even in Denmark, where the right to vote was much broader, mass participation was restricted to lower house elections (the *Folketing*) and the monarch did not have to respect lower house majorities in forming governments (Miller 1996).

European electoral systems were substantially reformed after the First World War. By 1921, restrictive property-based electoral rules had been eliminated and universal male suffrage had been adopted in all West European countries. Changes in electoral laws had a profound impact on the constellation of political parties in West European parliaments. Table 7.1 displays the share of parliamentary seats held by each of the major political parties in a few West European countries before and after the First World War to illustrate this political transformation. Prior to World War I political parties of the right—Conservatives, Liberals, and Catholics—dominated European parliaments. While parties of the left were not totally absent from parliaments, in only one country, Belgium, did a leftist party capture a significant share of parliament. Even here, however, the Belgian Catholic Party's parliamentary majority meant that

Table 7.1
Parties in Parliament, Pre and Post World War I

	1870–1900	1920–1930
Belgium	Catholic (46–93%) Liberals (4–53%)	Catholic (40%) Liberal (12–15%) Workers Party (35–40%)
Denmark	Liberals (60–75%) Conservatives (25–30%)	Social Democrats (32–40%) Liberals (30–35%) Conservative (16–20%)
France	Republicans (60–80%)	Republican Union (30–35%) Socialists (16–25%) Radical Socialists (17–25%)
Germany	Center (20%) National Liberals (12–30%) Conservatives (10–20%)	Social Democrats (20–30%) National People's Party (20%) Center (13%) People's Party (10%)
Netherlands	Liberal Union (35–53%) Catholics (25%) Anti-Revolutionary (15–25%)	Catholics (28%) Social Democrats (20%) Anti-Revolutionary (12%)
Britain	Conservatives (37–50%) Liberals (26–48%)	Conservative (40–67%) Labour (30–47%)

Source: Mackie and Rose 1991.

the political left had little influence on policy in this period. After World War I, leftist parties—Socialists, Social Democrats, and Labour—became large, and in some instances the largest, parliamentary parties in the West European countries. This shift in the balance of political power within European parliaments altered the pattern of societal interests that were represented in the political process. Before World War I, the propertied interests represented by the political parties of the right had a virtual monopoly on political power, while the interests of workers were all but excluded from the political process. Following World War I, however, working class interests gained an authoritative voice in national parliaments. As a consequence, governments were forced to respond for the first time to the demands of workers in order to maintain their hold on political power.

The change in the balance of political power between the right and the left in turn had consequences for economic policy. In political systems monopolized by the right, governments primarily had incentives to protect the assets of the propertied classes and little incentive to adopt policies that favored the workers. In practice this meant that governments pursued policies that kept inflation to a minimum because high inflation erodes the real value of wealth. The gold standard, which effectively limited a government's ability to generate inflation, was fully consistent with this policy objective. Once the political power of workers strengthened, however, governments no longer had as strong an incentive to give priority to low inflation. Instead, politicians now had an incentive to deliver economic conditions that were more in line with workers' interests. And workers, who on average hold little wealth and whose standard of living thus depends heavily upon their weekly pay, have less concern about inflation. What workers do care more about are the employment opportunities available to them and the wages they earn in these jobs. The rise of worker power therefore created political incentives for governments to adopt economic policies that would raise employment and keep wages relatively high. For reasons we will examine in a moment, such policies were not consistent with a continued commitment to the gold standard. The shift in political power that resulted from electoral reform, therefore, created political incentives to move away from the rigid constraints of the gold standard.

While the rising political power of the working class pushed governments to adopt economic policies that would reduce unemployment, revolutionary ideas in economic theory that emerged during the 1930s provided a compelling theoretical rationale for governments to use monetary policy to do so. John Maynard Keynes, whom we encountered briefly in Chapter 6 as the leader of the British team, engaged in postwar planning of the Bretton Woods system, spurred this revolution in his role as academic economist. Keynes's most influential work was shaped by his observations of the British economy during the 1920s and 1930s. What Keynes focused on in particular was unemployment. British unemployment rose to about 20 percent in the early 1920s and never fell below 10 percent during the remainder of the decade (Skidelsky 1992, 130; Temin 1996). Such persistently high rates of unemployment defied the expectations of the standard economic theory, neo-classical economics. Neo-classical economics argued that such persistent high unemployment was impossible because markets have equilibrating mechanisms that would keep the economy at full employment. High unemployment meant that the demand for labor was lower than the supply of labor at the prevailing wage rate. Because labor markets are no different from any other

market, an imbalance between supply and demand should give rise to an adjustment process that eliminates the imbalance. In this case, the excess supply of labor represented by high unemployment should have caused the price of labor—wages—to fall. As the price of labor falls the demand for labor will increase. Eventually such adjustments will guide the economy back to full employment. In neo-classical theory, therefore, unemployment was expected to give rise to an automatic adjustment process that would lead the economy back to full employment.

The persistence of high unemployment in interwar Britain caused Keynes to reevaluate the neo-classical explanation of unemployment (Lekachman 1966; Skidelsky 1994). Keynes's thinking about the causes of unemployment culminated in a book written in the early 1930s (and published in 1936) called *The General Theory of Employment, Interest, and Money* which challenged neo-classical economics in two connected ways. First, Keynes suggested that neo-classical economists were wrong to think that an economy would always return to full employment automatically. For reasons that we explore in a moment, Keynes argued that an economy could get stuck at an equilibrium characterized by under-utilized production capacity and high unemployment. Second, Keynes argued that governments need not accept persistent high unemployment. Instead, governments could use macroeconomic policy—monetary policy and fiscal policy—to restore the economy to full employment.

According to Keynes, economies can get stuck at high levels of unemployment because of the fragility of investment decisions. Investment expenditures typically account for about 20 percent of total national expenditures. Variation in investment expenditures, therefore, can have an important influence on the overall level of economic activity: when investment rises, the economy grows, and when investment falls, the economy stagnates. Investment decisions, however, are strongly influenced by firms' expectations about the future demand for their products. When firms expect future demand to be strong, they will invest and the economy will experience robust growth. When firms expect future demand to be weak, however, they will make few new investments and economic growth will slow. If an economy experiences some sort of shock that causes domestic demand to collapse and unemployment to rise, firms will develop very pessimistic forecasts of the demand for their products in the future. New investments will not be made and the economy will remain stuck at a high level of unemployment. This, according to Keynes, is what had happened to Britain during the 1920s.

Because Keynes believed that the cause of persistent high unemployment ultimately lay in inadequate demand for goods, he proposed that governments use fiscal and monetary policy to manage aggregate demand. **Aggregate demand** is the sum of all consumption and investment expenditures made by the government, by domestic and foreign consumers, and by producers. When we talk about managing aggregate demand, we are therefore talking about policies that increase or decrease these expenditures. Governments manage aggregate demand with fiscal and monetary policies. Fiscal and monetary policies each affect aggregate demand in different ways. Fiscal policy affects aggregate demand directly. When the government cuts taxes without reducing expenditures, aggregate demand increases because private individuals' consumption expenditures increase by some proportion of the tax reduction. When the government increases its expenditures without raising taxes, total government expenditures rise. The additional demand for goods and services that results from these increased expenditures causes

firms to hire more workers to produce the additional goods being demanded. Monetary policy affects aggregate demand indirectly by changing domestic interest rates. An increase in the money supply will cause the domestic interest rate to fall. Lower interest rates make it cheaper to borrow. As the cost of borrowing falls the demand for investment-related expenditures, such as new homes, and high-price consumer items like cars, rises because these are usually purchased with credit and are therefore sensitive to the interest rate. Firms will hire more workers in order to produce the higher level of output being demanded. A monetary expansion, therefore, will lead to falling interest rates, lower interest rates will increase aggregate demand, and increased aggregate demand will cause output and employment to rise.

In short, Keynes argued that by spending when others would not or by increasing the money supply to induce others to spend, the government could increase demand in the economy. By increasing total demand in the economy, investment would rise and unemployment would fall. Thus, by using macroeconomic policy to manage aggregate demand, governments could keep the economy running at full employment. Keynes's *General Theory* therefore represented a substantial challenge to the prevailing wisdom about the role governments could and should play in managing the domestic economy. Neo-classical economists saw the market economy as an inherently stable system that would return automatically to full employment following a shock that raised unemployment. There was therefore no need for active government management of the economy. In contrast, Keynes saw the market economy as potentially unstable and susceptible to large and sustained departures from full employment. Such an unstable economic system needed a stabilizer, and in Keynes's vision governments could perform this stabilizing function by using macroeconomic policy to manage aggregate demand. In one remarkable book, Keynes "rewrote the content of economics and transformed its vocabulary . . . [He] informed the world that fatalism toward economic depression, mass unemployment, and idle factories was wrong" (Lekachman 1966, 59).

The ascent of the political left in national parliaments and of Keynesian theories combined to generate a revolution in macroeconomic policymaking. This revolution began prior to the Second World War and gathered strength during and after the War. The Great Depression that began with the 1929 American stock market crash played an important role in spreading the Keynesian revolution beyond Britain. The Depression brought persistent high unemployment to much of Western Europe and to the United States, and this helped convince governments of the shortcomings of neo-classical theory. Experience with government economic management during the Second World War, when governments intervened extensively to mobilize resources for the War, gave governments a degree of confidence in the policy measures Keynes offered as solutions to the problem of persistent high unemployment (Hall 1989). By the War's end most governments had reevaluated the role they could and should play in the domestic economy. Legislation enacted in the United States and Great Britain illustrates the impact that this reevaluation had on government policy. In 1945 the U.S. Congress considered "The Full Employment Act" that assigned to the Federal government the responsibility for maintaining full employment. While Congress did not pass the 1945 act, in 1946 the bill was renamed and passed as the Employment Act. And while the Employment Act replaced the term "full employment" with "maximum employment," the bill nevertheless symbolized a fundamental change: no longer would the U.S. Government leave the operation of the American economy fully to market forces (Stein 1994, 76–77). In

Britain, the government published a "White Paper on Employment Policy" in 1944 which stated in its very first line, "the government accepts as one of their primary aims and responsibilities the maintenance of a high and stable level of employment after the war" (cited in Hall 1986, 71). This commitment provided the foundation for the macroeconomic policies of successive British governments until the late 1970s.

In most countries, governments relied more heavily upon monetary policy than fiscal policy to manage aggregate demand. While fiscal policy was useful in theory, it proved cumbersome in practice. Government budgets are planned on the basis of an annual spending cycle, and cannot be easily changed in response to changing economic conditions. Moreover, government budgets must be passed by national legislatures, and thus even if governments could make incremental adjustments to overall spending on a quarterly or even monthly basis, securing legislative approval each time is a difficult task. Monetary policy, by contrast, is much easier to manipulate. Interest rates can be easily reduced or raised without elaborate planning. Even more importantly, in most countries governments retained authority over monetary policy and could therefore make interest rate decisions without legislative approval. Thus, for both practical and political reasons, governments relied more heavily on monetary policy than on fiscal policy to manage domestic economic activity.

The Unholy Trinity and the Domestic Politics of Exchange Rate Policies

The emergence of political incentives to use monetary policy to manage the domestic economy greatly reduced the willingness of governments to maintain fixed exchange rates. As we saw in Chapter 6, governments confront a tradeoff between domestic economic autonomy and exchange rate stability. In order to maintain a fixed exchange rate, a government must accept the economic costs associated with domestic adjustment. If a government refuses to accept these costs, it will be unable to maintain a fixed exchange rate. Because this tradeoff is so central to the domestic politics of monetary and exchange policies, we examine it again using a framework called the unholy trinity. The **unholy trinity** (Table 7.2) highlights the tradeoffs that governments face when making decisions about fixed exchange rates, monetary policy, and international

Table 7.2
The Unholy Trinity

If a Government Wants:	It Must Choose Between:
Monetary Policy Autonomy	Fixed Exchange Rate or Capital Mobility
A Fixed Exchange Rate	Monetary Policy Autonomy or Capital Mobility
Capital Mobility	Monetary Policy Autonomy or Fixed Exchange Rate

capital flows. Governments have three policy goals, each of which is desirable in its own right: (1) maintaining a fixed exchange rate, (2) having the ability to use monetary policy to manage the domestic economy, which we will refer to as monetary policy autonomy, and (3) allowing financial capital to flow freely into and out of the domestic financial system, or capital mobility for short. The unholy trinity states that any government can achieve only two of these three goals simultaneously. If a government wants monetary policy autonomy, it must choose between capital mobility and a fixed exchange rate. If a government wants to maintain a fixed exchange rate, it must choose between monetary policy autonomy and capital mobility.

We can look at one example to understand why governments face this tradeoff. Beginning in May 1981, the French government, which had placed the French franc in the European monetary system at a fixed exchange rate, adopted an expansionary monetary policy in an attempt to stimulate the domestic economy and reduce unemployment. The government reduced domestic interest rates and financed approximately one-third of the government's budget deficit through the French central bank (Sachs and Wyplosz 1986, 271). The French financial system was relatively open to capital inflows and outflows. Because participants in financial markets are always seeking the highest return possible, they responded to lower interest rates in France by selling financial assets denominated in French francs and purchasing foreign financial assets. In other words, the French government's monetary expansion generated large capital outflows. These capital outflows produced an imbalance in the foreign exchange market. Demand for the French franc fell below the supply of the franc at the existing exchange rate, and the franc began to depreciate inside the EMS. The French government now had to choose between its desire to use monetary policy to stimulate the French economy and its desire to maintain a fixed exchange rate inside the EMS. If it wanted to maintain the fixed exchange rate, the Bank of France would have to intervene in the foreign exchange market to stop the depreciation. These foreign exchange market transactions would in turn reduce the money supply, causing French interest rates to rise. The franc would stop depreciating only when the imbalance in the foreign exchange market was eliminated, and this would occur only when French interest rates once again equaled interest rates in foreign countries. But the French government was unwilling to reverse its monetary expansion, and chose instead to allow the franc to depreciate. It devalued the franc by 8.5 percent against the German mark in October of 1981. France devalued twice more in the summer of 1982 and March of 1983. The mobility of capital made it impossible for the French government to use monetary policy to stimulate the French economy and at the same time maintain a fixed exchange rate. What holds for the French government in this example holds for all governments in the international monetary system. When capital can move freely across national borders, a monetary expansion will generate capital outflows that force the government to choose between using monetary policy to manage the domestic economy and maintaining a fixed exchange rate.

A government can maintain a fixed exchange rate and use monetary policy to manage the domestic economy if it is willing and able to restrict cross-border capital flows. Suppose in the example above that the French government had implemented capital controls that effectively prevented financial capital from flowing into and out of the French financial system. The French government then expands the money supply.

French interest rates fall, reducing the return on French financial assets relative to the return on foreign assets. While this creates an incentive for capital to move out of France, capital controls prohibit French residents from purchasing foreign financial assets. As a result, the monetary expansion does not generate capital outflows, no imbalance in the foreign exchange market develops, and the franc does not depreciate. In the absence of currency depreciation the French government has no need to intervene in the foreign exchange market. Thus, a government can maintain a fixed exchange rate and use monetary policy to manage domestic economic activity if it is willing and able to prevent cross-border capital flows. More broadly, therefore, if governments want to use monetary policy to manage the domestic economy they must choose between a fixed exchange rate and capital mobility. If they want to maintain a fixed exchange rate they must restrict capital flows. If they cannot or will not restrict capital flows, they will be forced to accept a greater degree of exchange rate flexibility.

The unholy trinity helps us understand how the changes in the domestic politics of monetary policy have shaped the international monetary system since World War II. The tradeoffs inherent in the unholy trinity led governments to allow restrictions on international capital flows in the Bretton Woods system. Keynes and his American counterpart, Harry Dexter White, both recognized that if governments wanted to use monetary policy to manage their domestic economies and simultaneously maintain fixed exchange rates, they would have to restrict international capital flows. As Keynes noted, "the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world," something that would be possible only if governments limited international capital flows (cited in Helleiner 1994, 34). This sentiment was shared by White, who noted that restricting capital flows "would give each government much greater measure of control in carrying out its monetary and tax policies" because governments would not have to fear that expansionary monetary or fiscal policies would generate large capital outflows (Helleiner 1994, 33). The unholy trinity thus found practical expression in the Bretton Woods Articles of Agreement in Article VI Section 3 which expressly allows governments to limit cross border flows of capital as long as doing so does not interfere with trade-related payments (Dam 1982, 100).

The unholy trinity also helps us understand how domestic politics contributed to the collapse of the Bretton Woods system in the early 1970s. As we saw in Chapter 6, international capital flows began to increase rapidly during the 1960s driven by the development of the Eurodollar markets. The emergence of capital flows forced governments to either maintain fixed exchange rates or sacrifice their ability to use monetary policy to manage the domestic economy. This choice took different forms in different countries. In Germany, the choice was between a fixed exchange rate and low inflation. The large speculative crises that shook the Bretton Woods system in the late 1960s and early 1970s forced the German central bank, the Bundesbank, to sell marks and buy dollars, thereby expanding the German money supply and generating inflation. The fixed exchange rate, in other words, prevented the Bundesbank from using monetary policy to achieve its economic priority, maintaining low inflation in Germany. Forced to make a choice between low inflation and the fixed rate, German policymakers allowed the mark to float. In the United States, the choice was between faster economic growth and a fixed exchange rate. Sustaining the dollar in the face of

speculative attacks required the American government to contract the money supply. Since this cut against the domestic economic objectives of President Richard M. Nixon, he allowed the dollar to float (we will look at this example in greater detail later). Thus, the emergence of capital flows during the 1960s forced governments to choose between retaining the ability to use monetary policy to manage the domestic economy and maintaining a fixed exchange rate. Almost without exception, governments in advanced industrialized countries opted to float their currencies in order to retain monetary policy autonomy.

Finally, the unholy trinity helps us understand how domestic politics limit the prospects for far-reaching reform of the contemporary international monetary system. Given the high degree of international financial integration that has resulted from the elimination of capital controls since the early 1980s, returning to a more stable international exchange rate system requires governments to relinquish the ability to use monetary policy to manage their national economies. Moreover, because fixed-but-adjustable exchange rate systems in the contemporary global economy are so vulnerable to speculative crises (for the reasons we explored in Chapter 6), exchange rate stability requires governments to surrender irrevocably monetary policy autonomy by permanently fixing their exchange rates. Because there is little indication that the United States, Japan, and the EU governments (as a group), are willing to surrender this ability, there is little prospect that governments will shift the contemporary international monetary system from its current system of floating exchange rates toward a system of fixed exchange rates. It is important to recognize, therefore, that the current system of floating exchange rates is as much a product of domestic political processes as it is a result of the challenges posed by international financial integration. After all, governments were willing to maintain fixed exchange rates and allow full capital mobility under the nineteenth century gold standard. They are no longer willing to do so because the greater political power of the working class has created powerful political incentives to use monetary policy to manage the domestic economy.

The interaction between electoral reform and the Keynesian revolution, in conjunction with the tradeoffs imposed by the unholy trinity, have therefore had a profound effect on postwar exchange rate policies. Electoral reform altered the balance of political power, shifting the center of gravity away from the propertied classes toward the workers. These political changes gave rise to political incentives to use economic policies to maintain relatively low rates of unemployment. The Keynesian revolution made governments and publics more aware of the policy measures that could be used to promote employment and at the same time broke the neoclassical strictures on their use. As a consequence, voters have come to expect governments to manage the economy in a manner that minimizes unemployment and governments have responded by becoming more willing to use monetary policy to meet these expectations (Hall 1989, 4). These domestic changes in turn had an important impact on the international monetary system. Because governments could not simultaneously use monetary policy to manage the domestic economy and maintain a fixed exchange rate unless they restricted international capital flows, exchange rate stability came to depend upon the ability of governments to effectively impose such restrictions. And while many governments attempted to restrict capital flows in the early postwar period, such efforts ultimately failed to prevent the emergence of large cross-border capital flows. As a consequence, governments have found it increasingly difficult to sustain fixed exchange rate systems.

Society-based Approaches to Monetary and Exchange Rate Policy

Electoral reform, the Keynesian revolution, and the tradeoff between exchange rate stability and domestic economic autonomy have combined to make governments more willing to use monetary policy to manage the domestic economy and correspondingly less willing to maintain fixed exchange rates. Yet, governments have exhibited considerable differences in the exchange rate policies they have pursued. Some governments, such as many members of the EU, have maintained fixed exchange rates for long periods of time, while others, such as the United States and Great Britain, have been unwilling to do so. Some governments have pursued strong currencies by maintaining their currency at an over-valued exchange rate while others have pursued weak currencies by under-valuing their exchange rate. This section presents three society-based explanations for these different exchange rate policies. These society-based models argue that domestic interest group pressures shape the monetary and exchange rate policies that governments adopt. Domestic interest groups have different preferences about the degree of exchange rate stability, about the importance of monetary policy autonomy, about the desired macroeconomic policy objective, and about the level of the exchange rate. The specific monetary and exchange rate policies that a government adopts, therefore, reflect the balance of political power among these competing interest groups.

The three different society-based models to monetary and exchange rate policy are an electoral approach, a partisan approach, and a sectoral approach. The electoral and the partisan approaches share some important commonalities. Both focus on the question of exchange rate stability, asking why some governments fix their exchange rates while others float. In addition, both argue that exchange rate stability is largely determined by the macroeconomic policies that governments adopt. The two approaches differ in the way they conceptualize how social pressures shape a government's macroeconomic policy decisions. The electoral approach argues that macroeconomic policy decisions reflect the need for politicians to satisfy voters in order to win elections. The partisan approach argues that policy decisions reflect the macroeconomic policy objectives of the different social groups that political parties represent. The sectoral approach differs sharply from both of these approaches. The sectoral approach focuses on the level of the exchange rate, whether the government pursues a strong or a weak currency, as well as on the question of exchange rate stability. In addition, the sectoral approach argues that exchange rate policy decisions have little to do with either electoral or partisan preferences. Instead, exchange rate policy is determined by competition between economic interest groups located in the traded goods, nontraded goods, and financial services sectors.

The Electoral Model of Exchange Rate Politics

We begin by examining theories that link exchange rate and monetary policies to electoral politics. At the center of this "political business cycle" model is the recognition that in democratic political systems governments must periodically stand for reelection. In most advanced industrialized societies, domestic economic conditions have an important influence on how voters evaluate an incumbent government. Economic conditions can

influence how people vote in two different ways. At the simplest level, we might expect people to be **pocketbook voters.** A pocketbook voter is a person who votes for or against a government depending upon how they personally have fared under that government. A voter whose income rose under a particular government would be expected to vote for the incumbent while a voter who lost her job or saw her income fall under a particular government would vote against it in the next election. Alternatively, we might expect people to evaluate a government less on the basis of their personal experience and more on the basis of aggregate economic performance. In this approach, called the **sociotropic model,** people support a government that has delivered strong economic growth, low levels of unemployment, and moderate inflation. People will vote against a government that has reigned over recession, rising unemployment, and high inflation (see Lewis-Beck 1988). Whether we assume that people are pocketbook voters or assume instead that they evaluate governments based on the broader economic environment, the central point remains the same: voters reward a government that has delivered good economic conditions and punish a government that has delivered a poor economic environment.

Because voters hold politicians accountable for the economic conditions that prevail during their time in office, governments have an incentive to establish their macroeconomic policy objectives with at least one eye on the electoral calendar (see Kramer 1971; Nordhaus 1989; Tufte 1978; Drazen 2000). In particular, politicians may be more likely to adopt expansionary macroeconomic policies in the 18 months prior to an election in order to create strong economic growth and falling unemployment at the time of the election (Tufte 1978, 9). Even if politicians are not inclined to engineer pre-electoral economic booms (and existing research does not provide compelling evidence that there is a systematic electoral cycle in macroeconomic policy), politicians may believe that voters will punish them for poor economic conditions. As an election approaches, politicians might therefore be reluctant to adopt macroeconomic policies that reduce growth and raise unemployment, such as raising interest rates or reducing a budget deficit. The important point is that because economic performance shapes how people vote, politicians will be less inclined to adopt economic policies that slow economic growth and raise unemployment and more inclined to adopt policies that boost economic growth and lower unemployment.

The influence of electoral politics on macroeconomic policy can in turn affect a government's willingness to maintain a fixed exchange rate. Because governments must stand for reelection, and because macroeconomic conditions shape their electoral fortunes, governments may be less willing to accept the constraints on monetary policy that are imposed by a fixed exchange rate as the next election approaches. Given a choice between maintaining a fixed exchange rate and engineering a preelection jump in economic growth, governments will choose the latter. Alternatively, governments may be less willing to tighten monetary policy to maintain a fixed exchange rate in the months preceding an election. That is, given a choice between raising interest rates in order to support a fixed exchange rate and allowing the currency to float, the government will choose the latter. In short, as an election approaches, a government that is otherwise committed to a fixed exchange rate may be much less willing to adopt the policies required to maintain this exchange rate.

One of the most widely publicized instances of a government sacrificing a fixed exchange rate to electoral politics occurred in the United States in the early 1970s.

The United States ended the convertibility of the dollar into gold in August 1971 and devalued the dollar by 10 percent in the following months. According to one scholar, the decision by President Richard M. Nixon to break the link with gold and devalue was viewed "through a lens that focused on the 1972 presidential election, then 15 months away" (Gowa 1983, 163). American economic conditions in 1971 were not encouraging. Early in his first term Nixon had allowed his economic team to reduce inflation, which was at a then-high level of about 5 percent, but cautioned them to not adopt policies that would raise unemployment in doing so (Stein 1994, Chapter 5). The effort to reign in inflation without raising unemployment was unsuccessful, however. By 1970 the American economy had slipped into a recession and unemployment was beginning to rise. The rise in unemployment evoked painful memories for Nixon. In 1960, Nixon, who was at the time vice president, had run for president against John F. Kennedy. The 1960 campaign took place in the context of a recession, and in October unemployment increased by almost half a million. Nixon was convinced that the rise in unemployment just prior to the November election caused him to lose to Kennedy. "All the speeches, television broadcasts, and precinct work in the world could not counteract that one hard fact" of higher unemployment, he later wrote (Nixon 1962, 309).

Nixon was determined to avoid again falling victim to an economic slump in the 1972 election. With economic forecasts predicting that unemployment would rise to 6 percent in 1972, the Nixon Administration decided to make the reduction of unemployment the number one objective of macroeconomic policy (Tufte 1978, 48). As one senior administration official later recounted, "[in 1971] the word went out that 1972, by God, was going to be a good year" (cited in Tufte 1978, 48). Action was taken on both monetary and fiscal policy. The administration made it known that it wanted the Federal Reserve Bank (the Fed) to increase the rate of growth of the money supply, and the Fed obliged (though it remains unclear whether the Fed's expansion was coincidental or a direct response to White House pressure). In addition, government spending was increased through a range of measures. By the middle of 1971, the Nixon Administration was using monetary and fiscal policies to reduce unemployment in the run-up to the 1972 presidential election. The consequences for the dollar's fixed exchange rate against gold were clear and dramatic. The boost to domestic demand caused by the expansionary policy widened the U.S. trade deficit. Interest rate cuts led to capital outflows. The combination of a widening current account balance and capital outflows worsened the United States' overall balance of payments position and provoked gold outflows. It quickly became apparent that the Nixon Administration would have to choose between its domestic economic expansion and the dollar's fixed exchange rate (Gowa 1983, 170). In an August 1971 meeting at Camp David, therefore, the Nixon Administration made two decisions that were inextricably linked: to push forward with their macroeconomic expansion in the hope that this would reduce unemployment in the run-up to the election; to end the convertibility of the dollar into gold, in effect devaluing the dollar.

The end of dollar convertibility therefore nicely illustrates the logic of the electoral approach to exchange rate policy. President Nixon's concern that high unemployment would reduce his chances for reelection led him to adopt expansionary macroeconomic policies. When it became apparent that expansionary macroeconomic

policies were inconsistent with a fixed exchange rate, the Nixon Administration devalued the dollar. While the electoral approach highlights an important dynamic driving macroeconomic and exchange rate policy, it does suffer from two important weaknesses. First, it offers only a very partial explanation of exchange rate policy. It tells us that a government might abandon a fixed exchange rate prior to an election, but it tells us little about exchange rate policy at other times. If the government wins the election, for example, will it return to a fixed exchange rate? Second, the electoral approach does not provide deterministic predictions. The approach does not claim that all governments will abandon a fixed exchange rate prior to an election. Rather, it suggests only that governments sometimes have an incentive to do so. Thus, an electoral approach offers a quite limited explanation of exchange rate policy.

The Partisan Model of Exchange Rate Politics

Our second model of exchange rate politics is called the partisan approach. Like the electoral approach, the partisan approach links the exchange rate policy that a government pursues to its macroeconomic policies. At the center of the partisan model is a tradeoff between unemployment and inflation called the Phillips curve. The **Phillips curve** is named after British economist A.W. Phillips, who was the first to posit such a relationship in 1958 using data from Britain during the late nineteenth and early twentieth centuries. It suggests that a government can reduce unemployment only by causing more rapid inflation, and can reduce inflation only by causing higher unemployment. One can clearly see the tradeoff between inflation and unemployment that American policymakers faced between 1961 and 1970 (see Figure 7.1). Each data point in Figure 7.1 represents the rate of inflation and unemployment for a single year. Notice how in the years when inflation was low unemployment was high, while in years when unemployment was low inflation was high. This relationship produces the negative line on the figure, characteristic of the Phillips curve tradeoff.

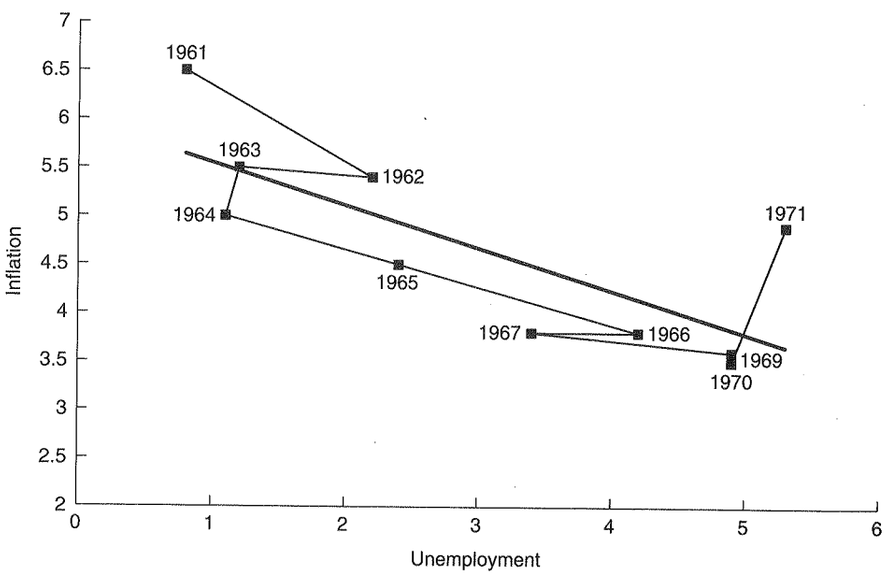

Figure 7.1 The Phillips Curve in the United States, 1961–1971.
Source: Data from Economic Report of the President 2002.

Political economists have used the apparent tradeoff between inflation and unemployment to suggest that different political parties representing different social groups use macroeconomic policy to move the domestic economy to different portions of the Phillips curve. Parties from the political left, such as Socialist Parties, Social Democratic Parties, Communist Parties in Western Europe, the Labour Party in Britain, and the Democrats in the United States, have traditionally given priority to achieving a low level of unemployment even though this entails higher inflation. Such parties will try to shift the economy to the upper left portion of the Phillips curve. Parties from the political right, such as the Conservative Party in Britain, the Republicans in the United States, Liberal Parties, and Christian Democratic Parties in Europe, have traditionally given priority to low inflation even though this entails higher unemployment. These parties will use macroeconomic policy to move the economy to the lower right portion of the Phillips curve. Such distinct partisan macroeconomic policies reflect the interests of the different social groups represented by parties of the left and parties of the right. Leftist parties traditionally have had strong ties to organized labor. In Western Europe, for example, the emergence and development of the labor movement was intimately connected to the emergence and development of leftist political parties. Each of the large union confederations in European countries developed close ties to the political left. In Great Britain, labor union leaders composed about half of the delegates present at the conference that founded the modern Labour Party in 1900. Labor unions support leftist political parties because these parties, once in office, can help them achieve their objectives. Because employment is a central concern of labor unions, the tight link between organized labor and leftist parties creates an incentive for leftist governments to use macroeconomic policy to maintain high levels of employment.

Parties of the right have traditionally had closer links to business interests, the financial sector, and the middle class. These social groups tend to hold more accumulated wealth than workers. Moreover, because they are typically employed in high-skilled and management-related positions rather than in low-skill manufacturing positions, they tend to be more insulated from changes in the unemployment rate than most unionized employees. As a result, these groups are typically less concerned about unemployment and more concerned about protecting the value of their accumulated wealth. Because in modern economies people maintain large portions of their wealth in financial instruments, the desire to protect the value of wealth is transformed into a desire to protect the real value of financial assets. And since inflation erodes the real value of financial wealth, wealth holders have an interest in policies that maintain stable prices. In representing the interests of people with accumulated wealth, therefore, parties of the right have an incentive to adopt macroeconomic policies that maintain stable prices.

A large body of research suggests that leftist and rightist governments in the advanced industrialized countries have in fact pursued distinct macroeconomic policies throughout the postwar period. Research on West European democracies has found that leftist governments have been more willing to tolerate inflation and more inclined to pursue expansionary fiscal and monetary policies than rightist governments (Oatley

1997; Oatley 1999; Garrett 1998). Studies of macroeconomic policy and macroeconomic policy outcomes in the United States have identified similar patterns. Eight of the ten recessions that have occurred in the United States between 1946 and 2002, for example, came under Republican administrations and only two occurred under Democratic administrations (Keech 1995, 72–73). Moreover, historically, unemployment rates have been 2 percentage points higher, on average, under Republican than under Democratic administrations, while the growth of incomes has been 6 percentage points lower under Republican leadership than under Democrats (Hibbs 1987). Republican administrations appear, therefore, to be more willing to tolerate rising unemployment in order to restrain inflation than Democratic administrations. While there have certainly been exceptions to this general pattern, research suggests that political parties from the left and right have in fact pursued distinct macroeconomic policies when in office. Leftist governments have been more willing to tolerate inflation in order to reduce unemployment while rightist governments have been more willing to tolerate unemployment in order to restrain inflation.

Distinct partisan macroeconomic policies can give rise to distinct partisan exchange rate policies. According to the partisan approach, leftist parties are less likely to maintain a fixed exchange rate. Expansionary policies will reduce domestic interest rates and raise domestic demand. Such policies will in turn cause capital outflows and increasing imports. Capital outflows and a widening current account deficit will in turn lead to foreign exchange market imbalances and a weakening currency. Committed to the domestic expansion, leftist governments are likely to resist the policy changes required to support a fixed exchange rate against these pressures. Conservative parties are more likely to maintain a fixed exchange rate. Restrictive monetary policies are less likely to generate capital outflows or to increase domestic demand. As a result, conservative governments are unlikely to confront persistent imbalances in the foreign exchange market, and therefore will not be forced to change their monetary policies to sustain a fixed exchange rate. Conservative governments are therefore more likely to establish and maintain a fixed exchange rate. Thus, the partisan approach suggests that leftist governments are less likely to maintain a fixed exchange rate than rightist governments.

The politics of macroeconomic policy in France between 1978 and 1982 nicely illustrate how changes in the partisan composition of a government can affect macroeconomic and exchange rate policies. A center-right government, led by President Valery Giscard d'Estaing and Prime Minister Raymond Barre, held office in France during much of the 1970s. Giscard and Barre gave priority to reducing inflation (Oatley 1997). This choice was by no means dictated by economic conditions. French inflation was high during the 1970s, rising to 13 percent in 1975 and hovering around 10 percent for the rest of the decade. But French unemployment had also risen steadily throughout the 1970s, from a low of 2.7 percent in 1971 to 6 percent by the end of the decade. The government's decision to give priority to reducing inflation thus reflected a partisan preference. The emphasis on reducing inflation was accompanied by a willingness to establish and maintain a fixed exchange rate for the French franc. Both Giscard and Barre saw a fixed exchange rate as a useful constraint. On the one hand, fixing the franc would constrain French monetary policy, forcing the government to dedicate monetary policy to maintaining the exchange rate. Because the franc was pegged to the German mark, this would require a restrictive monetary policy. In addition, a binding exchange rate would force French industry and labor to slow the growth of wages that was fuelling inflation. With a floating exchange rate, French businesses could accede to the large wage increases demanded by French unions and then pass on these higher costs to consumers by raising their prices. Because the franc was floating, currency depreciation would enable French businesses to remain competitive in international markets. If they faced a fixed exchange rate, however, continual price increases in response to large wage concessions would reduce the competitiveness of French producers. Fixing the exchange rate would therefore force French firms to stop raising their prices, which in turn implied that they would have to reduce the size of the wage increases they granted to their workers. Operating under this logic, Giscard d'Estaing worked with the German government and other members of the European Union to create the European monetary system.

This emphasis on reducing inflation, along with the associated policy of a fixed exchange rate, was abandoned in the early 1980s. The Socialist Party candidate Francois Mitterrand defeated Giscard d'Estaing in presidential elections in May of 1981. Upon assuming the presidency, Mitterrand adjourned the French National Assembly and called new parliamentary elections. This election yielded a parliamentary majority for the Socialist Party and its coalition partner, the French Communist Party. Once installed in power, the Socialists abandoned Giscard and Barre's commitment to reducing inflation. Again, this decision was not dictated by economic conditions. Inflation remained strong, rising to about 13 percent in 1981, despite the efforts of the previous government to reduce it. Unemployment had also continued to rise in the late 1970s and early 1980s, reaching what was then a postwar high of 7 percent in 1981. The decision on the part of the Mitterrand government to address unemployment and pay less attention to inflation was thus a reflection of this government's close ties to the French working class. In order to reduce unemployment the government implemented expansionary macroeconomic policies. The government budget deficit was increased, pumping more government spending into the economy, and the Bank of France reduced domestic interest rates. As we saw in the previous section, this expansion was inconsistent with the French franc's fixed exchange rate inside the EMS. Financial capital began to leave France in response to the falling interest rates. In addition, the French current account deficit widened from $4.8 billion in 1981 to $12.1 billion in 1982 as strong domestic demand limited the goods available for export and pulled in imports. The deteriorating balance of payments position weakened the franc in the foreign exchange market, giving rise to a series of speculative attacks against the franc's parity in the EMS. Rather than abandon their effort to reduce unemployment, the Socialist government devalued the franc three times between May 1981 and March 1983. Thus, a leftist government implemented an expansionary policy that was inconsistent with a fixed exchange rate and, when forced to choose between the two objectives, abandoned the fixed exchange rate.

The French case therefore highlights how partisan politics can shape macroeconomic and exchange rate policies. A rightist government committed to low inflation tightened monetary policy and embraced a fixed exchange rate. The leftist government that followed gave priority to reducing unemployment, adopted expansionary macroeconomic policies in pursuit of this objective, and repeatedly devalued the currency. While the partisan approach tells us more about the politics of monetary and exchange rate politics than the electoral approach, it too has weaknesses. The chief weakness is that the

partisan macroeconomic policies are differentiated too sharply. Not all leftist governments pursue expansionary macroeconomic policies and adopt floating exchange rates. The French Socialists, for example, embraced a fixed exchange rate inside the EMS in mid-1983, and then maintained this fixed rate for the remainder of the decade. We will examine the reasons for this policy U-turn later in the chapter. Nor do all rightist governments adopt fixed exchange rates. The Conservative Party government led by Margaret Thatcher that governed Britain throughout the 1980s, for example, steadfastly refused to adopt a fixed exchange rate for the pound. And even once the pound was placed in the EMS after John Major replaced Thatcher in 1990, it was a Conservative Party government that took the pound out of the system and returned to a floating exchange rate in 1992. Thus, while the partisan approach highlights the historical tendency for distinct partisan macroeconomic and exchange rate policies, it is important to remain sensitive to the specific context when applying this approach to a particular case.

The Sectoral Model of Exchange Rate Politics

The sectoral approach, our third model of exchange rate politics, differs in three important ways from the electoral and partisan approaches. First, electoral and partisan theories focus exclusively on the choice of the exchange rate regime, that is, these approaches explain why some governments maintain fixed exchange rates while others float. Along with the choice of exchange rate regimes, the sectoral approach also attempts to explain the level of the exchange rate, that is, why some governments want strong or over-valued exchange rates while others want weak or under-valued exchange rates. Second, rather than focus on voters or classes, the sectoral approach argues that exchange rate policy is shaped by competition between sector-based interest groups. Finally, whereas the partisan and electoral approaches argue that exchange rate policy results from governments' macroeconomic policy decisions, the sectoral approach argues that sectors have exchange rate preferences: some sectors prefer fixed exchange rates while others prefer floating; some sectors prefer a strong currency while others prefer a weak currency. The exchange rate policy that a government adopts will be determined by the balance of power among these competing sector-based interest groups.

The sectoral approach divides domestic interest groups into four economic sectors: import-competing producers, export-oriented producers, nontraded goods producers, and the financial services industry (see Frieden 1997a; Frieden 1991). As each of these sectors has been defined in earlier chapters, we will not define them again here. Each sector has a preference over both the stability and the level of the exchange rate. Two considerations determine a sector's preference for the degree of exchange rate stability. First, to what extent is the particular sector hurt by exchange rate volatility? The sectors that do suffer harm from a large amount of exchange rate volatility will prefer fixed exchange rates while those that are less vulnerable to volatility will have little desire for a fixed exchange rate. Second, to what extent is the particular sector dependent upon the domestic economy for most of its business? Sectors that are heavily dependent upon the domestic economy will want the government to maintain the ability to use monetary policy to manage domestic economic activity. They will resist efforts to use monetary policy to maintain a fixed exchange rate. Sectors that are less dependent upon the domestic economy will have less need for the government to use monetary policy to manage domestic economic activity. They will lose little if the government dedicates monetary policy to maintaining a fixed exchange rate.

These two considerations lead to fairly clear preferences regarding exchange rate stability for three of the four sectors. Firms based in the export-oriented sector will prefer a fixed exchange rate. These firms are heavily engaged in international trade, and according to this approach suffer considerable harm from the uncertainty generated by exchange rate volatility. Moreover, because these firms are oriented more toward foreign markets than the domestic economy, they lose little when the government sacrifices its ability to use monetary policy to manage the domestic economy. Conversely, the nontraded goods and the import-competing sectors prefer a floating exchange rate. Neither of these sectors is deeply integrated into the global economy and, in fact, the nontraded goods sector is not integrated into the global economy at all. Instead, both generate their revenues from sales in the domestic market. As a consequence, firms based in these sectors are affected little by exchange rate volatility and gain few benefits from a stable exchange rate. Moreover, because firms based in these two sectors depend so heavily upon the domestic economy, they have a keen interest in having the government retain the ability to use monetary policy to ensure that the domestic economy grows strongly. As a result, firms based in the nontraded goods and the import-competing sectors will want monetary policy autonomy and exchange rate flexibility.

The financial sector's preferences over exchange rate stability are less clear. Financial services are highly internationalized and exchange rate volatility can have a negative effect on international lending. This international exposure creates some interest in exchange rate stability. Other factors, however, create an interest in exchange rate flexibility and monetary policy autonomy. Banks and other financial institutions actually profit from exchange rate volatility. Currency trading has become an increasingly important source of profits for the financial services industry. In addition, banks offer services that help businesses engaged in international trade manage their exchange rate risk. This means that financial institutions can actually profit from exchange rate volatility (Destler and Henning 1989, 133). Financial institutions also have reasons to want the government to maintain monetary policy autonomy. They depend upon the central bank to maintain the stability of the domestic banking system and to keep domestic inflation in check. Both objectives require the central bank to maintain monetary policy autonomy. In addition, financial institutions are hurt by excessive fluctuations in domestic interest rates. Using monetary policy to maintain a fixed exchange rate can give rise to more volatile domestic interest rates. The financial sector therefore has crosscutting interests, but on balance its interests are better served by a floating exchange rate (Destler and Henning 1989, 133–134).

Each sector also has preferences over the level of the exchange rate. These preferences arise from the way currency values affect their incomes. The export-oriented and import-competing sectors both prefer a weak or undervalued currency. A weak domestic currency reduces the foreign currency cost of domestic traded goods and raises the domestic currency cost of foreign traded goods. When the dollar depreciates, for example, American goods become cheaper in foreign markets and foreign goods become more expensive in the American market. These price effects enhance the competitiveness of export-oriented producers in global markets, thereby allowing

them to expand their exports. They also reduce the competitiveness of foreign producers in the domestic market, making it easier for import-competing producers to dominate the home market. Thus, firms in the traded goods industries, as well as workers employed in these industries, prefer an under-valued or weak currency. Conversely, firms based in the nontraded goods sector prefer an over-valued or strong currency. A substantial share of the products that people employed in nontraded goods industries consume come from the traded goods sector. A strong domestic currency reduces the domestic currency price of traded goods, both those imported from abroad and those produced at home. When the dollar appreciates, for example, foreign goods become cheaper in the American market and domestic producers must match these falling prices to remain competitive. A strong or over-valued exchange rate, therefore, raises the incomes of people employed in the nontraded goods sector. For this reason, this sector prefers a strong currency.

Once again, the financial services sector has crosscutting interests. Financial institutions benefit from a strong currency because it allows them to purchase foreign assets at a lower price. But as was the case with the choice between a fixed or floating exchange rate, other factors create an interest in a weak currency. Most financial institutions, even those deeply involved in international business, continue to lend heavily to domestic firms. Because an over-valued exchange rate harms firms in the traded goods sectors, a strong currency can weaken financial institutions that have loaned heavily to firms in the traded goods sector. In addition, financial institutions purchase and hold foreign assets for the returns they provide. As these returns are typically denominated in foreign currencies, a weak currency will raise the domestic currency value of these returns. It is not easy for financial institutions to balance these crosscutting considerations. What best suits the interests of financial institutions is the ability to buy foreign assets when the domestic currency is strong and repatriate the returns on these assets when the domestic currency has weakened. Because of these crosscutting interests, financial institutions "tend to be agnostic with respect to the level of the exchange rate" (Destler and Henning 1989, 132).

Bringing these two dimensions of exchange rate policy together provides a full picture of sectoral preferences over exchange rate policy (see Table 7.3). The columns in

Table 7.3
Sectoral Exchange Rate Policy Preferences

		Preferred Degree of Exchange Rate Stability	
		High	**Low**
Preferred Level of the Exchange Rate	**High**		Nontradable goods Financial Services Industry
	Low	Export-oriented Industries	Import-competing Industries

Source: Based on Frieden 1991, 445.

Table 7.3 depict the degree of exchange rate stability. The column labeled "High" denotes a fixed exchange rate (and thus no monetary policy autonomy), while the column labeled "Low" denotes a floating exchange rate (and thus full monetary policy autonomy). The rows in the table depict the level of the exchange rate. The row labeled "High" denotes a strong currency while the row labeled "Low" denotes a weak currency. Each cell of the table thus represents a combination of the level of the exchange rate and the degree of exchange rate stability. We can place each sector into the cell that corresponds to its exchange rate policy preference. The "High-High" cell is empty; there is no sector that desires a strong currency and a fixed exchange rate. The nontraded goods sector and the financial services industry occupy the "High-Low" cell. Firms in the nontraded goods sector want a strong currency to maximize their purchasing power and they want a floating exchange rate so the government can use monetary policy to manage the domestic economy. The financial services industry fits less clearly in this cell. Its preference for a floating exchange rate places it in the left column, but its agnosticism about the level of the exchange rate prevent us from assigning it definitively to the top row. The export-oriented sector occupies the "Low-High" cell. Export-oriented firms want a weak currency to enhance their export competitiveness, and they want a stable exchange rate to minimize the disruptions caused by exchange rate volatility. Because these industries are not heavily dependent upon the domestic economy, they are willing to sacrifice monetary policy autonomy to stabilize the exchange rate. Finally, the import-competing sector occupies the "Low-Low" cell. Firms in this sector want a weak currency to enhance their competitiveness against imports in the domestic market, and they want a floating exchange rate so the government can use monetary policy to manage the domestic economy.

Governments thus face contradictory pressures from the different sectors about how to manage the exchange rate. The political dynamics surrounding the sharp appreciation of the U.S. dollar in the early 1980s and its subsequent depreciation after 1985 nicely illustrates these pressures (see Destler and Henning 1989; Frankel 1990). As we saw in Chapter 6, the U.S. dollar appreciated by 50 percent between 1980 and 1985. This large appreciation generated considerable pressure on the Reagan Administration as interest groups sought to shape the administration's policy concerning both the level and the stability of the dollar. Export-oriented producers organized and lobbied for a weaker and more stable dollar. Farmers, for example, argued that the strong dollar was reducing their incomes and they pressured the Reagan Administration to bring the dollar down. Manufacturing industries, led by the Business Roundtable and the National Association of Manufacturers, also pressed for depreciation. The Business Roundtable put together a broad-based coalition of businesses including representatives from Caterpillar, Ford, U.S. Steel, Honeywell, Motorola, IBM, and Xerox to pressure the U.S. Treasury, the Federal Reserve, and Congress for policies to weaken the dollar. This group also advocated measures to increase the stability of the dollar against the other major currencies. While few suggested that the United States return to a fixed exchange rate, most of the executives in the coalition welcomed the process of coordinated foreign exchange market intervention initiated by the 1985 Plaza Accord and encouraged the Reagan Administration to pursue additional coordinated intervention. In addition, the group applauded the 1987 Louvre Accord, under which the United States, Japan, Germany, Great Britain, and France, agreed to stabilize exchange rates at their current

levels. And finally, they encouraged the U.S. government to explore the possibility of implementing a target zone to bring stability to international monetary arrangements on a more permanent basis. Thus, just as the sectoral approach suggests, export-oriented producers pressured for a weak dollar and for greater exchange rate stability.

The financial services industry also exhibited the preferences highlighted by the sectoral approach. During the early 1980s, the financial services industry displayed little concern about the dollar's appreciation. For the most part, this industry benefited from the falling prices of foreign assets that the strong dollar implied. To the extent that financial service firms voiced any concerns as the dollar appreciated, they focused on the impact the strong dollar was having on traded goods industries in the United States (Destler and Henning 1989). Financial institutions also failed to register strong opposition to the Reagan Administration's concerted effort to engineer a depreciation of the dollar after 1985. Thus, the financial sector was neither a strong supporter of the strong dollar nor a vocal opponent of a weaker dollar. Financial services firms did react strongly, however, to the attempt by the traded goods sector to pressure the Reagan Administration to stabilize the dollar. The American Bankers' Association's Economic Advisory Committee argued that the agreement among the Group of Five governments to stabilize the dollar under the Louvre Accord was a mistake. In addition, the Committee opposed broader international monetary reforms that would lead to the adoption of a target zone system. Monetary policy, they argued, should not be dedicated to maintaining a stable exchange rate, and foreign exchange market intervention should be undertaken only in "exceptional circumstances." As the sectoral approach leads us to expect, therefore, the financial services sector was largely agnostic about the level of the exchange rate, but opposed to efforts to stabilize the dollar at a fixed exchange rate. American exchange rate policy during the 1980s thus highlights the dynamics emphasized by the sectoral approach. The interests and power of two prominent sectors of the American economy, export-oriented producers and the financial services industry, shaped American exchange rate policy.

While the sectoral approach provides greater detail about exchange rate policy than the partisan approach, it too has weaknesses. Three such weaknesses are most troublesome. First, the sectoral approach probably over-estimates the importance that export-oriented firms attach to exchange rate stability. While it is true that exporters can be harmed by exchange rate volatility, it is also true that these businesses can reduce their exposure to volatility by using forward markets to cover the risk they face. As a consequence, exchange rate volatility is much less damaging in practice than it may be in theory. Second, the approach probably over-estimates the importance that the traded good sector attaches to a weak currency. In the contemporary global economy, many firms import a portion of the intermediate inputs used in the final goods that they export. Because a weak currency raises the domestic currency price of these imported inputs, a weak currency raises the costs of the goods that these firms produce. As a consequence, a portion of the gains that these firms realize from a weak currency is eliminated. Finally, the sectoral approach tells us little about exchange rate policy outcomes. As we first saw in our discussion of society-centered approach to trade policy, this approach provides little insight into which of these competing sectoral demands will ultimately become represented in exchange rate policy. In so far as we are interested in explaining policy outcomes, this will remain an important weakness of the sectoral approach.

Weaknesses of the Society-centered Approaches

The society-centered models thus argue that domestic political pressures determine the monetary and exchange rate policies that governments adopt. The three approaches presented here suggest that governments face a multitude of social pressures—from voters, from classes, and from sector-based interest groups. These pressures are transmitted to governments through multiple channels, including mass-based elections, class-based party systems, and interest group lobbying. Social pressures can influence exchange rate policy indirectly by shaping a government's macroeconomic policy objectives, and they can influence exchange rate policy directly by shaping the choices that a government makes between a fixed or floating exchange rate and between a strong or weak currency. Rather than suggesting that monetary and exchange rate policies are determined exclusively by one type of pressure or another, it is probably the case that they are influenced by all of the social pressures discussed here. One approach may be better suited to some countries than to others, or to some time periods than to others. A full understanding of how domestic politics influence monetary and exchange rate policies, however, will probably require attention to all three approaches.

As a group, however, these society-centered approaches to exchange rate politics are susceptible to many of the same criticisms that have been directed toward society-centered approaches to domestic trade politics. Chapter 3 pointed to three specific criticisms: they don't explain outcomes; they assume that governments do not have independent preferences; and they omit the interests of noneconomic interest groups. How powerful are these criticisms when applied to a society-centered approach to monetary and exchange rate policy? Let us look at each of these criticisms in turn. The criticism that society-centered approaches tell us a lot about interests but little about outcomes is less powerful in the context of exchange rate politics than in the context of trade politics. Two of the three society-centered approaches discussed here provide explicit linkages between societal interests and policy outcomes. In the electoral model, outcomes result from government macroeconomic policy choices taken in reference to electoral concerns. In the partisan model, policy outcomes result from decisions made by the party that controls government. The sectoral approach is more vulnerable to this criticism. As was noted above, the sectoral approach convincingly accounts for interest group preferences over monetary and exchange rate policy, but it tells us very little about the process through which these competing interests are transformed into policy outcomes.

Society-centered approaches to exchange rate policy are more vulnerable to the second criticism: that they overstate the ability of domestic interest groups to influence policy and underestimate the importance of independent state action. A fairly large literature suggests that monetary and exchange rate policies are heavily insulated from domestic pressure groups (see e.g. Krasner 1978; Odell 1982). In the United States, for example, exchange rate and monetary policy decisions are made by the Treasury Department, the Federal Reserve, and the White House, all of which are "well insulated from particular societal pressures" (Krasner 1978, 65). Moreover, and as we will see in greater detail in the next section, in many countries central banks operate with considerable independence from elected officials. Politically independent central banks can pursue monetary and exchange rate policies free of pressures from societal interest groups and electoral considerations. In fact, over the last 15 years more and more governments have

granted their central banks greater political independence hoping to insulate monetary policy from social and more broadly political pressures. Thus, society-centered approaches to monetary and exchange rate policy must be sensitive to the domestic institutional context within which policy decisions are made.

Finally, society-centered approaches to exchange rate and monetary policy are less vulnerable to the third criticism: that they ignore the interests of noneconomic actors. While these approaches do in fact exclude noneconomic interest groups, such interest groups appear to have less of a stake in monetary and exchange rate policies than they may have in trade policy. The exchange rate is a very blunt policy instrument. A government cannot easily use exchange rate policy to punish or reward specific foreign governments for their human rights records or for their environmental policies. For example, while the United States can deny China access to the U.S. market without disturbing its other trade relationships, the United States cannot easily alter the dollar's exchange rate against the yuan (the Chinese currency) without also altering the dollar's exchange rate against other currencies. For this reason, human rights activists, environmental groups, and other noneconomic interest groups have not pressured governments to use exchange rate policy to achieve specific foreign policy objectives. Thus, the omission of noneconomic interest groups from the society-centered approach may be less worrying in the context of exchange rate and monetary policies than in trade policy.

The State-centered Approach to Monetary and Exchange Rate Policy

Contemporary economic theories claim that allowing politicians to control monetary policy is costly for society as a whole, while insulating monetary policy from political pressure can raise national welfare. The logic behind these claims, which are the source of the current enthusiasm for politically independent central banks, is based on three components that we explore here. First, an over-arching economic model suggests that society is best served by monetary policies that consistently deliver low inflation. Second, a political model suggests that politicians have little incentive to devote monetary policy to maintaining low inflation. Because elected officials must respond to societal pressures in order to maintain office, they have an incentive to use monetary policy to reduce unemployment in the short run. Over the long run, however, this political incentive to expand the money supply in an attempt to reduce unemployment simply results in higher and higher inflation. Third, allowing the central bank to make monetary policy free from political influence can result in low inflation and higher social welfare. While this body of literature is not often called "a state-centered approach" to monetary policy, it contains the central characteristic of such an approach: insulating policymakers from short-term political pressures can raise social welfare.

This argument has powerfully shaped central bank reforms since the early 1980s. In most advanced industrialized countries, as well as in many developing countries, governments have taken monetary policy out of the hands of elected politicians and placed it in the hands of central bankers that are largely insulated from political pressures. These reforms have in turn altered the domestic politics of monetary and exchange rate policies in ways that are not yet fully clear. We explore these issues here, looking first at the economic model underlying the approach. We then explore how political incentives lead to excessive inflation and examine how central bank independence can solve this problem. We then discuss how the changes in central banks in the advanced industrialized countries are likely to shape the politics of monetary and exchange rate policies. Finally, we look at weaknesses in this state-centered approach.

Monetary Policy and Unemployment

Contemporary economic theory argues that there is no long-run Phillips curve tradeoff between inflation and unemployment. A tradeoff does exist in the short run, but a government cannot reduce unemployment for any extended period of time without generating an ever-higher rate of inflation (Friedman 1968; Phelps 1968). At the center of this theory is the claim that all countries have a natural rate of unemployment. The **natural rate of unemployment** is the economy's long-run equilibrium rate of unemployment, that is, the rate of unemployment to which the economy will return after a recession or a boom (Sachs and Larrain 1993). This natural rate of unemployment is determined by the economy-wide real wage. This real wage is the wage at which all workers who want to work can find employment. The natural rate of unemployment is never zero, and can in fact be substantially above zero. Every economy will always experience some unemployment. Some people will have left one job and be seeking another. New entrants into the labor market, such as recent high school and college graduates, will not find jobs immediately. Moreover, labor market institutions can raise the natural rate of unemployment substantially. Labor market institutions include labor unions as well as labor market regulations that govern such things as minimum wages, hiring and firing practices, unemployment compensation, and other social welfare benefits. These institutions can raise the economy-wide real wage. Higher real wages reduce the demand for labor and thus raise the natural rate of unemployment. As a result, each country will have a distinct natural rate of unemployment, and there can be a considerable gap between these national rates. In the United States, for example, the natural rate in the early 1990s was believed to be about 6.4 percent, and it has subsequently fallen to somewhere around 4.5 percent. In many EU countries, the natural rate of unemployment is much higher, and in some countries as high as 9 percent (OECD 1994).

Contemporary economic theory argues that a government cannot use monetary policy to move unemployment below or above the natural rate of unemployment for more than a short period of time. To understand this claim we must first look at how wage bargaining affects unemployment in the short run. We can then examine how monetary policy affects unemployment in the short run and in the long run. The unemployment rate in the short run, such as a one- or two-year period, is determined by the wage agreements concluded between employers and employees. Suppose that in the current year the economy is at its natural rate of unemployment, and labor is bargaining with management to determine its real wage for the next year. Wage bargaining is complicated by inflation. Workers care about their real wage, the actual purchasing power of the money they are paid each week, but they are paid a nominal wage—a specific amount of cash per hour or per week. Because wage contracts usually

A Closer Look

The Natural Rate in the United States and European Union

The natural rate of unemployment has traced very different paths in the United States and the EU during the last 25 years. In the United States, the natural rate of unemployment rose during the 1970s, reaching a peak of about 6.4 percent in 1984. It has subsequently fallen steadily, so that by the late 1990s it stood at about 5.7 percent, with some estimates suggesting it may be even lower (Gordon 1997). Economists point to three factors to account for the decline in the natural rate of unemployment since the mid-1980s (see Stiglitz 1997). The first is demographic change. The baby boom generation now constitutes a larger share of the total American labor force. This makes the U.S. labor force older than it has been in the past, and mature workers typically have lower unemployment rates than the young. Second, economists point to a "wage aspiration effect." During periods of high productivity growth, workers get accustomed to large real wage increases. When productivity slows workers continue to demand large real wage increases, pushing up the real wage and unemployment. Workers moderate their wage demands only after they have become accustomed to the slower productivity growth. Such dynamics are believed to have contributed to the rise in the natural rate that followed the slowdown in productivity growth during the 1970s and early 1980s. The reduction in the natural rate since the early 1980s reflects the adjustment in workers' aspirations (Stiglitz 1997, 7). Finally, increased competitiveness in labor and product markets probably caused the natural rate to fall. Greater trade openness has forced American firms to manage their labor costs in order to remain competitive. Declining union strength in the United States has reduced the bargaining power held by workers. Together, these developments have slowed the growth of real wages, causing the natural rate to fall.

The downward trend in the American natural rate of unemployment has led many economists to question the usefulness of the concept. If the natural rate can move so much, and if economists cannot predict where exactly it is at any particular moment, then it cannot be a useful guide for monetary policymakers. One prominent economist has challenged his colleagues, "Can you imagine a petition . . . calling on the Federal Reserve to raise interest rates sharply at the present 5.1 percent unemployment in order to ward off imminent inflation? If you cannot imagine such a thing . . . then we as a scientific profession have not advanced this concept to the point where it is suitable for practical use" (Galbraith 1997, 102). Others are less concerned that the downward trend in the natural rate renders the concept less useful. As one such economist has written, "since 1960, inflation rose in 26 of the 32 quarters when the unemployment rate was below 5 percent, but inflation fell in 24 of the 27 quarters when unemployment was above 7 percent" (Stiglitz 1997, 5). The natural rate of unemployment thus does tell us something about the relationship between unemployment and inflation and therefore should guide the monetary policy decisions taken by the Federal Reserve.

In the European Union, the natural rate of unemployment has risen during the last 25 years. Prior to the first oil shock, unemployment in EU countries averaged less than 3 percent. It has since risen steadily, peaking at 11 percent in the mid-1980s before settling at somewhere around 9 percent (Bean 1994; Blanchard and

Continued

Katz 1997, 66). The rise of the natural rate in the EU has been attributed to the interaction between economic shocks and labor market institutions. Adverse economic shocks during the 1970s and 1980s raised the rate of unemployment. Productivity growth slowed, which in conjunction with the aspiration effect led to rising real wages. High real interest rates resulting in part from the efforts by European governments to reduce inflation slowed economic activity and pushed unemployment up. Finally, there was a reduction in the demand for labor independent of these other developments caused by a shift to more technology intensive forms of production (Blanchard 1997).

Once unemployment had risen, labor market institutions limited the wage-based adjustments required to bring unemployment back down. Labor unions, which have traditionally been very strong in many EU countries, kept real wages high by protecting workers from direct competition with nonunionized workers (OECD 1994, 11–12). Government labor market regulations, including laws that make it difficult to fire workers and generous unemployment compensation and other welfare benefits, also limited adjustment. They discouraged firms from employing new workers, and they discouraged people from seeking work because the benefits they get while unemployed allow them to maintain a reasonable standard of living. Over time, these policies generated a large pool of long-term unemployed workers who lost job skills and consequently became less employable (Blanchard and Katz 1997, 68). In short, labor market institutions prevented workers who had lost jobs from competing for available jobs. As a result, higher unemployment failed to spark the wage adjustments needed to bring unemployment back down.

The apparent rigidity of European labor markets has gained increased importance as EU governments implemented monetary union (see e.g., Soltwedel et al. 2000). Prior to monetary union, a government could respond to a country-specific shock that raised unemployment by expanding the money supply and devaluing the currency. Since this response is no longer possible, adjustment following such shocks must now occur through a reduction of wages. The need for wage-based adjustment under monetary union has led the EU Commission, as well as many EU governments, to begin to emphasize the need for reforms that impart greater flexibility to EU labor markets. Many EU Governments have been slow to embrace far-reaching reform, however, in part because labor unions in many countries have been reluctant participants in the reform process.

fix wages for a specific period, typically from one to three years, the nominal wage embodied in a contract will lose purchasing power as inflation raises prices over the life of the wage agreement. Because workers recognize that inflation will erode the value of the nominal wage they receive, they will take inflation into account when negotiating their wage contracts with businesses. In other words, workers will seek nominal wage agreements that protect their desired real wage against the inflation they expect. If labor is seeking stable real wages for the next year, for example, but expects 4 percent inflation in the course of the next year, it will seek a 4 percent nominal wage increase.

How does labor know what inflation rate will prevail in the future? The obvious answer is that they don't. Instead, labor will formulate **expectations** about the future rate of inflation, which are essentially their "best guess" about the inflation rate that is likely to occur during the time period covered by their contract. To what can labor

look to formulate their expectations about future inflation? They may look to the current government's track record—if inflation has persistently run at around 5 percent during the last few years, it might be reasonable to expect 5 percent inflation in the next few years. They may also look for evidence that the government is committed to reducing inflation in the future, or for evidence that the government is likely to produce higher inflation in the future. They may also take in to account the partisan composition of the government or its position in the electoral cycle. Irrespective of the source, however, these expectations are likely to be imprecise.

When nominal wage agreements are based on an expected inflation rate that turns out to be mistaken, the real wage will rise or fall. If workers secure a nominal wage increase that is greater than the actual rate of inflation, then the real wage will rise by the difference between the nominal wage increase and the rate of inflation. So if a wage agreement raises nominal wages by 8 percent, but inflation is only 4 percent, then the real wage will rise by 4 percent. Conversely, if workers secure an agreement that raises their nominal wage by less than the actual rate of inflation, real wages will fall by the difference between the nominal wage increase and the rate of inflation. So if the wage agreement calls for a 4 percent nominal wage increase, but actual inflation is 8 percent, the real wage will fall by 4 percent. Changes in the real wage in turn affect the short-run unemployment rate. An increase of the real wage makes labor more costly to employ, thereby causing unemployment to rise. A reduction of the real wage makes labor less costly to employ, thereby causing unemployment to fall. Thus, in the short run, unemployment rises above or falls below the natural rate of unemployment in response to changes in the real wage.

We can now examine how monetary policy affects unemployment in the short run and in the long run. In the short run, an *unanticipated* change in monetary policy, that is, a change in the rate of inflation that workers did not expect and therefore did not incorporate into their nominal wage contract, can shift unemployment above or below the natural rate. An unexpected *increase* in the rate of inflation generated by a monetary expansion will lower the real wage and reduce unemployment; an unexpected *reduction* in the rate of inflation caused by monetary contraction will raise the real wage and increase unemployment. In the long run, however, these short-run changes in unemployment caused by the unanticipated inflation are reversed. They are reversed because adjustments in the labor market will eventually push unemployment back to the natural rate. Such adjustments occur as a result of the impact that unemployment has on the real wage. Suppose unanticipated inflation has reduced the real wage. As unemployment falls there are fewer people available to work and businesses will have to compete against each other to attract new workers and to maintain their current employees. This competition will cause real wages to begin to rise, making it more costly to employ workers. The demand for labor falls and unemployment rises back to its natural rate. This dynamic was evident in the American economy in the late 1990s. As unemployment fell between 1995 and 1999, the real wages of American workers rose by an average of 2.5 percent per year in 1997 and 1998 (*Economic Report of the President* 2002, Table B-47). Now suppose that lower-than-anticipated inflation has increased the real wage causing unemployment to rise above the natural rate. A larger number of people are now competing for fewer jobs. This competition will cause real wages to fall, as each worker offers to accept employment at a real wage below other workers.

As real wages are bid down through this process, the unemployment rate moves back toward its natural rate. This dynamic has also been evident in the American economy. Unemployment rose sharply in the late 1970s and early 1980s, peaking at 9.8 percent in 1983. As unemployment rose, the real wages of American workers declined, falling by an average of 2.8 percent per year between 1979 and 1982 (ibid. Table B-42). Over time, therefore, adjustments in the labor market bring the real wage back to the wage that clears the labor market, and the economy will return to its natural rate of unemployment. Thus, while an unanticipated change in monetary policy can move unemployment below or above the natural rate in the short run, these changes will be reversed over the long run.

This theoretical framework, which has been widely accepted by professional economists and governments, has clear implications for monetary policy. The most obvious is that governments cannot use monetary policy to reduce unemployment over the long run. Moreover, and much less obvious, the **accelerationist principle** claims that a government that is determined to use monetary policy to keep unemployment below the natural rate for any lengthy period of time will have to continually increase the rate of inflation. We can see why using a modified version of the Phillips curve (see Figure 7.2). In this modified version the economy is characterized by multiple Phillips curves. In each short run period, policymakers face a tradeoff between inflation and unemployment—the downward sloping curves labeled T_1, T_2, and T_3 in Figure 7.2. Because there is no long-run tradeoff between inflation and unemployment, the long-run Phillips curve is drawn as a vertical line that crosses the horizontal axis at the economy's natural rate of unemployment ($\mathbf{U_n}$). Now suppose that from the natural rate of unemployment, point **A** on Phillips Curve T_1, the government expands monetary policy in an attempt to push the rate of unemployment below the natural rate, say to point $\mathbf{U_b}$. Inflation rises, thereby initially reducing real wages and boosting employment, pushing the economy along the

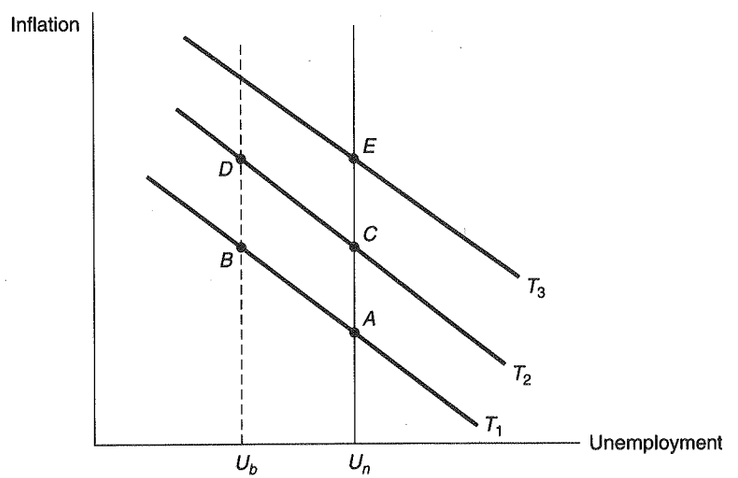

Figure 7.2 The Long-Run Phillips Curve.

short-run Phillips curve T_1 to point **B.** As workers and businesses react to this higher inflation in the way described above, the real wage will rise back to its initial level and unemployment will return to the natural rate. The inflation produced by the expansion is permanent, however, and consequently the government now faces a new short-run Phillips curve, the curve labeled T_2. If the government wants to push unemployment below the natural rate again, it must again expand the money supply. Once again the resulting inflation will reduce the real wage and cause unemployment to fall to point **D.** However, adjustments will return the economy to its natural rate of unemployment at an even higher rate of inflation, point **E** on short-run Phillips curve, T_3. In short, if a government wants to keep unemployment below the natural rate for any extended period, it must continually increase the rate of inflation.

The experience of the United States since the early 1960s illustrates these dynamics at work. One can identify four distinct short-run Phillips curves for the United States between 1961 and 1999 (see Figure 7.3). During the 1960s, the inflation-unemployment tradeoff occurred within a fairly narrow range of relatively low inflation, which averaged about 3 percent. In the early 1970s the American economy jumped to a new short-run Phillips curve that persisted until about 1983. The tradeoff between inflation and unemployment is apparent on this new Phillips curve, but it occurs at a higher rate of inflation (which averaged about 8.2 percent throughout the period) without a corresponding decrease in the average level of unemployment. In fact, unemployment averaged 7.2 percent during this period, much higher than the level that prevailed during the 1960s. The American economy moved to a third short-run Phillips curve between 1984 and 1994. Once again, the tradeoff between inflation and unemployment is apparent in this period, although now it takes place at a lower rate of inflation. Moreover, the reduction

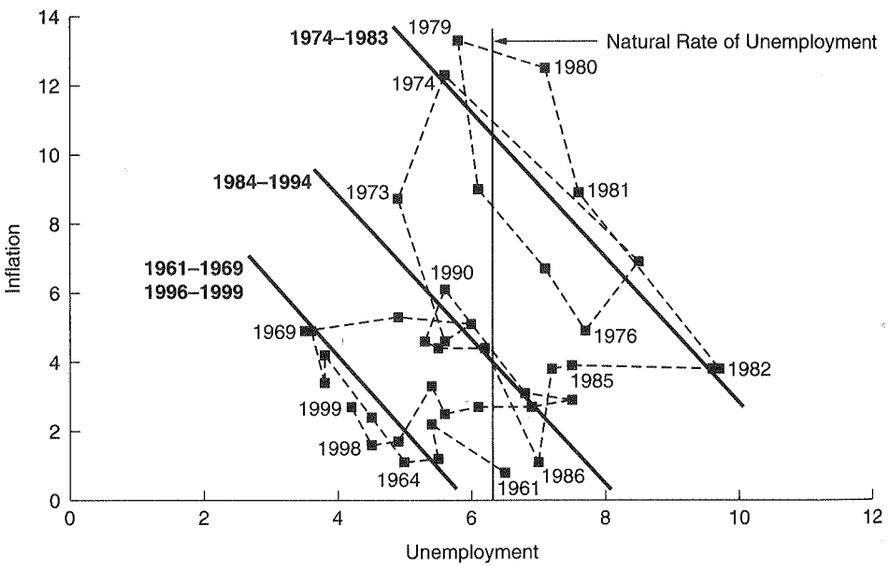

Figure 7.3 Phillips Curves in the United States, 1961–1999.
Source: Data from Economic Report of the President 2002.

of inflation in this period did not cause unemployment to rise. In fact, average unemployment was lower during these ten years (6.5 percent) than in the previous ten years, precisely the opposite of what we would expect if a stable long-run Phillips curve tradeoff were at work. Finally, during the 1990s the United States migrated to a fourth short-run Phillips curve, which coincides well with the Phillips curve that held during the 1960s. As was the case during the previous ten years, falling inflation did not raise unemployment relative to the earlier period. In fact, unemployment in this period was again lower, on average, than it had been during the previous ten years. The American experience during the last 40 years therefore illustrates the absence of a stable long-run tradeoff between inflation and unemployment. Higher inflation during the 1970s did not reduce unemployment relative to the 1960s; lower inflation in the 1980s did not raise unemployment relative to the 1970s; and lower inflation in the 1990s did not raise unemployment relative to the 1980s.

The American experience was not unique, but was widely shared by most advanced industrialized countries. Average inflation rates in most EU countries during the 1970s were more than twice as high as they had been during the 1960s (see Table 7.4). In the European Union, average inflation rose from 4.4 percent in the 1960s to 11 percent in the 1970s. Some countries experienced much higher inflation than these averages suggest; Italy and Great Britain, for example, saw their inflation rates rise above 20 percent in the mid-1970s. Yet, higher inflation failed to produce any sustained reduction in unemployment. In fact, unemployment rose almost continuously throughout the decade (see Table 7.2). Unemployment more than doubled in the European Union countries during the 1970s, jumping from 2.3 percent at the end of the 1960s to 5.4 percent in 1980. Thus, economic developments during the 1970s suggested that there was no stable tradeoff between inflation and unemployment. Any gains in employment realized from monetary expansion were short-term at best, and were accompanied by an increase in the rate of inflation that persisted.

All of this would be of little concern if inflation were innocuous. Inflation isn't innocuous, however, and may have a large negative impact on a country's economic performance. Inflation raises uncertainty among firms and unions, and this uncertainty can reduce investment and economic growth rates. Less investment and lower economic growth can in turn raise the natural rate of unemployment. The experience of the

Table 7.4
Inflation and Unemployment, 1960–1990 (period averages)

	1964–1970		1971–1980		1981–1990	
	Inflation	Unemployment	Inflation	Unemployment	Inflation	Unemployment
United States	3.0	4.2	7.4	6.4	4.2	7.1
Germany	3.7	0.7	5.3	2.2	2.8	6.0
France	4.4	2.0	9.9	4.1	6.3	9.3
Britain	4.2	1.7	14.0	3.8	6.5	9.7
Italy	4.5	5.0	14.8	6.1	10.4	9.5
Japan	5.4	1.2	7.6	1.8	1.4	2.5

Source: Commission of the European Communities.

advanced industrialized countries provides some evidence about how inflation has affected economic performance during the last 30 years. Figure 7.4 illustrates the relationship between inflation and economic growth rates for 15 advanced industrialized countries during the last 30 years. Each point on the graph represents the average rate of inflation and the average rate of economic growth for one country between 1969 and 1995. The graph suggests that on balance, countries with relatively high inflation rates have experienced lower rates of economic growth, while countries with relatively low rates of inflation have experienced faster rates of economic growth. It should be noted, however, that this relationship is not terribly strong. In fact, Japan, which had one of the lowest rates of inflation and the fastest rate of economic growth of all the countries, is a bit of an anomaly. If we exclude Japan, the negative relationship between inflation and economic growth disappears altogether. A stronger pattern is evident when we look at the relationship between inflation and unemployment in these same countries (Figure 7.5). Here each data point represents the average rate of inflation and the average rate of unemployment for one country between 1969 and 1995. This graph suggests that countries with high inflation have had relatively high rates of unemployment, while countries with low inflation have had relatively lower rates of unemployment. At the high end, inflation in Italy averaged just under 12 percent, and unemployment averaged just under 8 percent. At the low end, inflation in Japan averaged 4.9 percent and unemployment averaged only 2 percent. As with economic growth, however, the relationship is not terribly strong. Of course, the determinants of economic growth and unemployment are far more complex than this simple correlation suggests. It may be the case that once the other factors that determine economic growth and unemployment are taken into account, inflation has no impact at all. What does seem clear, however, at least

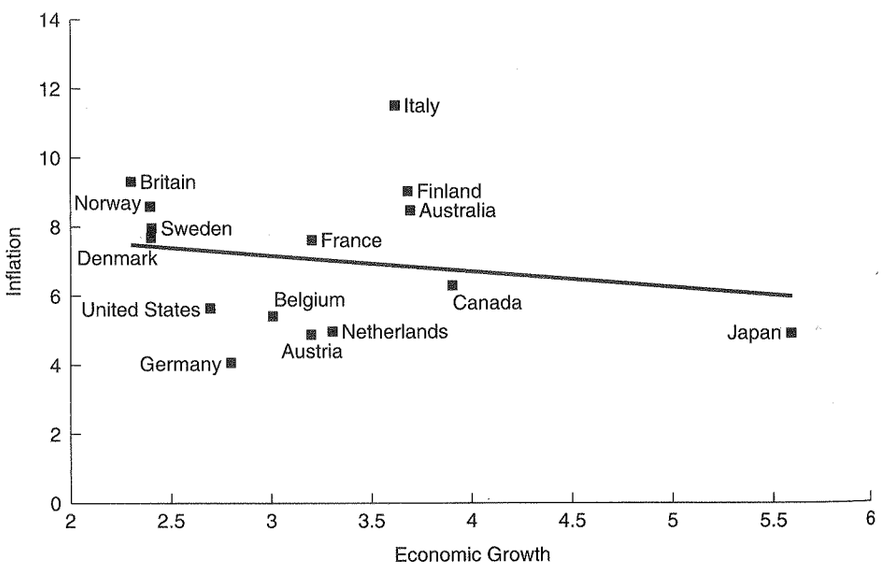

Figure 7.4 Inflation and Growth.
Source: OECD.

based on the experience of the advanced industrialized countries, is that high inflation has not been associated with *better* economic performance. Because inflation provides no permanent gains in terms of higher employment or growth, and carries potentially large costs in terms of fewer jobs and less growth, society is best served by monetary policies that consistently deliver low inflation.

Economic developments during the 1970s and changes in economic theory combined to alter how governments in the advanced industrialized countries thought about monetary policy. The Keynesian strategies that most governments had adopted in the early postwar period were based on the assumption of a stable long-run tradeoff between inflation and unemployment. As evidence accumulated that such a tradeoff did not exist, and as economists developed new theories to explain why this tradeoff should not exist, governments began to question the utility of Keynesian strategies. If monetary policy could not be used to maintain full employment but only produced inflation, and if inflation in turn had a negative impact on economic performance, what good was served by continuing to pursue Keynesian strategies of demand management? During the 1980s, the answer that most governments provided to this question was "not much." As a consequence, policymakers in the advanced industrialized countries began to abandon the Keynesian approach to macroeconomic management in favor of an alternative approach. In this alternative approach, the only proper objective for monetary policy was to achieve and maintain **price stability,** which can be defined as a very low and stable rate of inflation. The shift from Keynesian strategies to the pursuit of price stability occurred first in Great Britain, under the leadership of Margaret Thatcher, and in the United States. Most governments in the other advanced industrialized countries had followed suit by the late 1980s.

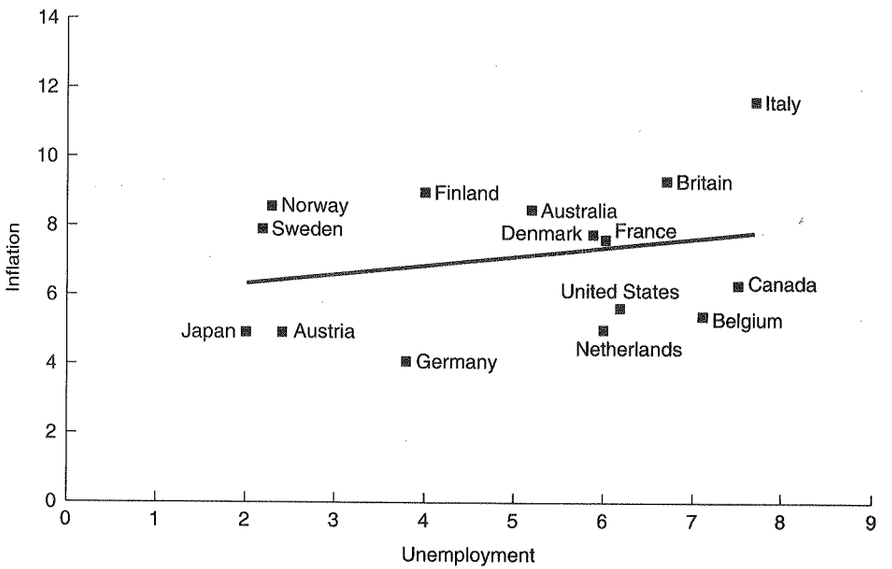

Figure 7.5 Inflation and Unemployment.
Source: OECD.

The Time Consistency Problem

Though most governments were determined to achieve and maintain price stability, few could easily do so. Inflationary expectations were deeply embedded in society as the ten-year history of high inflation made workers and businesses expect inflation to continue in the future. These inflationary expectations in turn shaped wage bargaining, giving inflation a momentum of its own. In order to end inflation, each government would have to make a **credible commitment** to price stability, that is, each government would have to convince workers and businesses that it was truly determined to bring inflation down and keep it down. A government cannot easily make a credible commitment to low inflation, however, because of something called the time consistency problem (Kydland and Prescott 1977). A **time consistency problem** arises when there is an inconsistency between what is the best course of action in general and what is the best course of action at a particular moment in time (Keech 1995, 38). Examinations provide a good example (Drazen 2000, 103). Professors are principally interested in getting their students to learn the material being taught in the course. Examinations are important only because they force students to study more than they would otherwise. As the semester begins, therefore, the professor's optimal strategy is to schedule a final exam for the course. Without an exam, most students will study less, but with an exam, students will study harder and learn more from the course. Once exam day arrives, however, the professor's optimal strategy is to cancel the exam. Because they expected an exam, students have studied and learned as much about the material as they can. Giving the exam is pointless. Moreover, the professor is better off if she does not give the exam; she need not devote time to grading the exam and can instead use that time for other purposes. The students are also better off, for they are spared the time and anxiety associated with taking the exam. Thus, the professor's optimal strategy at the beginning of the semester—declare that a final exam will be given—is not her optimal strategy at the end of the semester. The professor, therefore, has time inconsistent preferences.

Governments often have time inconsistent monetary policy preferences. The government's optimal strategy this year is to declare that it will use monetary policy next year to maintain price stability. If workers believe that the government is committed to price stability, they will set nominal wages accordingly. Once next year's nominal wages are set, however, the government can use monetary policy to reduce the rate of unemployment. By raising inflation above the level that it had announced and upon which workers had based their nominal wage contracts, the government reduces real wages and raises employment. This decrease in unemployment can boost the government's popularity, making it more likely to win the next election. The government's monetary policy preferences, therefore, are not consistent over time. It has an incentive to convince wage bargainers that it is committed to low inflation, and then once it has done so it has an incentive to expand the money supply to reduce unemployment.

Because the government has time inconsistent monetary policy preferences, wage bargainers have little incentive to believe any inflation target that the government announces. Imagine, for example, that you know that in the past your current professor has always announced at the beginning of the semester that there will be a final exam, but subsequently has always cancelled it. How credible would you find this professor's current beginning-of-the-semester promise to give a final examination? You are likely to disregard the professor's promise because you recognize that he has an incentive to renege, and because you have knowledge that he has reneged in the past. Given this conclusion, how much work would you put into the course? Unless you were deeply interested in the subject matter, it is likely that you would work less hard in that class than you would in others where you know a final will be given. The same logic applies to how workers will respond to the government's statements about inflation. Because workers recognize that the government has an incentive to renege on any promise to deliver low inflation, workers will always expect the government to deliver higher inflation than it promises. These expectations cause workers to seek nominal wage agreements that protect real wages from the inflation that they expect.

This interaction between wage bargainers and government has perverse consequences that reduce social welfare. Suppose the government truly intends to keep inflation next year at 2 percent, and publicly announces its intention to do so. Workers disregard this promise, however, for the reasons detailed above. Instead, workers expect the government to actually deliver 6 percent inflation during the next year, and they gain a nominal wage increase based on this expectation. The government must now choose between two sub-optimal monetary policy responses. On the one hand, the government can refuse to expand the money supply in response to the 6 percent wage increase and deliver 2 percent inflation instead. If it does so, however, real wages will rise by 4 percent, and unemployment will rise. On the other hand, the government can expand the money supply in response to the 6 percent nominal wage increase, thereby generating the higher inflation that labor anticipated but that nobody really wants. Thus, either inflation or unemployment will be higher than they would be if the government could make a credible commitment to low inflation.

Independent Central Banks as Commitment Mechanisms

Many governments have solved the commitment problem by establishing independent central banks. **Central bank independence** refers to the degree to which the central bank can set monetary policy free from interference by the government. More specifically, central bank independence is a function of three things: the degree to which the central bank is free to decide what economic objective to pursue, the degree to which the central bank is free to decide how to set monetary policy in pursuit of this objective, and the degree to which central bank decisions can be reversed by other branches of government (Blinder 1999, 54). A fully independent central bank has complete freedom to decide what economic goals to pursue, the ability to determine on its own how to use monetary policy to pursue these goals, and complete insulation from attempts by other branches of government to reverse its decisions. Switzerland's central bank, the Swiss National Bank, provides a good illustration of a highly independent central bank (Eijffinger and Schaling 1993, 80–81). The National Bank Law that established the Swiss National Bank contains no provision whatsoever for allowing the government to influence monetary policy. In addition, the bank's principal policymaking body, the Bank Committee, is composed of 10 members who are selected by the Bank Council, a group of 40 individuals responsible for the management of the bank. Thus, the government has no direct role in selecting the people that make monetary policy

decisions. As a consequence, the Swiss government cannot easily influence the monetary policies adopted by the Swiss National Bank. At the other end of the spectrum lies a fully subordinate central bank. Such a central bank implements monetary policy on behalf of the government. The government determines the goals of monetary policy, the government instructs the central bank how to set monetary policy to achieve these goals, and if the central bank were to make decisions contrary to those desired by the government, these decisions could easily be reversed by the government. The Reserve Bank of Australia provides a good illustration of such a central bank (Eijffinger and Schaling 1993, 82–83). In Australia, the secretary of the treasury, a government minister, has final authority over monetary policy decisions and must approve any interest rate changes that the bank may propose. In addition, one government official has a vote on the Reserve Bank Board, the principal monetary policy decision-making body. The Australian government thus has considerable control over the monetary policy decisions made by the Reserve Bank. Of course we are talking about a spectrum of independence rather than a simple dichotomy between completely independent and fully subordinate.

Granting the central bank independence from the government solves the time consistency problem because it takes monetary policy completely out of the hands of politicians. Monetary policy is no longer made by electorally motivated politicians, but by appointed officials who cannot be easily removed from office. Insulating monetary policy decisions from the short-term incentives created by politics makes it less likely that monetary policy will be directed toward short-term goals, such as a temporary increase in employment, and more likely that it will be oriented toward price stability. Moreover, many independent central banks are legally obligated to give priority to maintaining low inflation. In Germany, for example, the Deutsche Bundesbank Act that established the Bundesbank legally required that it safeguard the value of the Deutsche mark (Eijffinger and Schaling 1993, 77). An independent central bank, therefore, can make a credible commitment to low inflation even though a government cannot. Such a commitment should in turn affect wage bargaining because labor and businesses will believe that the central bank has every intention of keeping inflation down. Granting the central bank independence should, therefore, lead to lower inflation, higher economic growth, and lower unemployment over the long run.

Do independent central banks in practice have the economic consequences that are attributed to them in theory? There is some evidence that they do. Figure 7.6 depicts the relationship between central bank independence and average inflation rates in 15 advanced industrialized countries between 1969 and 1995. The graph shows quite clearly that countries with more independent central banks (the countries located further to the right along the horizontal axis) have experienced lower rates of inflation on average than countries with less independent central banks. Germany, Austria, and the United States, home to three of the most independent central banks in the advanced industrialized countries, have enjoyed substantially lower inflation than Italy and Britain, where politicians controlled monetary policy until quite recently. Other evidence suggests, however, that the lower inflation enjoyed by countries with independent central banks may not have come without cost. Figure 7.7 suggests that countries with more independent central banks have experienced lower rates of economic growth on average than countries without independent central

A Closer Look

The European Monetary System as a Commitment Mechanism

By the late 1970s most governments in the European Union were attempting to reduce inflation. Inflation had risen steadily throughout the decade, reaching double-digit rates in some countries, and averaged just under 10 percent. Yet with the exception of Germany and the Netherlands, no EU country had an independent central bank. As a consequence, few EU governments could readily make a credible commitment to price stability in order to alter the deeply embedded inflationary expectations within their societies. As a substitute for an independent national central bank, they turned to fixed exchange rates in an attempt to make credible commitments to price stability. As a consequence, the European monetary system became the central component of efforts by European Union governments to achieve and maintain price stability (Giavazzi and Giovannini 1989; Oatley 1997).

The EMS had the potential to allow governments to make a credible commitment to price stability because it was centered upon the Bundesbank. The Bundesbank used monetary policy to maintain price stability in Germany and was relatively passive toward the German mark's exchange rate against other EU currencies. It engaged in some foreign exchange market intervention, but did so reluctantly and only when required to do so by the system's rules. Never in the history of the system did it substantially alter its monetary policy in order to stabilize exchange rates. Other EMS member governments then used monetary policy to fix their currencies to the German mark. EU governments accepted this structure because the Bundesbank was the most independent of all EU central banks, and as a result German monetary policy was little influenced by political pressure. Moreover, German inflation was the lowest among all EU countries, averaging only 4.4 percent between 1975 and 1984 (Oatley 1997, 82). By using monetary policy to peg their currencies to the German mark, governments in the EU countries with high inflation were forced to mimic German monetary policy. When the Bundesbank tightened monetary policy, other EMS member governments had to tighten their monetary policies in order to maintain the fixed exchange rate. As long as the Bundesbank continued to maintain low inflation in Germany, a fixed exchange rate inside the EMS would force other EU governments to pursue low inflation monetary policies too. The EMS, in other words, enabled other EU governments to "import" German monetary policy.

EU governments hoped that fixing their currency to the mark would provide a credible commitment to price stability. For this to occur, workers and businesses had to believe that the government was determined to maintain the national currency in the EMS at a given fixed exchange rate. If the government's commitment to the fixed exchange rate was credible, workers and businesses would adjust their behavior. They would recognize that the government had to pursue a low-inflation, monetary policy in order to maintain the fixed exchange rate. This would in turn lead them to reduce their estimates of the level of future inflation. As inflationary expectations fell, workers would seek smaller nominal wage increases and businesses would have smaller cost increases to pass on to consumers. Thus, if a government could make a credible commitment to a fixed exchange rate, it could break the large nominal wage increases that were driving European inflation. Moreover, these adjustments would enable governments

Continued

to reduce inflation without raising unemployment. The risk in this approach was that workers and businesses would not view the government's commitment to a fixed exchange rate as credible. Expectations about future inflation would then not change. Nominal wages would continue to increase rapidly and businesses would continue to pass these higher costs onto consumers as higher prices. The government would then face a choice between sticking to the tight monetary policy required to keep the currency in the EMS, and thereby allowing real wages and unemployment to rise, or allowing inflation to rise and devaluing the currency inside the EMS. Thus, if a government was credibly committed to its fixed exchange rate, disinflation could be achieved without a large increase in unemployment. But if the government's commitment was not viewed as credible, inflation would fall only at the cost of higher unemployment.

While EU governments did reduce inflation, and while the EMS played an important role in facilitating their effort to do so, there is little evidence that the exchange rate system provided a credible commitment to price stability. Instead, inflation appears to have fallen in EU countries because most EU governments were willing to tolerate the higher unemployment that tight monetary policies in the context of large nominal wage increases generated. The EMS failed to provide a credible commitment because the system did not take control of monetary policy away from the government and place it in the hands of appointed officials insulated from political pressures. Instead, workers and businesses simply shifted their attention away from whether or not the government was committed to a stated target for inflation to whether or not the government was truly committed to the fixed exchange rate inside the EMS. And because EU governments retained full discretion over their currencies' exchange rates in the EMS, workers and businesses believed that the government could easily devalue to escape the constraints the system imposed.

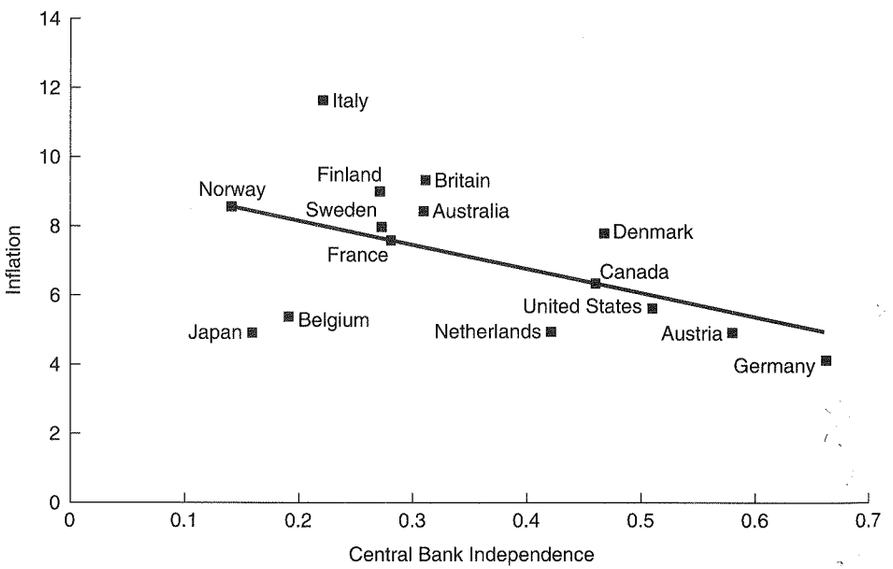

Figure 7.6 Central Bank Independence and Inflation.
Source: OECD and Cukierman 1992.

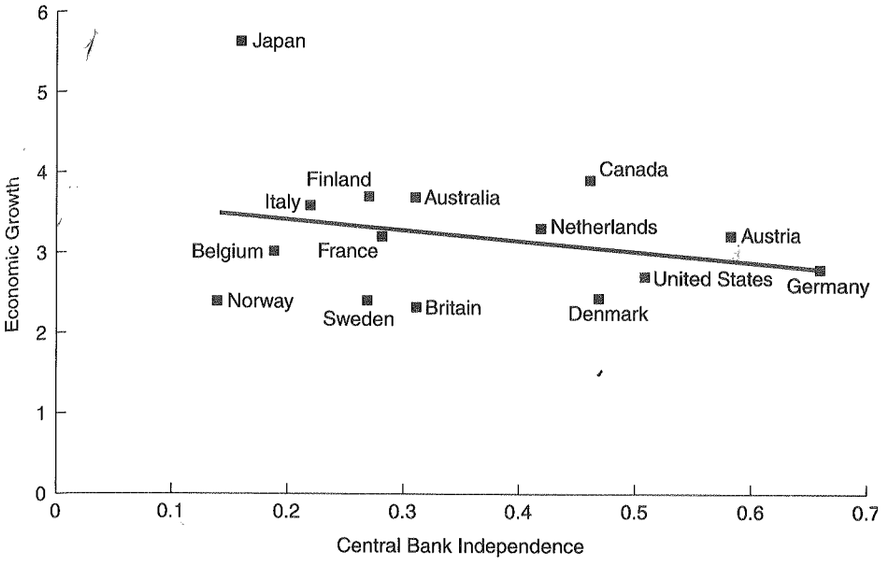

Figure 7.7 Central Bank Independence and Economic Growth.
Source: OECD and Cukierman 1992.

banks. Economic growth in Germany, for example, averaged 2.8 percent in this 30-year period compared to 3.6 percent average annual growth rates in Italy. A similar effect appears to exist for unemployment, where countries with independent central banks have had higher rates of unemployment, on average, than countries without independent central banks (Figure 7.8). Germany and the United States, for example, averaged higher unemployment over the period than did Norway and Sweden, two countries in which governments retained control over monetary policy. Thus, while central bank independence does appear to reduce inflation, there is some evidence that it may also be associated with lower growth and higher unemployment. It is important, however, that we do not conclude too much from these simple correlations. These economic outcomes are determined by a complex set of factors. Once these other factors are taken into account, it may turn out that independent central banks do not have a negative impact on economic growth and the rate of unemployment. Moreover, as we saw in the previous section, low inflation has been associated with faster growth and lower unemployment, and independent central banks have been associated with lower inflation. What is clear, however, at least among the advanced industrialized countries, is that independent central banks have been better able to deliver low inflation than governments.

Believing that independent central banks would be better able to deliver low inflation, many governments began to reform central bank laws in the late 1980s in order to grant their central banks greater independence. Some countries, such as the United States and Germany, have had highly independent central banks throughout the postwar period. In many other countries, however, central banks have traditionally been subordinate to the

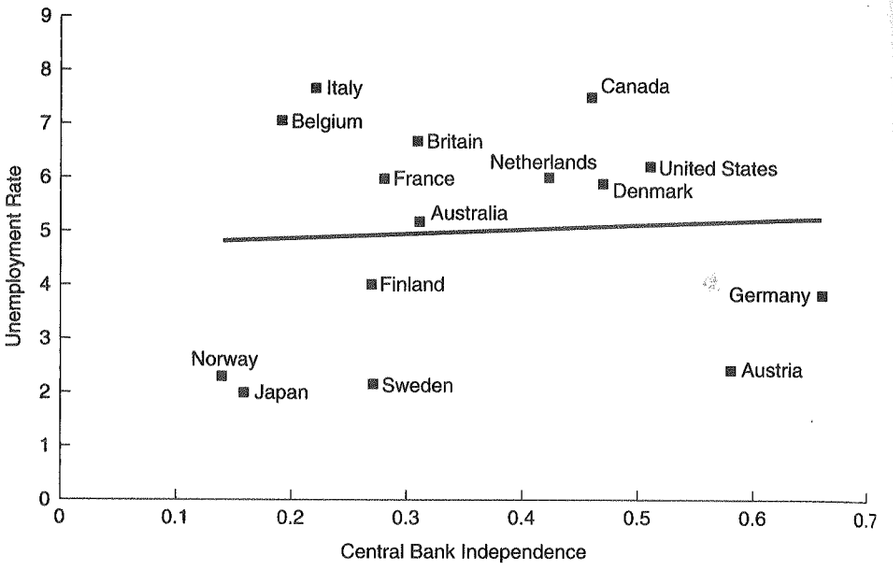

Figure 7.8 Central Bank Independence and Unemployment.
Source: OECD and Cukierman 1992.

government, and only recently have they been granted greater political independence. Until the mid-1990s independent central banks were not common in the European Union. In Great Britain, France, and Italy, for example, central banks served as agents of their respective government (Goodman 1992). During the 1990s, EU governments reformed central banking institutions in conjunction with the transition to economic and monetary union. The European Union's central bank, the European Central Bank (ECB), was established in January 1999 and is one of the most independent central banks in the world. Once in EMU, European governments no longer have national monetary policies, a factor that greatly reduces their ability to determine national monetary policy. In addition, as a condition for membership in EMU, EU governments have granted their own national central banks, which have become the operating agencies of the ECB, considerable independence. Finally, the laws governing the ECB and monetary policy in the EU prohibit national governments from attempting to influence the vote of their respective national central bank governor in the ECB, and they prohibit the EU's Council of Ministers from attempting to influence ECB decisions. National governments in EMU, therefore, are three times removed from monetary policy decisions—once by EMU, a second time by domestic central bank independence, and yet a third time by the rules governing decision making within the ECB.

The Japanese government also moved in the mid-1990s to provide its central bank, the Bank of Japan, with greater independence. Historically the Bank of Japan had nominal independence but in fact acted as an agent of the government through the Japanese Ministry of Finance (Henning 1994). In 1997, the Japanese government altered the rules

governing the relationship between the Bank of Japan and the government, granting the Bank of Japan greater independence. Effort was made in particular to reduce the role played by the Ministry of Finance in Bank of Japan decisions by attempting to eliminate the Ministry of Finance's control of the Bank of Japan's budget and to exclude Ministry of Finance officials from Bank of Japan Policy Board meetings. The reformed Bank of Japan Law achieved neither of these objectives, however, as Ministry of Finance officials are still allowed to attend policy board meetings (though they cannot vote) and the bank's budget is still controlled by the Ministry of Finance (Bank of Japan 2000). Thus, although the Japanese government has attempted to grant the Bank of Japan greater independence, the extent to which they have successfully done so remains unclear.

Independent central banks have implemented monetary policy frameworks oriented toward price stability, an objective that is often defined as about 1 to 2 percent inflation per year. Central banks have adopted a range of strategies to achieve this goal. Some have adopted explicit inflation targets. In the early 1990s, for example, the New Zealand central bank stated that it would bring inflation down to between 3 and 5 percent by the end of 1990 and then further down to between 1.5 and 3.5 percent by the end of 1991. It then adopted as a medium-term objective an inflation target of between 0 and 2 percent. New Zealand's approach is not unique. During the 1990s, central banks in many other advanced industrialized countries also adopted specific numerical targets for inflation (see Bernanke et al. 1999). Other central banks target a range for the growth of the money supply. The European Central Bank, for example, adopts an annual target for the rate of growth of the money supply that it believes is consistent with price stability. Still others, like the U.S. Federal Reserve, don't establish a specific target or focus on a specific indicator, but are guided by monetary growth and the inflation rate. While central banks differ in how they operate monetary policy, they have increasingly converged on the notion that monetary policy's primary goal should be to deliver stable prices.

Independent Central Banks and Exchange Rates

The creation of independent central banks in most advanced industrialized countries, as well as the shift to monetary union in the EU, will affect the domestic politics of monetary and exchange rate policy in ways that are not yet clear. One possibility is that the politics of monetary and exchange rate policies will be increasingly characterized by conflict between elected officials and central banks. Such conflicts are likely to emerge because of three interconnected aspects of monetary and exchange rate politics in this new institutional environment. First, although the institutional framework governing monetary policy has changed, the preferences of domestic interest groups have not. Interest groups, whether they are class-based or sector-based, are still affected by monetary and exchange rate policies in the ways we have examined in this chapter. As a consequence, interest groups still have incentives to pressure the government and the central bank to adopt the monetary and exchange rate policies they prefer. The change in central bank institutions only means that interest groups must pursue these goals through different channels.

Second, despite the creation of highly independent central banks, monetary policy is not perfectly insulated from political influence. Even as national governments have relinquished control over monetary policy to independent central banks, they have retained

control over exchange rate policy. In the United States, the Department of the Treasury, an executive branch agency, takes the lead in setting exchange rate policy for the dollar (Destler and Henning 1989). Treasury officials are responsible for negotiating any currency agreements with foreign governments, and the Treasury takes the lead in foreign exchange intervention, although foreign exchange intervention is conducted by the New York Federal Reserve Bank. The Treasury's control over the dollar's exchange rate is not absolute, however. In general, the Treasury is reluctant to act without the consent of, or at least the absence of opposition from the Federal Reserve. Moreover, while the Treasury can request the Federal Reserve to engage in foreign exchange intervention, it cannot order it to do so on its account. Thus, while the Treasury takes the lead in U.S. exchange rate policy, it has consistently sought cooperation with the Federal Reserve. A similar split of authority is evident in the European Union. While the ECB controls monetary policy, the Council of Ministers has authority over the Euro's exchange rate against non-EU currencies. Article 109 of the Maastricht Treaty gives to the Council of Ministers the authority to "conclude formal agreements on an exchange rate system . . . in relation to non-Community currencies," and it allows the Council to "adopt, adjust or abandon" specific parities within such a system. The treaty also gives to the Council the authority to "formulate general orientations" for exchange rate policy toward non-EU currencies (Gros and Thygesen 1998, 486–488; Henning 1997, 31–42). In making decisions in line with this authority, however, the treaty requires the Council of Ministers to consult with the ECB and to take into account the central bank's commitment to price stability.

Because monetary and exchange rate policies are two sides of the same coin, government control of exchange rate policy can be used to force the central bank to pursue the monetary policies that the government and its supporters desire. For example, some have argued that Helmut Schmidt, who was the German chancellor in the late 1970s and early 1980s, sought to create the European Monetary System in order to force the Bundesbank to pursue a more expansionary monetary policy (Oatley 1997). Fixing the German mark to the French franc, the Italian lira, and other EU currencies, Schmidt thought, would force the Bundesbank to intervene in the foreign exchange market. In most instances, this intervention would be oriented toward preventing the mark from appreciating and would therefore cause an expansion of the German money supply. An exchange rate commitment, therefore, would force the Bundesbank to pursue a looser monetary policy than it wanted. The same logic applies to the contemporary international monetary system. A government or, in the case of the EU, a group of governments that wants a more expansionary monetary policy than the central bank is willing to adopt can try to use its control over exchange rate policy to force the central bank to adopt a different stance. Control over exchange rate policy, therefore, provides governments with a back door through which they can attempt to influence monetary policy. To the extent they use this back door, they are likely to come into conflict with the central bank.

Such conflicts are most likely to arise when the central bank wants the exchange rate to move in one direction in order to maintain price stability, while the government wants the exchange rate to move in the other direction to satisfy demands made by important interest groups. Such conflicts arose periodically between the German government and the Bundesbank prior to the creation of EMU, and such a conflict recently emerged in the EU. In the fall of 1999 and summer of 2000, the euro depreciated sharply against the dollar and the yen. The ECB became very concerned that the depreciation would generate inflation in the EU as the price of traded goods rose in response to the euro's weakening. As Matti Vanhala, governor of the Bank of Finland and therefore a member of the ECB's Governing Council, noted, the euro's weakness is "a bad thing from the point of view of the ECB's goals." The Bank of France's Jean-Claude Trichet echoed these concerns, emphasizing that the ECB needed to be "vigilant about inflation risks" arising from the euro's weakness (*The Financial Times* September 5, 2000). The ECB responded to the euro's depreciation by raising interest rates six times between November 1999 and September 2000. European governments were much less concerned about the euro's weakness and in some cases even welcomed this development. German Chancellor Gerhard Schroder, for example, stated that "the euro's low level [is] a cause for satisfaction rather than concern" because it increases German growth rates by making it easier for German companies to export (*The Financial Times* September 6, 2000). Most governments were also critical of the ECB's attempt to slow the euro's depreciation by raising interest rates. Such conflicts will not be simply conflicts between the government and the central bank. Interest groups may exert pressures on whichever actor they believe is most likely to pursue its preferred policy. Thus, drawing on the sectoral model, we might expect firms in the traded goods industries to exert pressure on the government for some form of exchange rate arrangement because they benefit from a weak currency. Firms in the nontraded goods sector, who benefit from a strong currency, might in turn become strong supporters of the central bank.

Of course, precisely how the creation of independent central banks throughout the advanced industrialized countries, and the creation of monetary union in the EU, will affect the domestic politics of monetary and exchange rate policies is unclear. These developments are so recent that it is difficult to distinguish new patterns of exchange rate politics. What is clear, however, is that the last 20 years have seen far-reaching changes in the political economy of monetary and exchange rate policy. The consensus on Keynesian strategies that existed during the first 30 years of the postwar period has been replaced by a consensus on the advantages of dedicating monetary policy to achieving and maintaining price stability. The political dynamics of monetary and exchange rate policy have also changed as governments have opted to grant their central banks greater political independence. Electoral, partisan, and sectoral interest group pressures could rather easily influence the monetary and exchange rate policies that governments adopted during the early postwar period. The granting of political independence to central banks makes it much more difficult for these groups to influence policy. Nevertheless, interest groups are still affected by monetary and exchange rate policies in the ways detailed in the first half of this chapter. Consequently, these groups still have an incentive to try to influence monetary and exchange rate policy. How they do so, and the extent to which they are successful, will become clear only in the future.

Criticisms of the State-centered Approach

Two principle criticisms can be advanced against the central bank independence literature. First, this approach offers more of a prescriptive framework than an explanatory framework. This approach tells us that social welfare is higher with an independent central bank than with a politically controlled central bank, and based on that claim it suggests that governments should grant their central banks greater political independence.

This approach tells us very little, however, about what factors motivate elected officials to create independent central banks. One might argue that governments create independent central banks to maximize long-term social welfare. Yet, such an explanation rests uneasily with the central logic of the time consistency problem. After all, the entire rationale for central bank independence rests on the claim that elected officials care more about short-term electoral gains than long-run social welfare. We need some explanation for why governments that are supposedly unconcerned with long-run welfare gains create central bank institutions whose sole purpose is to raise long-run social welfare. Nor does this approach explain how monetary authorities responsible for an independent central bank are likely to behave. While an independent central bank that gives priority to price stability may raise social welfare, little attention has been devoted to the question of whether or not the people who run the independent central bank actually have an incentive to give priority to price stability. Thus, much work remains before this approach offers an explanation for the changes in central banking institutions that have taken place since the early 1980s.

Second, and much more broadly, independent central banks may be considered inconsistent with democracy. As former member of the Federal Reserve Board, Alan Blinder has asked, "Isn't there something profoundly undemocratic about making the central bank independent of political control? Doesn't assigning so much power to unelected technocrats contradict some fundamental tenets of democratic theory" (Blinder 1999, 66)? Blinder points to a number of factors that he believes lessens the extent to which independent central banks are inconsistent with democracy. Two in particular are worth emphasizing here. First, independent central banks are created through the legislative process. Moreover, because no legislation is irreversible, societies retain the ability to reexert control over monetary policy by rescinding the legislation that granted independence to their central bank. Second, the top officials in independent central banks throughout the advanced industrialized world are appointed by elected officials and can be removed from office by elected officials when they fail to perform their duties. Independent central banks are therefore nondemocratic in a narrow sense of this term, in that individual monetary policy decisions do not represent the preferences of a majority of society's voters or elected representatives. Independent central banks are democratic, however, in the broader sense, in that the institutions themselves, and the technocrats that govern them are the product of majority rule decisions. The real question seems to be, therefore, not whether or not independent central banks are consistent with democracy, but whether the economic benefits of independent central banks are greater than the costs imposed by preventing elected officials from making monetary policy in response to societal interests. This question cannot be answered in the abstract; only the individuals that compose society can answer it.

Conclusion

The interaction between interests and institutions shapes the exchange rate policies that governments adopt. The society-centered approaches examined here assert that monetary and exchange rate policies reflect politicians' responses to the demands made by domestic interest groups. These pressures can come from the electoral process, from party-based politics, or from sectoral interest groups. Whatever the precise mechanism, society-centered approaches suggest that exchange rate policy is a direct result of the need for politicians to be responsive to societal pressures. The state-centered approach, which is perhaps more accurately characterized in this context as an institution-centered approach, asserts that political institutions mediate the impact of societal interests on exchange rate policy. Monetary institutions, particularly those that provide the central bank with a high degree of independence from elected officials, can enable monetary policy authorities to make policy without the need to respond directly to societal pressures. The monetary and exchange rate policies that governments adopt are shaped by the interaction between these societal interests and institutions.

Both approaches help us understand the evolution of exchange rate policies in the advanced industrialized countries since World War I. The society-centered approaches highlight the political pressures to which elected officials must respond when making exchange rate policy. It has been these pressures that led governments to seek greater exchange rate flexibility. In addition, variation in the balance of power among competing domestic interest groups helps us understand why some governments are willing and able to maintain fairly stable exchange rates while other governments are unwilling or unable to do so. The state-centered approach helps us understand how the reform of monetary institutions has reinforced governments' preferred monetary and exchange rate policies. The emergence of highly independent central banks throughout the advanced industrialized world reflects a frustration with the alleged inflationary consequences of active monetary policies. The creation of independent central banks in turn affects exchange rate policies. On the one hand, the creation of European central bank has led to permanently fixed exchange rates among most of the members of the EU. On the other hand, the existence of independent central banks in the United States and the EU seems likely to reinforce the system of floating exchange rates among the dollar, yen, and euro.

Key Terms

Accelerationist Principle
Aggregate Demand
Central Bank Independence
Credible Commitment
Expectations
Natural Rate of Unemployment
Phillips Curve
Pocketbook Voters
Price Stability
Sociotropic Voting
Time Consistency Problem
Unholy Trinity

Web Links

Central banks in the advanced industrialized countries maintain websites with plenty of information about monetary and exchange rate policy.

The Federal Reserve Board: *http://www.federalreserve.gov/*.

The Bank of England: *http://www.bankofengland.co.uk/*.

The European Central Bank: *http://www.ecb.int/*.

The Bundesbank: *http://www.bundesbank.de/ind.ex_e.html.*

The Bank of Japan: *http://www.boj.or.jp/en/.*

Bank of France: *http://www.banque-france.fr./gb/home.htm.*

New York University maintains a website dedicated to the study of central banks. You can visit this site at *http://www.law.nyu.edu/centralbankscenter/.*

Bradford DeLong, a professor of economics at University of California, Berkeley, maintains a very useful website dedicated to macroeconomics. You can visit this site at *http://www.j-bradford-delong.net/Index.html.*

Suggestions for Further Reading

For a good introduction to the politics of macroeconomic policy, see William R. Keech, *Economic Politics: The Costs of Democracy* (Cambridge: Cambridge University Press, 1995). For a more advanced treatment, see Alan Drazen, *Political Economy in Macroeconomics* (Princeton: Princeton University Press, 2000).

For an in-depth and readable exploration of the development of Keynes' economic ideas, see Robert Skidelsky, *John Maynard Keynes: The Economist as Saviour 1920–1937* (New York: Penguin Press, 1992).

A detailed discussion of the partisan approach to exchange rate politics can be found in Thomas Oatley, *Monetary Politics: Exchange Rate Cooperation in the European Union* (Ann Arbor: University of Michigan Press, 1997).

Two excellent readings on the sectoral approach to exchange rate politics are Jeffry A. Frieden, "Invested Interests: the Politics of National Economic Policies in a World of Global Finance," *International Organization* 45 (Autumn 1991): 425–451 and Jeffry A. Frieden, "Monetary Populism in Nineteenth Century America: An Open-Economy Interpretation," *The Journal of Economic History* 57 (June 1997): 367–395.

Perhaps the most comprehensive work on central bank independence is Alex Cukierman, *Central Bank Strategy, Credibility, and Independence: Theory and Evidence* (Cambridge: MIT Press, 1992).

CHAPTER 8

Developing Countries and the International Financial System

Developing countries have had a difficult relationship with the international financial system. At the center of these difficulties lies a seemingly inexorable boom and bust cycle. The cycle typically starts with changes in international capital markets that create new opportunities for developing countries to attract foreign capital. Wanting to tap into foreign capital to speed economic development, developing countries exploit this opportunity with great energy. Eventually, developing countries accumulate large foreign debt burdens that they cannot easily repay and are pushed toward default. The looming threat of default frightens foreign lenders, who refuse to provide additional loans to developing countries and attempt to recover many of the loans they had made previously. As foreign capital flees, the developing countries are pushed into severe economic crises. Governments then turn to the International Monetary Fund and the World Bank for assistance, and are required to implement far-reaching economic reforms in order to gain this aid. This cycle has repeated twice in the last 25 years, once in Latin America during the 1970s and 1980s, and once in Asia during the 1990s. The political economy of north-south financial relations focuses on this three-phase cycle of over-borrowing, crisis, and adjustment.

Interests and institutions in the international system and within developing countries shape each phase of this cycle. Interests and institutions in the international system, including changes in international financial markets, the International Monetary Fund, and government policies in the advanced industrialized countries, powerfully affect north-south financial relations. All of these factors shape the ability of developing countries to borrow foreign capital, to repay the debt they accumulate, and the economic reforms they must adopt when crises strike. Interests and institutions within developing countries also play an important role. Domestic interests and institutions determine the amount of foreign debt that developing countries accumulate and influence how governments and economic actors in developing countries use this foreign

debt. These decisions in turn shape the ability of governments to service their foreign debt, and therefore influence the likelihood that the country will experience a debt crisis. Finally, domestic interests and institutions shape the ability of governments to implement economic reforms in the wake of a crisis.

This chapter examines the evolution of this cycle in north-south financial relations through the last 50 years. We begin by examining the relatively stable immediate postwar period during which capital flows to developing countries were dominated by foreign aid and foreign direct investment. We then examine the first large crisis of the postwar period, the Latin American debt crisis of the 1980s. We examine how this crisis developed during the 1970s, the international debt regime established to manage this crisis, and the domestic politics of economic reform. Our attention then shifts to the second major crisis of the postwar period, the Asian crisis of the 1990s. We look first at how this crisis emerged from the interaction between changes in international financial markets and the politics of financial regulation in Asia. We then examine the impact that this crisis has had on the broader international financial system.

The Early Postwar Period

If, as noted above, a cycle of over-borrowing, crisis, and adjustment has characterized the history of capital flows from the advanced industrialized countries to the developing world, why do developing countries continue to draw on foreign capital? Why do they not simply refrain from borrowing foreign capital, thus bringing the cycle to an end? Developing countries continue to draw on foreign capital because of the potentially large benefits that accompany the apparent dangers of foreign debt. These benefits arise from the ability to draw on foreign savings to finance economic development. According to most models of economic growth, the accumulation of physical capital is one of the most important factors in the ability of any society to raise per capita incomes. A larger stock of physical capital per worker will increase worker productivity, and these productivity improvements are in turn the key to rising incomes (Cypher and Dietz 1997, 239).

In order to accumulate physical capital, however, societies need to invest in productive equipment. Yet, two resource constraints limit the ability of developing countries to do so (Bruton 1969; McKinnon 1964). First, investment requires savings. Savings, however, are scarce in most developing societies. Table 8.1 provides average savings rates during the last 40 years, grouping countries by their income level and by

Table 8.1
Average Savings Rates, 1960–1999 (percent of GDP)

High Income OECD	24.12
Least Developed Countries	8.03
East Asia and the Pacific	31.43
Latin America and the Caribbean	21.1
Sub-Saharan Africa	17.73
South Asia	16.65

Source: World Bank, *World Development Indicators on CD-ROM,* 2001.

region. The most striking difference that the table highlights is between the high-income OECD countries and the poorest countries in the world, those that the United Nations has labeled the "Least Developed Countries." On average, the high-income countries saved almost one quarter of their national income each year between 1960 and 1999. In contrast, the least developed countries have been able to save less than 10 percent of their national income per year. Even when the savings rate in a developing country is relatively high, as in East Asia and the Pacific and in Latin America, the low incomes that characterize developing countries mean that the total pool of savings generated by even a high savings rate is small. The shortage of savings in developing countries limits the amount of investment that can occur. Second, developing countries often face shortages of foreign exchange. Foreign exchange matters because investment is often dependent upon imports. Investment involves the purchase and installation of capital goods—machines that produce other goods. Because few developing countries produce capital goods, in order to invest they must import capital goods from other countries. Without external finance, the ability of any country to import capital goods is limited by its ability to export in order to earn the necessary foreign exchange.

Importing foreign capital reduces the severity of both shortages. When a country imports foreign capital it adds to the domestic savings it has available to fund investments, and the capital inflows provide the foreign exchange that the country needs to purchase capital goods. The ability to import financial capital from the rest of the world, therefore, allows developing countries to accumulate physical capital more rapidly than would be possible otherwise. The accumulation of physical capital in turn contributes to a more rapid increase in per capita incomes. Some studies have found that foreign capital makes a substantial contribution to industrialization in developing countries. Many have found a one-to-one relationship between capital inflows and investment: one dollar of additional foreign capital in a developing country produces one dollar of additional investment (Bosworth and Collins 1999; World Bank 2001a). Other studies have found that the developing countries that have participated more heavily in international financial markets during the last 30 years have experienced faster economic growth rates than countries that have insulated themselves from international financial flows (see IMF 2001; World Bank 2001a). Of course, these conclusions are not universally supported. Many studies have failed to find any strong relationship between foreign capital inflows, investment, and economic growth (see e.g., Rodrik 1998). On balance, however, what the historical evidence seems to suggest is that foreign capital creates the *opportunity* for higher investment and faster economic growth in developing countries. Many other factors, some of which lie inside developing countries and others that inhere to the international financial system, shape the extent to which developing countries are able to take full advantage of this opportunity.

While developing countries can benefit from importing foreign capital, foreign capital has not always been available to them. Such was the case in the early postwar period, which we examine here. We focus first on the amount and primary sources of foreign capital during this period and then examine how governments in most developing countries organized their domestic financial systems in response to the scarcity of investment capital and foreign exchange that they faced.

The Supply of External Finance

The principal problem that most developing countries faced in the first 20 years following World War II was a shortage of foreign capital. Foreign aid and foreign direct investment were the principal sources of foreign capital for developing countries in the 1950s and 1960s, and neither flowed in great abundance. **Foreign aid,** or official development assistance, is financial assistance provided to developing countries by governments in the advanced industrialized countries and by multilateral financial institutions like the **International Bank for Reconstruction and Development** (IBRD), known more commonly as the **World Bank.** The largest share of foreign aid is provided as **bilateral development assistance,** that is, foreign aid granted by one government directly to another government. In 1999, the 22 countries that make up the **Development Assistance Committee** provided a total of $37.9 billion of aid to developing countries (excluding the contributions that these same governments made to multilateral financial institutions). The World Bank and the regional development banks provided a total of $18.8 billion to developing countries (World Bank 2001c, 344, 358). The largest donors in absolute terms are the largest countries. Japan topped the list in 1999, providing $10.5 billion of bilateral aid (Figure 8.1). The United States was the second largest donor, providing $6.9 billion. The picture changes somewhat, however, when aid expenditures are measured as a percentage of the donor country's national income (Figure 8.2). By this measure, Denmark is the most generous donor, dedicating 1.01 percent of its gross national income to foreign aid in 1999. Norway is the second most generous donor country, providing about .9 percent of its gross national income in the same year, followed closely by Sweden with .7 percent. The United States is the least generous country, dedicating only .1 percent of its national income to foreign aid programs.

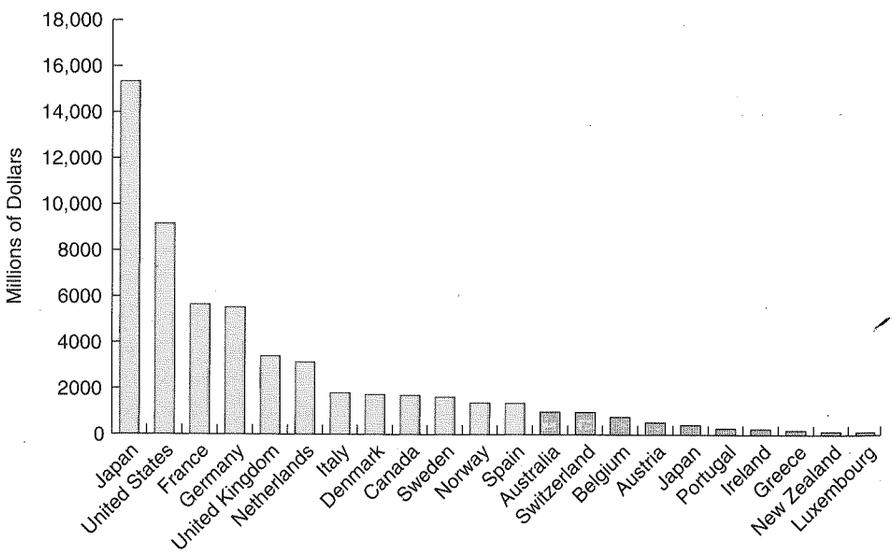

Figure 8.1 Foreign Aid Flows, 1999.
Source: World Bank 2001c.

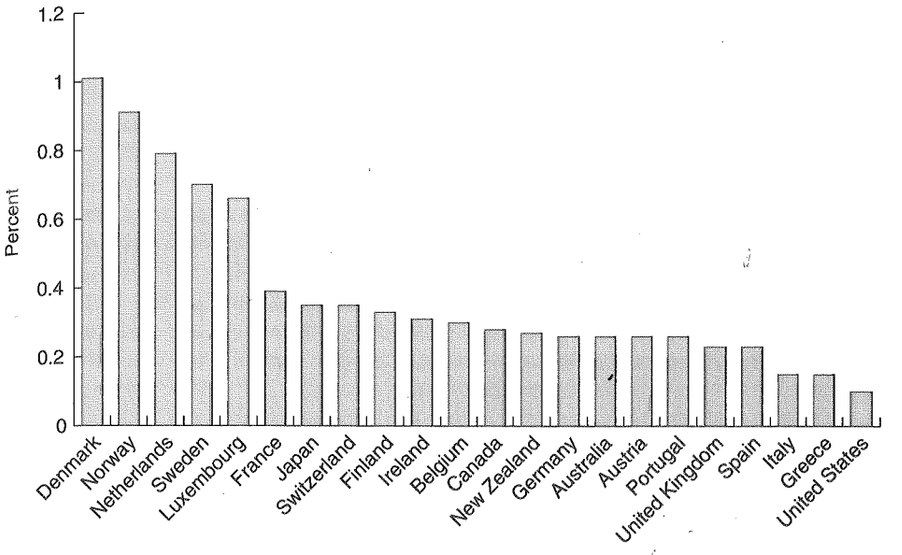

Figure 8.2 Foreign Aid as a Share of GNP.
Source: World Bank 2001c.

Foreign aid can be offered as a grant, which does not require repayment, or as a loan that the borrowing government must repay. A large share of bilateral aid is offered as grants. In 1999, developing countries received $33.9 billion in grants from DAC countries, and $3.9 billion in loans. Multilateral lending agencies, in contrast, provide all of their assistance in the form of loans. All development loans are in turn divided into two categories. Under **nonconcessional lending programs,** the interest rate charged on a loan is close to market interest rates. Under **concessional lending programs,** the interest rate charged on a loan is below the market interest rate. In general, the world's poorest countries draw a higher proportion of their aid from concessional lending programs. In 1999, the low-income developing countries as a group received a total of $6.2 billion in aid from multilateral financial institutions other than the IMF, of which $4.7 billion, or 76 percent, was in concessional programs. In contrast, middle-income developing countries draw a higher proportion of their aid from nonconcessional aid programs. As a group, these countries received $12.2 billion of aid from these same multilateral institutions in 1999, of which $11.1 billion, or 91 percent, was nonconcessional (World Bank, 2001c 358).

Some developing countries are more dependent upon foreign aid as a source of foreign capital than others. As Figure 8.3 illustrates, South Asia and Sub-Saharan Africa receive more foreign capital in the form of development aid than in the form of private capital. In fact, aid accounted for two-thirds of South Asia's total foreign capital inflows in 1999, and for more than half of Sub-Saharan Africa's capital inflows. In Latin America and East Asia and the Pacific, foreign aid accounts for a very small share of total capital inflows. Foreign aid accounted for only 5 percent of the total capital inflows in Latin American and 16 percent in East Asia. These differences reflect in

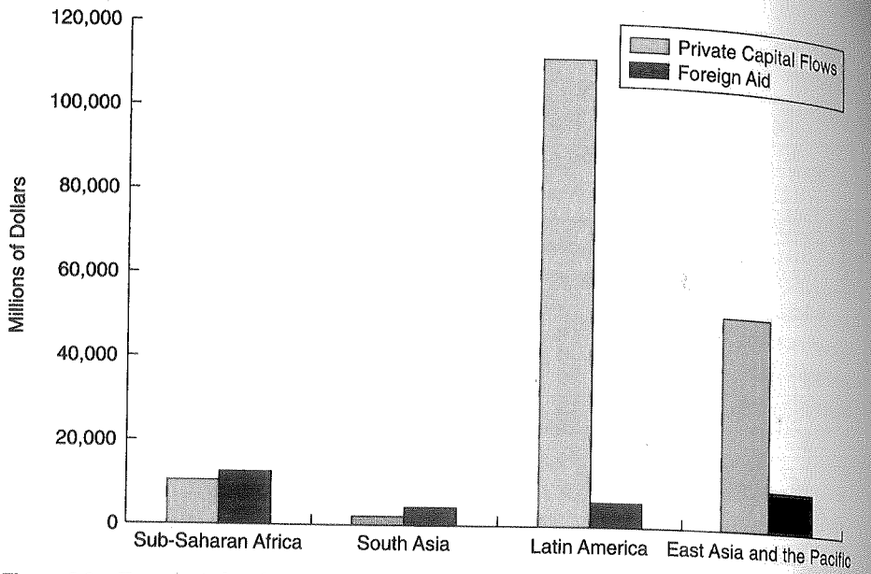

Figure 8.3 Foreign Aid and Private Capital.
Source: World Bank 2001c.

large part the differing abilities of these groups to attract private capital. As a consequence, foreign aid represents a much more important source of investment funds in Sub-Saharan Africa and South Asia than in the other two regions. Such dependency on foreign aid is most evident in Sub-Saharan Africa, where aid flows equaled 22 percent of all investment in 1999. Aid dependence is less evident in South Asia, where aid equaled only 3.3 percent of total investment. In Latin America and East Asia and the Pacific, aid equaled only about 1.5 percent of total investment. Thus, foreign aid is more important than private capital flows for the least developed countries, and an important source of investment capital in many.

Governments in the advanced industrialized countries have argued that private capital should play as large a role as possible in financing development. Foreign aid should be made available only for projects that are central to development and that private financial institutions are unwilling to finance. As a consequence, foreign aid flows to developing countries were relatively small throughout the 1950s. The bias in favor of private capital flows to finance development was reinforced by the weakness of European economies, by American aid priorities, and by the lending practices of World Bank. Because the Second World War weakened Western European countries, whatever financial resources they had were dedicated to economic reconstruction at home. Few funds were available for foreign aid programs. The United States, therefore, was the only country capable of providing foreign aid. And during the late 1940s and the 1950s, American aid priorities focused on the reconstruction of Western Europe. Little aid was allocated to Latin America, with the American government preferring to leave Latin American investment to the private market. For its part, the World Bank perceived its mission as providing loans at "close-to-commercial rates of interest to

cover the foreign exchange costs of productive projects" (Mason and Archer 1973, 381). Most World Bank lending in the late 1940s and the 1950s financed postwar reconstruction in Europe (Mason and Archer 1973).

A Closer Look

The World Bank

The World Bank, created alongside the IMF at the Bretton Woods conference, was established to finance development projects that could not attract private finance. Like the WTO and the IMF, the World Bank is owned and controlled by its member governments. Ownership is based on the shares that each country purchases upon joining, and the number of shares each country purchases is determined by its economic size. The decision-making structure is similar to the decision-making process in the IMF. The Board of Governors, composed of representatives of all member countries, has ultimate authority, but responsibility for most of the Bank's operation rests with the executive directors. There are 24 executive directors. Each of the Bank's five largest shareholders (the United States, Japan, Germany, France, and Great Britain) appoints its own executive director. The remaining executive directors are elected by the member countries every two years to represent groups of countries. Decisions by the Board of Directors are made on a weighted voting scheme in which each country has votes equal to the number of shares it owns. Larger shareholders therefore have greater influence over World Bank decisions. As in the IMF, the United States is the largest shareholder and, therefore, has the most votes.

The IBRD functions as a bank. It sells bonds to private investors and lends the resulting funds to developing countries to finance specific projects. World Bank regulations limit the total amount of loans it can extend at any point in time to the combined total of its capital and reserves. This ensures that the Bank always has the funds necessary to pay its bond-based debt. As a consequence, the World Bank is a very low-risk borrower, which enables it to pay very low rates of interest on the money it borrows. It can then pass these low interest rates on to the developing countries that borrow from it. World Bank loans typically carry maturities of 15 to 20 years and a three- to five-year grace period before repayment begins. Interest rates on World Bank loans are slightly higher than the interest rates the World Bank pays on its debt. Since its creation in 1945, the IBRD has loaned $360 billion to developing countries.

In 1960, the member governments created a new lending agency within the World Bank called the International Development Association (IDA). The IDA is a concessional lending agency, which means that it provides development finance at below-market rates of interest. The terms of IDA lending are quite generous. Loans have maturities of 35 or 40 years and most loans have a ten-year grace period before repayment begins. All IDA loans are made at zero interest rates. The IDA lends only to the poorest developing countries, however. Currently, a country must have a per capita income below $885 to qualify for IDA lending. The IDA loaned a total of $107 billion to 109 developing countries between 1960 and 2001, and it loans an average of $6–7 billion per year. Most IDA loans are targeted at basic needs, including primary education, health services, and clean water and sanitation. In contrast to the IBRD, the IDA is

Continued

funded by contributions from World Bank member countries. Historically, the United States has been the largest contributor, providing about 24 percent of all contributions to the IDA. Japan is a close second, having contributed about 22 percent of the total. Germany has been the third largest contributor, accounting for 11 percent of the total.

World Bank loans fall into two broad categories. Investments loans are long-term loans dedicated to "creating the physical and social infrastructure necessary for poverty reduction and sustainable development" (World Bank 2000a, 5). Such loans were originally oriented toward creating physical infrastructure—buying capital goods, constructing buildings, providing engineering assistance. Now such loans are increasingly oriented toward what the World Bank calls institution building and social development. In Turkey, for example, the World Bank loaned $300 million to support the Turkish government's plan to extend compulsory education from five to eight years. World Bank loans helped construct 802 new basic education schools, which in turn helped expand primary school enrollment by 802,000 students. In Ecuador, a $10.7 million World Bank loan helped nongovernmental organizations provide free legal services to poor women who were greatly disadvantaged in the Ecuadorian legal system. Other projects include urban poverty reduction, rural development, water and sanitation, natural resource management, and health. Investment loans have accounted for 75 to 80 percent of all World Bank lending. Adjustment loans, which have become an important component of World Bank lending only during the last 25 years, are short-term loans advanced in support of structural reform within a particular sector or for the economy as a whole. Adjustment loans seek to promote the creation of competitive market structures by supporting legal and regulatory reforms, reform of trade and taxation policies, as well as political institutional reform (World Bank 2000a, 13). During the last 20 years, adjustment loans have accounted for between 20 and 25 percent of all World Bank lending.

Private capital flows were also quite small during the 1950s, and dominated by foreign direct investment. The dominance of direct investment resulted from two considerations. First, many Latin American governments had defaulted on their foreign debt during the 1930s, and few lenders were willing to extend new loans to governments that had so recently defaulted. Second, the slow recovery of international financial markets in the immediate postwar period meant that few bank loans or bonds crossed international boundaries. To the extent that private investment flowed to developing countries at all during the 1950s, therefore, it tended to flow in the form of direct investment. Governments in most developing countries were not content to rely so heavily on direct investment. There were two problems with direct investment from the perspective of developing countries' governments (Nurske 1967). First, most foreign direct investment during this period was concentrated in the primary commodity export sectors, particularly mining and petroleum, and therefore did little to promote domestic manufacturing industries. This was inconsistent with the determination of developing countries to industrialize. Second, the slow growth of demand for primary commodities in the advanced industrialized world meant that the amount of investment made by MNCs in developing countries' primary commodity sectors was likely to decline over time. Thus, while developing countries' governments did not necessarily discourage private investment in this period, they did not believe it would help them achieve their development objectives.

Desiring additional foreign capital but having little opportunity to borrow on private markets, developing countries pushed the advanced industrialized countries to expand their foreign aid programs. Such pressure began to bear fruit in the late 1950s and early 1960s. The World Bank created the International Development Association (IDA) and began to provide concessional loans to many of its member governments. At the same time, a number of **regional development banks,** such as the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank were created to provide concessional lending on the model of the International Development Association. Advanced industrialized countries also expanded their bilateral aid programs during the 1960s. As a consequence, the amount of aid provided through multilateral development agencies increased four-fold between 1956 and 1970, while bilateral development assistance more than doubled in the same period (see Table 8.2). By the end of the 1960s, official development assistance to developing countries was almost twice as large as private capital flows.

The expansion of foreign aid programs during the 1960s reflected changing attitudes among governments in the advanced industrialized countries. These changing attitudes were in turn largely a product of the dynamics of de-colonization. World Bank officials recognized that governments in the newly independent countries would have great difficulty borrowing on private capital markets and would be unlikely to qualify for lending under the World Bank's normal terms. The World Bank therefore began to reconsider its resistance to concessional lending. American attitudes toward foreign aid were also beginning to change in response to political concerns that arose from the process of decolonization. American policymakers believed that the rising influence of developing countries in the United Nations (UN) would eventually lead to the creation of a UN agency that offered development loans at concessional rates. The creation of such a UN agency could undermine the World Bank and weaken American influence over development lending. U.S. officials began to support a concessional lending agency within the World Bank, therefore, in order to prevent the creation of a rival lending agency within the UN where developing countries had greater influence. At the same time, during the late 1950s and early 1960s American policymakers increasingly came to view foreign aid as a weapon in the battle against the spread of Communism throughout the developing world. Nowhere was this more evident than in the Kennedy

Table 8.2
Financial Flows to Developing Countries, 1956–1970
(millions of U.S. dollars)

	1956	1960	1965	1970
Official Development Assistance				
Official Government Aid	2,900.0	4,236.4	5,773.1	6,587.4
Multilateral Organizations	272.5	368.5	312.9	1,176.0
OPEC				443.5
Private Finance				
Foreign Direct Investment	2,500.0	1,847.9	2,207.4	3,557.2
Portfolio Flows	0.0	408.2	836.0	777.0

Source: Wood 1986, 83.

Administration's "Alliance for Progress," which was designed to use U.S. government aid to promote socioeconomic reform in Latin America to prevent the spread of Cuban-style socialist revolutions throughout Latin America (Rabe 1999). These changes in attitude contributed to the tremendous growth of foreign aid programs during the 1960s.

Financial Arrangements in Developing Countries

Unable to attract much private finance from the advanced industrialized countries, facing limited foreign aid flows, and determined to industrialize, most developing countries constructed domestic financial systems through which they could first mobilize domestic savings and foreign exchange and then channel these funds to the manufacturing industries they were trying to develop through import substitution industrialization. These financial arrangements were composed of three broad policies. First, governments intervened in domestic financial systems to mobilize domestic savings and to allocate these resources to sectors targeted by government economic development plans. Second, governments used exchange restrictions to keep domestic savings at home and to ensure that foreign exchange was allocated to priority uses. Third, most governments maintained fixed but over-valued exchange rates in order to reduce the foreign exchange cost of imports. We look at each component in turn.

Many developing countries' governments intervened in domestic financial systems in order to direct domestic savings to the industries that they targeted in their economic development plans. The need for such intervention arose in part from perceived inadequacies in domestic financial systems. Commercial banks were the most important financial institutions in most developing countries. Most savings were held as deposits in commercial banks, and as a consequence most capital had to be raised by getting a loan from a commercial bank. Stock markets and bond markets played little role. The problem with these financial arrangements, from the perspective of many developing country governments, was that commercial bank lending did little to promote economic development. Industrialization required that the industries that governments targeted in their development plans had access to medium and long-term loans. Commercial banks had little interest in making medium or long-term loans to finance the construction of new factories, however. Instead, they favored making short-term loans to finance foreign and domestic commerce (Johnson 1974). In other words, whereas governments wanted commercial banks to extend long-term loans to new manufacturing industries, commercial banks preferred to make short-term loans to existing industries primarily to finance imports and exports. To achieve their development objectives, therefore, governments had to shift savings away from the short-term purposes that commercial banks favored to medium- and long-term industrialization objectives.

The financial systems that governments created were thus designed to ensure that savings were allocated to the projects they wanted to promote (McKinnon 1993). Most governments required commercial banks to keep a substantial share of their deposits with the central bank as interest-free reserves. These **reserve requirements** averaged around 30 percent throughout Latin America, and reserve requirements as high as 50 percent were not uncommon (McKinnon 1993). Such high reserve requirements contrasted sharply to the practice in advanced industrial countries, where commercial bank reserve requirements rarely rise above ten percent of total deposits. What the high reserve requirements did, however, was provide the government with a large share of domestic savings at zero cost that the government could then allocate to its priority projects. In order to allocate these funds, many governments created **national development banks** and **specialized credit agencies.** These government-controlled financial institutions provided low-interest loans to industries that the government targeted in its economic development plans. In the Philippines, for example, the government formed the National Cottage Industries Bank in 1963 in order to direct loans to small-scale industry (Fry 1988, 313). In a typical system, the deposits that the central bank received from commercial banks as reserve requirements were directed to specialized credit agencies at very low interest rates. The specialized credit agencies then loaned these funds to favored industrial borrowers at low interest rates (McKinnon 1993, 43–45). To ensure that the cost of loans remained low, governments imposed **interest rate ceilings** on deposits and loans. In setting these ceilings, governments distinguished between favored and other borrowers. Favored borrowers, which were the industries the government wanted to promote, were provided credit at well below market rates of interest. In Colombia, for example, specialized credit agencies charged only 2–4 percent for many of their loans, while nonfavored borrowers paid interest rates five to ten times higher. Finally, most governments pursued expansionary monetary policies. Expansionary monetary policies encouraged commercial banks to expand their lending, and enabled governments to finance their budget deficits by selling government bonds to the central bank.

Governments in most developing countries also used an extensive array of exchange restrictions to exert control over foreign exchange transactions. Private foreign exchange markets were prohibited in most countries. Firms that exported their products were required to surrender to the central bank (or to one of the central bank's foreign exchange agents, usually a commercial bank) all of the foreign currency that they earned from doing so. Capital outflows were also tightly restricted, with government approval required before a resident could send financial capital abroad. Capital inflows also required prior approval, and the foreign exchange arising from capital inflows had to be surrendered to the central bank. As a consequence of these arrangements, the central bank was the only domestic agent that legally could deal in foreign exchange and any domestic resident that wanted foreign currencies had to go to the central bank to acquire it. This extensive system of exchange restrictions allowed the government to exert a high degree of control over all balance of payments transactions. This control was used to ensure that whatever foreign exchange was available in the country was used in a manner that was consistent with the government's development objectives. Remember that the financial system was set up to support import substitution industrialization. Thus, governments that were determined to promote industrialization had to import capital goods and many intermediate inputs in order to construct and then operate a manufacturing enterprise. The ability of the government to control foreign exchange transactions ensured that whatever foreign exchange was available would be used to pay for imported capital goods and inputs rather than used to purchase imported luxury items or other consumer goods that the government deemed to be unnecessary.

Finally, most governments established fixed and over-valued exchange rates. The commitment to fixed exchange rates arose in part from structuralist logic. The structuralists argued that the world's demand for developing countries' goods, as well as

developing countries' demand for imports were both insensitive to price changes. Because world demand for developing countries' goods was determined by the rate of economic growth in the core, exchange rate devaluation would do little to boost exports. The demand for imports in developing countries was determined by the amount of investment and production established by the government's development plan rather than by changes in the prices of imports. Because the demand for exports and imports were both relatively insensitive to price changes, governments could gain little from manipulating the exchange rate. Over-valued exchange rates resulted from the desire of many governments to maximize the volume of imports that a given volume of exports could purchase. The more highly valued the domestic currency in terms of foreign currencies, the fewer domestic goods that country must export in order to purchase a given amount of imports. For example, if Mexico's import requirements are $100 per year, and the exchange rate is one peso to one dollar, then Mexico has to export 100 pesos worth of domestic goods to pay for its needed imports. If the exchange rate falls to two pesos per dollar, however, then Mexico must export 200 pesos worth of goods to pay for the imports it needs. If, as the structuralists believed, the demand for Mexico's exports is not sensitive to prices, the lower exchange rate would simply generate less foreign exchange.

From a state-centered perspective, these domestic financial arrangements represented a rational state response to resource scarcities. Given the over-arching goal of rapid industrialization and the central importance of savings and foreign exchange in achieving this goal, governments created financial systems that maximized their control over savings and foreign exchange. These financial arrangements allowed governments to greatly restrict the ability of scarce savings and foreign exchange to exit the domestic economy. Moreover, these financial systems allowed governments to direct these scarce resources to high-priority projects. As a consequence, the state fully supplanted the market in deciding how to allocate these resources. Decisions about how savings and foreign exchange would be used were made by government agencies according to the government's development objectives rather than by markets according to considerations of risk and return.

From a society-centered perspective, these financial systems were established to redistribute wealth and income from groups outside the ruling coalition to groups inside the ruling coalition. Redistribution occurred in two distinct ways. First, government intervention in the financial system allowed the state to redistribute wealth from savers to borrowers. Savers were rendered worse off because the low interest rates paid on deposits and the persistent inflation generated by expansionary monetary policies eroded the real value of their savings. Borrowers, many of which were based in the import-competing sector, gained from the system because low interest rates and persistent inflation reduced the real value of their debts. Governments redistributed wealth, therefore, from savers to borrowers. Second, over-valued exchange rates allowed governments to transfer income from export-oriented sectors to import-competing sectors. Exporters were paid less domestic currency for each unit of foreign currency they earned than they would have been paid had the exchange rate been correctly valued. The import-competing and nontraded goods sectors, the primary users of foreign exchange, were able to purchase foreign exchange for fewer units of domestic currency than they would have had to pay had the exchange rate been correctly valued. From a society-centered perspective, therefore, these domestic financial arrangements could be used to redistribute resources in order to construct and maintain political coalitions.

In summary, developing countries had little access to foreign capital during the 1950s and 1960s. Governments in the advanced industrialized countries continued to restrict international financial flows. Government restrictions on private capital flows were accompanied by fresh memories of widespread Latin American defaults during the 1930s. The two combined to make it difficult for developing countries to borrow in foreign markets. Multinational corporations did invest in developing countries, but most developing countries' governments doubted that these investments would help them achieve their goal of industrialization. By the early 1960s foreign aid had become the most important source of foreign capital. Aid also had problems. Advanced industrialized countries provided aid for political reasons—as a weapon against Communist revolutions—and budget processes in the advanced industrialized countries determined its rate of growth. Developing countries' governments responded to the scarcities of savings and foreign exchange by creating domestic financial arrangements that they believed would allow them to mobilize domestic savings and foreign exchange and allocate them in accordance with their developmental and political objectives.

Commercial Bank Lending: Private Capital and the Debt Crisis

The composition of capital flows to developing countries changed fundamentally during the 1970s. A trickle of private capital was transformed into a flood as commercial banks began lending heavily to a select group of developing countries. In the course of the decade, the amount of debt that developing countries owed to foreign lenders grew dramatically, and the share of this debt that was owed to commercial bank loans rose sharply. These changes were driven by the interaction between developments within the international economy and dynamics internal to the political economy of import substitution industrialization. These factors combined to generate a growing demand for foreign capital by developing countries and an increased supply of private foreign capital to many of these governments. Increased demand and the greater supply combined to drive a boom and bust economic cycle in many developing countries between 1973 and 1983. The cycle culminated in an international debt crisis that dominated north-south financial relations throughout the 1980s.

The Oil Shock, ISI, and the Demand for External Finance

Independent developments in the international system and in domestic political and economic systems combined to generate a large increase in developing countries' demand for foreign capital in the late 1960s and throughout the 1970s. The most important international cause was the sharp rise in the price of oil in 1973. By one estimate, higher oil prices cost developing countries about $260 billion during the 1970s (Cline 1984). Because most developing countries were oil importers, the need to pay more for their energy imports required developing countries to reduce other imports, to raise their exports, or to borrow from foreign lenders to finance the larger current account

deficits they faced. Cutting imports was unattractive for governments deeply committed to ISI strategies. Imported capital goods were required to continue the deepening of industrialization, and imported inputs were required to continue production in existing manufacturing enterprises. Increasing exports was also difficult, as import substitution had brought about a decline in the export sector in most countries. As a consequence, the higher cost of oil widened current account deficits throughout the developing world. In order to finance these larger current account deficits, developing countries needed more foreign capital than they had required prior to the oil shock.

Import substitution industrialization also generated additional demand for foreign capital in developing countries. As we saw above, governments in most developing countries played a leading role in the process of capital formation. In part this was achieved by using state-owned enterprises to drive industrialization and in part this was achieved by providing subsidized credit to targeted sectors of the economy. The emphasis on both tools became particularly strong as governments shifted from easy ISI to the second stage emphasis on heavy industry. These strategies had two negative consequences for government budgets. First, the initial investments represented substantial government expenditures. Latin American governments were responsible for between one-third and one-half of total capital formation on average (Thorp 1998, 169). In some cases the government's role was much larger. In Brazil, for example, government agencies supplied about three-quarters of the private sector's investment capital, and 60 percent of total investment (Frieden 1981, 420). Second, state-owned enterprises were not profitable. Unable to make revenues match expenditures, state-owned enterprises became dependent upon continuing government infusions and thus became a continual drain on government resources.

In most countries, government revenues failed to grow in line with the growth of government expenditures. The export sector contributed an important share of government revenues. Export sectors in developing countries were not performing well, however, due to their neglect under import substitution industrialization. As productivity and output in the export-oriented sectors fell, governments found it harder to generate the revenues required to finance industrialization. Growing government expenditures and falling revenues combined to produce widening budget deficits. In Latin America, budget deficits averaged just below 2 percent in the early 1970s. These deficits grew throughout the 1970s, reaching 6.7 percent of GDP by the end of the decade. These averages hide considerable cross-national variation. In Argentina, which would become one of the most heavily indebted countries in Latin America, the government budget deficit rose to over 10 percent of GDP in the mid-1970s and remained above 7 percent of GDP until the early 1980s. In Mexico, another country destined to be among the most heavily indebted, the government's budget deficit increased in the early seventies, was brought under control in the late 1970s, and then exploded—to more than 10 percent of GDP—in the early 1980s.

Government budget deficits created a greater need for foreign capital. A country's need for foreign capital is determined by its **savings-investment gap,** which is simply the difference between how much a country saves and how much it invests. A country's savings rate is the difference between its total national income and the consumption expenditures made by the government and private individuals. When savings are less than investment, the country must import foreign capital equal to the difference.

Government budget deficits had an impact on savings and investment. Higher government consumption expenditures, due in part to the higher cost of energy, reduced savings in developing countries. The investment push that accompanied the shift to the second stage of ISI raised total investment expenditures. As a consequence, the gap between savings and investment in most developing countries widened during the 1970s, creating a greater demand for foreign capital. Figure 8.4 provides one example of this phenomenon, illustrating the relationship between savings and investment in Brazil during the 1970s. Investment as a share of GDP increased sharply in the early 1970s, reflecting the Brazilian government's emphasis on state-led investment in heavy industry during this period. Domestic savings were inadequate to finance this growing investment. In fact, available savings fell following the rise in oil prices, rose back to their initial level in 1975, and then gradually declined throughout the remainder of the decade. This gap between domestic savings and domestic investment could be filled only by foreign capital. The Brazilian case was not unique; throughout Latin America, governments confronted widening gaps between domestic savings and domestic investment that generated a larger need for foreign capital.

Commercial Banks and the Supply of External Finance

The oil shock also provoked significant changes in international financial markets. In particular, commercial banks based in advanced industrialized countries suddenly became willing to meet the greater demand for foreign capital in developing countries. The increased willingness of commercial banks to lend to developing countries originated in one specific consequence of the oil shock. As the price of oil rose, the countries

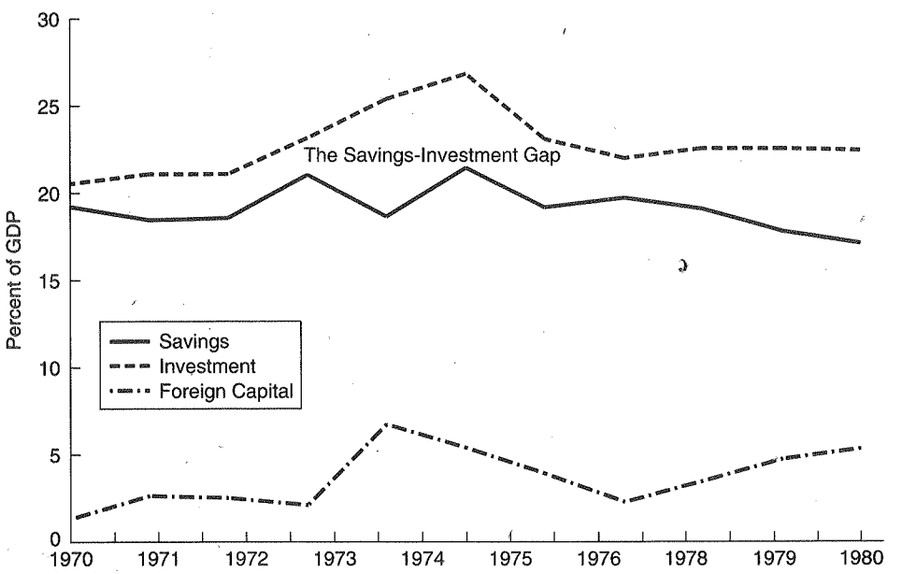

Figure 8.4 Savings and Investment in Brazil.
Source: World Bank 2001c.

belonging to the Organization of Petroleum Exporting Countries, or OPEC, began to run large current account surpluses. Saudi Arabia, for example, one of the world's largest oil exporters, saw its current account surplus jump from $2.5 billion in 1973 to $23 billion in 1974, and then average just under $14 billion during the next three years. The current account surpluses realized by OPEC countries came to be known as **petrodollars,** because they represented the income that oil exporters were earning from the sale of oil. Petrodollars provided the funds that were needed to finance the current account deficits in the rest of the developing world. In a process that came to be called **petrodollar recycling,** a portion of the income that the oil exporting countries earned from higher oil prices was loaned to developing countries. Developing countries then used these loans to pay for the oil that they imported and cover the gap between domestic savings and investment.

What was not clear in 1973–1974 was *how* OPEC countries' current account surpluses would be channeled to developing countries. The OPEC governments might have lent their surpluses directly to developing countries. OPEC governments did increase their foreign aid expenditures substantially during the 1970s, with aid flows from OPEC to other developing countries increasing from $443 million in 1970 to $6.7 billion in 1975 (see Table 8.2). For the most part, however, OPEC governments were more interested in placing their earnings in safe and relatively liquid assets. As a consequence, OPEC member governments deposited much of their oil revenues in commercial banks operating in the Euromarkets. Petrodollar recycling also could have been accomplished by expanding foreign aid programs in the advanced industrialized countries. Indeed, given the bilateral and multilateral structure developed during the 1960s, one might have expected an expansion of bilateral loans from advanced industrialized governments to developing countries or an expansion of lending by multilateral agencies such as the IMF and World Bank. Multilateral lending did play an important role for many of the low-income developing countries, as governments in these countries turned to the IMF for balance of payments financing. The IMF created a new facility specifically for governments facing rising import bills due to rising oil costs, called the Extended Fund Facility (Kenen 1994, 509; Bird 1987). Such efforts were limited, however, because governments in the advanced industrialized countries were unwilling to expand such programs either directly through larger bilateral aid or indirectly through larger multilateral aid programs.

With neither OPEC nor the advanced industrialized countries willing to recycle petrodollars, commercial banks stepped in to fill the gap. Flush with deposits from OPEC members, commercial banks began to look for profitable lending opportunities. Because economic activity was stagnating in the advanced industrialized countries, commercial banks looked to the developing world where governments were eager to borrow. Commercial banks thus began lending heavily to a small set of middle-income developing countries, many of which were located in Latin America. Commercial banks loaned directly to governments, to state-owned enterprises, and to government-owned development banks. Most commercial bank lending was syndicated. In a **syndicated loan,** hundreds of commercial banks each take a small share of a large loan to a single borrower. Syndicated loans allow commercial banks to spread the risk involved in such large loans among a number of banks rather than requiring one bank to bear the full risk that the borrowing country will default. Some of the banks involved in the syndicate

were large and had considerable international experience; others were small and had little experience with international lending. Most of the loans were denominated in dollars and carried variable interest rates linked to the London interbank offer rate (LIBOR), which is the interest rate that large commercial banks operating in the Euromarkets charge each other for short-term loans (Solomon 1999, 35).

The combination of growing demand for foreign capital and the greater willingness of commercial banks to lend to middle-income developing country governments generated a rapid expansion of foreign debt in developing countries during the 1970s (see Table 8.3). In 1970, just prior to the oil shock, the developing world as a whole owed only $72.7 billion to foreign lenders. By 1980, total foreign debt had ballooned to $586.7 billion. Most of this debt was held by a relatively small number of countries. Thirty developing countries (excluding Eastern Europe) were the most heavily indebted. Together, these 30 countries owed foreign lenders a total of $461 billion in 1980, close to 80 percent of the amount that all developing countries owed to foreign lenders. Latin American countries were among the largest borrowers. The seven most heavily indebted Latin American countries—Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela—saw their foreign debt increase by a factor of ten between 1970 and 1982. By the early 1980s, these seven countries together accounted for slightly more than 80 percent of all Latin American debt and for slightly more than one-third of the total foreign debt of all developing countries. This rapid accumulation of debt also reflected a fundamental change in the source of external finance for many developing countries. Whereas commercial bank lending accounted for less than half of all Latin American debt in 1967, by 1979 commercial bank debt accounted for more than 70 percent of Latin America's total external debt.

Commercial Bank Lending and the Boom and Bust Cycle in Latin America

Commercial bank loans fuelled robust economic growth throughout the 1970s. The positive impact of commercial bank lending is quite clear in aggregate statistics for the period. In Latin America as a whole, economic growth averaged 5.6 percent per year between 1973 and 1980. Some Latin American countries grew at even faster rates. In Brazil, one of the largest borrowers, economic growth averaged 7.8 percent per year between 1973 and 1980, while Mexico, another of the large borrowers, realized an average rate of growth of 6.7 percent in the same period. Behind this robust economic growth, however, lay some worrying trends. The accumulation of foreign debt is not worrying in itself. Problems arise when the growth of foreign debt is not matched by growth of the country's debt service capacity. **Debt service capacity** refers to the ability of a country to make the payments of interest and principal required by the terms of the loan. The ability of any country to service its foreign debt depends upon its export revenues. Because foreign debt is generally denominated in dollars (or another international currency such as the yen), debt payments are usually made in dollars. As a country's total foreign indebtedness grows, therefore, it must increase its exports in order to earn the dollars needed to service its debt. This means that the funds being borrowed, or alternative domestic funds, must be invested in export sectors. Latin American governments did not use commercial bank loans to expand their economies' export sectors, however. Instead, a lot of the foreign debt was invested in projects in the nontraded goods sector. Mexico,

Table 8.3
Developing Country Foreign Debt, 1970–1984 (Billions of U.S. dollars)

	All Developing Countries[1]	30 Most Heavily Indebted Countries[2]	7 Most Heavily Indebted Latin American Countries	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
1970	72.7	65	28	5.8	5.7	3.0	2.2	7.0	3.2	1.4
1971	84.3	75	32	6.3	7.4	3.1	2.5	7.5	3.3	1.9
1972	98.7	88	39	6.8	11.5	3.5	2.8	8.2	3.5	2.5
1973	117.7	104	46	7.2	14.7	3.9	3.2	10.5	3.9	2.8
1974	147.1	129	60	7.6	22.0	5.2	3.3	14.0	5.2	2.7
1975	194.0	157	71	7.7	27.3	5.5	3.8	18.2	6.1	2.2
1976	235.6	192	89	9.3	33.3	5.6	3.9	24.0	7.6	4.9
1977	313.7	258	116	11.4	42.0	5.9	5.1	31.2	9.2	10.7
1978	391.7	317	142	13.3	54.6	7.4	5.1	35.7	9.7	16.6
1979	480.8	377	174	21.0	61.3	9.4	5.9	42.8	9.3	24.1
1980	586.7	461	214	27.2	71.5	12.1	6.9	57.4	9.4	29.3
1981	703.2	539	261	35.7	81.5	15.7	8.7	78.2	8.6	32.1
1982	809.9	606	294	43.6	93.9	17.3	10.3	86.1	10.7	32.2
1983	880.1	661	316	45.9	98.5	17.9	11.4	93.0	11.3	38.3
1984	921.8	686	328	48.9	103.9	19.7	12.0	94.8	12.2	36.9

[1]All 157 Low- and Middle-Income Countries as Defined by the World Bank.
[2]Includes Algeria, Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Egypt, India, Indonesia, Jamaica, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, South Korea, Sudan, Syria, Thailand, Turkey, Uruguay, Venezuela, Yugoslavia, Zaire, Zambia.

Source: World Bank, *World Development Indicators on CD-ROM,* 2001.

Argentina, and Venezuela, for example, created massive hydroelectric projects that were unnecessary given realistic assessments of energy needs (Thorp 1998, 209). Such investments did nothing to expand export earnings. In addition, many governments used foreign debt to pay for current consumption expenditures that yielded no return at all. Such expenditures included significant purchases of military equipment in some countries, the higher cost of oil imports after 1973, and consumption subsidies to maintain popular support. When foreign capital was invested in traded goods sectors, the preference was for capital-intensive projects that had little chance of exporting.

Because Latin American governments failed to invest in projects that would generate export revenues, their external debt grew more rapidly than their capacity to service this debt. The standard way to measure the burden that foreign debt service imposes on an economy is with a concept called the debt-service ratio. The **debt-service ratio** is the percentage of a country's export earnings that must be devoted to payments of interest and principal on foreign debt. A large debt-service ratio means that a large share of the country's total export revenues must be used to make debt payments. Latin American debt service ratios began to rise during the 1970s (Table 8.4). In 1970, Latin American governments were using 13 percent of their export revenues (on average) to service foreign debt. By 1978, debt service was consuming 38 percent of Latin America's export revenues. In many countries, the debt-service ratio was even higher. In Brazil, Chile, Mexico, and Peru, for example, debt-service consumed more than 50 percent of export revenues in 1978. Rising debt service ratios rendered Latin American countries vulnerable to shocks coming from the international economy. A reduction in export earnings or an increase in the interest rates attached to their debt would make it even more difficult to service their debt.

Table 8.4
Debt Service Ratios in Latin America, 1970–1984
(Payments of Principal+Interest)/Export Earnings

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela	All Latin American Countries
1970	n.a.	n.a.	n.a.	28	n.a.	n.a.	4	n.a.
1971	n.a.	n.a.	n.a.	27	n.a.	n.a.	5	n.a.
1972	n.a.	n.a.	n.a.	26	n.a.	n.a.	8	n.a.
1973	n.a.	n.a.	n.a.	22	n.a.	n.a.	7	n.a.
1974	n.a.	n.a.	n.a.	21	n.a.	n.a.	5	n.a.
1975	n.a.	43	35	14	n.a.	n.a.	6	n.a.
1976	34	38	40	13	n.a.	n.a.	4	n.a.
1977	27	42	46	11	n.a.	53	8	27
1978	42	58	54	12	n.a.	50	9	38
1979	23	63	44	14	66	34	19	38
1980	37	63	43	16	44	45	27	36
1981	46	66	65	22	46	59	23	40
1982	50	82	71	30	51	49	30	47
1983	70	55	54	38	45	34	27	41
1984	63	45	60	30	45	30	25	39

Source: World Bank, *World Development Indicators on CD-ROM,* 2001.

While such shocks were absent throughout the 1970s, a combination of shocks hit Latin America very hard in 1979 and the early 1980s. The first such shock struck as interest rates in the United States and Western Europe rose sharply in 1979, pushed up in an attempt by governments in the advanced industrialized countries to reduce inflation. Interest rate increases in the advanced industrialized countries were transmitted directly to developing countries. Almost two-thirds of Latin America's commercial bank debt carried variable interest rates. As interest rates rose in the United States and Europe, therefore, the interest rates that Latin American governments paid on their commercial bank loans also rose. Rising interest rates also slowed economic activity in the advanced industrialized world. Economic growth in the industrialized world fell from an average rate of more than 3 percent between 1973 and 1979 to about 1 percent in 1980–1981 and then to −0.3 percent in 1982. Recession in the advanced industrialized countries imposed a trade shock on Latin America and the other developing countries. Falling demand for exports from developing countries caused their terms of trade to fall by 10 percentage points between 1980 and 1982 (Cline 1984). Moreover, as the advanced industrialized countries moved into recession, developing countries could not expand the amount of goods they exported in order to make up for the falling value of their exports. These economic shocks meant that in the early 1980s, Latin American governments were facing larger debt payments and declining export earnings. If these developments were not bad enough, OPEC raised oil prices sharply again in 1978–1979.

The combination of rising interest rates and declining export earnings widened current account deficits throughout the developing world. It has been estimated that higher interest rates added about $41 billion to developing countries debt service payments in 1981 and 1982 (Cline 1984). The deterioration in their terms of trade reduced developing countries' export earnings by about $69 billion and raised the cost of their imports by about $10 billion in 1981 and 1982. Finally, falling demand for developing country exports reduced their export revenues by another $21 billion. All together, therefore, developing countries' current account deficits widened by about $141 billion between 1980 and 1982 relative to the current account deficits they would have faced had interest rates not risen in the United States. The impact of these shocks on the current accounts for the seven most heavily indebted Latin American governments is clearly evident in Table 8.5. Whereas most countries had small current account surpluses or a moderately large current account deficit in 1978, all experienced

Table 8.5
Current Account Deficits in the Seven Largest Latin American Debtors (millions of U.S. dollars)

	Argentina	Brazil	Chile	Colombia	Mexico	Peru	Venezuela
1977	1,126	−5,049	−551	375	n.a.	−923	−3,179
1978	1,856	−6,996	−1,088	258	n.a.	−193	−5,735
1979	−513	−10,516	−1,189	438	−5,409	730	350
1980	−4,774	−12,831	−1,971	−206	−10,422	−101	4,728
1981	−4,712	−11,764	−4,733	−1,961	−16,240	−1,728	4,000
1982	−2,353	−16,317	−2,304	−3,054	−5,889	−1,609	−4,246

Source: World Bank, *World Development Indicators on CD-ROM,* 2001.

a sharp deterioration between 1979 and 1982. Argentina moved from a $2 billion surplus in 1978 to an almost $5 billion deficit in 1980. The deterioration of Mexico's current account was even more extreme, as it shifted from a deficit of $5.4 billion in 1979 to a $16.2 billion dollar deficit in 1981. Most developing countries responded to the worsening of their current account positions by borrowing more from foreign lenders. As a result, the total foreign debt owed by developing countries rose sharply after 1979, jumping from $480.8 billion in 1978 to $810 billion in 1982.

Rising interest payments, declining export receipts, and additional external debt raised debt service ratios (see Table 8.4). In Latin America as a whole, debt service consumed almost 50 percent of all export earnings in 1982. Brazil's position was the most precarious, as debt service consumed more than 80 percent of its export revenues in 1982. The increasingly precarious financial position of many developing countries was transformed into a debt service crisis on August 18, 1982, when the Mexican government informed the U.S. Federal Reserve and the U.S. Department of Treasury that it lacked sufficient foreign exchange to make a scheduled debt payment (see Kraft 1984). The Mexican government's announcement that it could not service its debt caused commercial banks to reduce their lending to other developing countries governments because they feared that many others were facing problems similar to Mexico.

Once commercial banks ceased lending, governments had to eliminate the macroeconomic imbalances that commercial bank loans had financed. Current account deficits had to be eliminated because governments could not attract the capital inflows required to finance them. Budget deficits had to be reduced because governments could no longer use commercial bank loans to pay for them. The need for such rapid adjustment caused economic activity to fall sharply throughout Latin America (Table 8.6). Economic growth rates throughout Latin America fell from an average of 9.0 percent in 1980 to −1 percent in 1981 and 1982 and −2 percent in 1983. Many of the most heavily indebted Latin American countries fared much worse. Argentina's economy shrank by 6 percent in 1981 and by another 5 percent in 1982. Brazil's economy shrank by 4 percent in 1981, recovered briefly in 1982, and then shrank by another 3 percent in 1983. The Chilean economy shrank by 10 percent in 1982 and then by another 4 percent in 1983. Mexico's economy shrank by 1 percent in 1982 and by another 3 percent in 1983. So, just as the large inflow of foreign capital had fuelled an economic boom during the 1970s, the abrupt cessation of foreign lending in 1982 provoked a severe economic crisis throughout the region that persisted throughout the 1980s.

Table 8.6
Economic Growth Rates in Latin America, 1979–1983

	Latin America	Argentina	Brazil	Chile	Mexico	Peru	Colombia	Venezuela
1979	7	10	7	9	10	6	5	1
1980	9	4	9	8	9	3	4	−4
1981	−1	−6	−4	5	9	7	2	0
1982	−1	−5	1	−10	−1	−1	1	−2
1983	−2	4	−3	−4	−4	−12	2	−4

Source: World Bank: *World Development Indicators on CD-ROM,* 2001.

Commercial bank lending to developing countries, therefore, proved a mixed blessing. On the one hand, commercial bank lending allowed many developing countries to finance the larger current account deficits that resulted from the oil shock. In the absence of these loans, governments would have been forced to reduce consumption sharply to pay for energy imports. In addition, commercial bank loans allowed developing countries to enjoy a higher rate of investment than would have been possible otherwise. The emergence of commercial bank lending, therefore, relaxed many of the constraints that had characterized the foreign aid-dominated system of the 1950s and 1960s. On the other hand, the rapid accumulation of commercial bank debt rendered economic activity in these countries vulnerable to international shocks. As world interest rates rose and economic activity in the core slowed down, developing countries began to face debt service problems, and these difficulties led commercial banks to stop lending. The cessation of lending pushed developing countries into severe economic crises. The management of this debt crisis dominated north-south financial relations throughout the 1980s.

Managing the Debt Crisis

By 1982 the 30 most heavily indebted developing countries owed more than $600 billion to foreign lenders based in the advanced industrialized countries. By late 1982, few of these governments could continue to service this debt. The management of this debt crisis dominated north-south financial relations during the 1980s and illustrates the interplay between international power asymmetries and domestic politics in north-south financial relations. International power asymmetries shaped the regime through which the debt crisis was managed. The creditor coalition, which included the commercial banks, the IMF, and the advanced industrialized countries, created an international debt regime that pushed the costs of the crisis onto the debtor countries by linking access to additional foreign capital to the adoption of market-oriented policy reforms. The pace at which developing countries implemented market-oriented reforms, however, was determined by domestic politics. Debtor governments adopted market-oriented reforms only after they had tried other options and had become convinced of the merits of a market-based approach. We examine the management of the debt crisis here, focusing first on the characteristics of the debt regime and the power asymmetries upon which it was based, and then turning our attention to the domestic politics of economic reform.

The Debt Regime

The debt crisis was managed within a framework that largely reflected the interests of the creditors' coalition. This **debt regime** was based on a simple, if somewhat unbalanced, exchange between the creditors' coalition and the debtor governments. The heavily indebted countries were given access to new loans and were allowed to reschedule their existing debt payments in exchange for implementing far-reaching policy reforms. This approach reflected the interests of the creditors' coalition. At the

base of the debt regime stood the belief held strongly by all members of the creditors' coalition that developing countries eventually could repay their foreign debt. The creditors' coalition initially diagnosed the debt crisis as a short-term balance of payments or **liquidity problem.** In other words, the creditors believed that high interest rates and falling export earnings had merely pushed interest and principal payments above the export revenues that the debtor governments currently had available. This liquidity crisis would ease once interest rates fell and growth resumed in the advanced industrialized world. Falling interest rates would reduce debt service, while economic growth would increase the demand for debtor country exports, thereby providing more export revenues. Even when this initial diagnosis proved inaccurate, as it had by the mid-1980s, the creditor coalition remained convinced that the heavily indebted countries could repay the debt. There was no consideration of debt forgiveness until the end of the decade.

In order to repay the external debt, however, the creditors' coalition believed that the debtor governments would have to implement far-reaching economic policy reforms. The required policy reforms comprised a coherent package of neo-liberal economic policies that have come to be called the Washington Consensus. **The Washington Consensus,** so named because it reflected views held by U.S. officials and by the IMF and World Bank staffs, encouraged debtor governments to stabilize their economies and to implement structural reforms (Williamson 1994, 26–27). The two principal reform programs, macroeconomic stabilization and structural adjustment, each addressed different components of the economic problems that the creditors' coalition believed to be at the base of the debt crisis. **Macroeconomic stabilization** programs focused on macroeconomic imbalances within the debtor countries and were designed to produce the trade surpluses needed to service external debt. The centerpiece of most stabilization programs was the reduction of government budget deficits. Balancing the government budget has a powerful effect on domestic economic activity. Bringing the government's budget into balance reduces domestic consumption and investment, thereby reducing the demand for imports. Unemployment increases as economic activity slows, thereby placing downward pressure on wages. Wage adjustment in turn makes exports more competitive internationally. In most instances, tight fiscal and monetary policies were accompanied by exchange rate devaluation to further improve the trade balance. As imports fall and exports rise, the trade balance moves into surplus, thereby providing the hard currency that the government needs to service its foreign debt.

Structural adjustment targets deeper problems in the economies of heavily indebted countries. Structural adjustment became a central component of the debt regime in the mid-1980s after it had become evident that the initial diagnosis of a short-term liquidity crisis was inaccurate. The push for structural adjustment was based on the premise that the economic structures developed under import substitution industrialization limited the potential of most of the debtor countries to expand their exports, with obvious consequences for their ability to resume debt service. According to the creditors' coalition, governments throughout the world were too heavily involved in economic activity, economic production was too heavily oriented toward the domestic market, and locally produced manufactured goods were uncompetitive in world markets. This economic structure stifled entrepreneurship, reduced the capacity for economic growth, and limited export potential. Structural adjustment programs sought to

reshape the heavily-indebted countries by increasing the role of the market and reducing that of the government. Reforms sought substantial market liberalization in four areas: trade liberalization; liberalization of foreign direct investment; privatization of state-owned enterprises; and broader deregulation to promote economic competition. Structural adjustment programs were supported by World Bank lending and by loans from newly created IMF programs called the Structural Adjustment Facility and the Enhanced Structural Adjustment Facility.

Stabilization and structural adjustment tackled the economic weaknesses that limited debt service. They did not address the short-term liquidity crises the heavily indebted governments faced in 1982 and 1983. The creditor coalition recognized that the debtor governments' short-run liquidity problems had to be resolved in order to prevent widespread defaults that could have serious repercussions for the health of the commercial banks in the advanced industrialized world that had loaned so heavily to these governments. Thus, the debt regime also provided new loans and rescheduled existing debt in order to relieve debtor governments' liquidity shortages. New loans were provided by the IMF and by commercial banks through a process called **concerted lending.** In 1983 and 1984, the IMF and commercial banks provided a total of $28.8 billion to the indebted governments (Cline 1995, 207). A second wave of funding was initiated in 1985 in connection with structural adjustment programs. U.S. Secretary of the Treasury James A. Baker III asked commercial banks to provide $20 billion of new loans over a three-year period in order to refinance one-third of the total interest coming due in the period. Multilateral financial institutions, particularly the World Bank, would provide $10 billion over the same period. In all cases, fresh loans from commercial banks hinged upon the ability of debtor governments to gain financial assistance from the IMF, and loans from the IMF and World Bank were contingent upon the willingness of governments to agree to stabilization and, after 1985, structural adjustment programs. Thus, new lending was conditional—offered only on the condition that governments implement the economic reforms embodied in the Washington Consensus.

Developing countries were also allowed to reschedule existing debt payments. Rescheduling took place in the **London Club,** a private association established and run by the large commercial banks. Because of the large number of commercial banks involved in the syndicated loans (Brazil, for example, had borrowed from about 1,200 banks), about 15 of the largest banks negotiated with the debtor government on behalf of all commercial banks that had loaned to that government. Agreements worked out within this committee were then submitted to the other commercial banks participating in the syndicate for approval. Rescheduling agreements neither forgave debt, nor reduced the interest payments attached to the debt. These agreements rescheduled the payments that debtor governments had to make, usually offering a grace period and extending the maturity of the debt. These agreements reduced the size of the debt service payment in any month, but by extending the maturity of the debt they also raised the total cost of the debt. In most instances, the debtor government had to reach agreement with the IMF on the terms of economic reforms before it became eligible to reschedule its debt.

The exchange of additional finance for far-reaching policy reforms embodied in the debt regime pushed most of the costs of the crisis onto the heavily indebted countries. Table 8.7 illustrates the economic consequences of the crisis for Latin America as a

Table 8.7
Economic Conditions in Latin America, 1982–1990

	1980–1981	1982	1983	1984	1985	1986–1990
GDP[1]	100	95.6	91.3	92.2	92.7	94.1
Consumption	77.0	74.0	70.3	70.4	69.9	71.6
Investment	24.4	19.6	14.9	15.2	16.1	15.9
Unemployment[2]	6.7%				10.1%	8.0%
Real Wages[3]	100.0				86.4	68.9
Imports	−12.3	−9.7	−7.5	−8.0	−7.9	−9.2
Exports	12.5	12.6	13.6	14.5	14.2	15.2
Net Transfers[4]	12.2	−18.7	−31.6	−26.9	−32.3	
Fiscal Deficit[5]	3.7	5.4	5.2	3.1	2.7	
Inflation	53.2	57.7	90.8	116.4	126.9	

[1]As a percentage of 1980–1981 GDP.
[2]Rate of open unemployment as percent of total labor force.
[3]Index of real wages in unemployment.
[4]$U.S. Billions
[5]Percent of GDP
Source: Thorp 1998; Edwards 1995, 24; Edwards 1989, 171.

whole. Investment, consumption, and economic growth in Latin America all fell sharply after 1982. Indeed, by the end of the decade most of these indicators still had not recovered to their 1980 levels. The economic crisis hit labor markets particularly hard, as unemployment rose and real wages fell by 30 percent over the course of the decade. Real exchange rates were devalued by 23 percent on average, and by more substantial amounts in Chile (96 percent), Uruguay (70 percent), and a few other countries (Edwards 1995, 29–30). Domestic macroeconomic adjustment had its counterpart in a small rise of exports, a sharp reduction of imports, and an overall improvement in trade balances. From an aggregate $2 billion deficit in 1981, Latin America as a whole moved to a $39 billion trade surplus in 1984 (Edwards 1995, 23). Latin American governments used these surpluses to service external debt. **Net transfers,** which measures new loans to a country minus interest rate payments made by this same country, provides a measure of the scale of this debt service. In 1976, net transfers for the 17 most heavily indebted countries totaled $12.8 billion, reflecting the fact that these countries were net importers of capital. Between 1982 and 1986, net transfers for these same 17 countries averaged −$26.4 billion per year, reflecting the substantial flow of funds from the debtor countries to banks based in the advanced industrialized countries (Edwards 1995, 24). Thus, domestic economic adjustment in the debtor countries generated the resources needed to service their foreign debt.

The Sources of Bargaining Power

Why was the creditors' coalition able to push the costs of the debt crisis onto the debtor governments? The power of the creditors coalition lay in its ability to control the flow of capital to Latin America. The ability to deny debtor governments the foreign

A Closer Look

The Debt Crisis in Africa

Sub-Saharan African countries also experienced a debt crisis resulting from the internal dynamics of import-substitution and the external shocks of the 1970s and 1980s. In absolute terms, Sub-Saharan Africa's total external debt is only a fraction of the debt incurred by Latin American governments. Total external debt for the 44 Sub-Saharan African members of the IMF was only $87 billion in 1983, while Mexico alone had borrowed $90.2 billion from commercial banks by 1983 (Bird 1987, 258). African debt was almost as large as Latin America's debt when measured as a share of GDP, however, and in many cases African debt service ratios were higher than in Latin America. Africa's total external debt in 1983 was 38 percent of GDP, compared to 48.1 percent in Latin America, while debt service ratios for this same group stood at 34.7 percent in 1985 (Lancaster and Williamson 1986, 40–41). For many African countries, debt service ratios were much larger. Based on debt service ratios prior to debt rescheduling, one study estimated that in 1985, the six African countries "most seriously affected" by the crisis had debt service ratios ranging from a low of 47 percent in Zaire to a high of 123.9 percent in Sudan. Even in those six Sub-Saharan African countries judged by this same study to be only "moderately affected" by the crisis, debt service ratios ranged from a low of 25.6 percent in Zimbabwe to a high of 45 percent in Uganda (Jaycox et al. 1986, 51). Thus, even though Africa's external debt was smaller in absolute terms than Latin America's debt, debt service ratios for some African countries were higher than even the worst cases in Latin America.

In contrast to Latin America, where 70 percent of the total debt was owed to private commercial banks, two-thirds of Africa's debt was owed to other governments and multilateral institutions including the World Bank and the International Monetary Fund. Only four Sub-Saharan African countries (Nigeria, Gabon, Ivory Coast, and Congo) borrowed more than two-thirds of their debt from private commercial banks. In spite of this difference, African governments were subject to essentially the same negotiation and rescheduling process as Latin American governments. Stabilization and structural adjustment packages were negotiated with the IMF and World Bank, additional financial support from the IMF and World Bank was provided, and debt was rescheduled. Because African governments' creditors were primarily official lenders, rescheduling took place in the Paris Club rather than in the London Club. **The Paris Club,** which was created in 1956 when European governments rescheduled their loans to Argentina, brings the debtor government together with its creditor governments, the IMF, the World Bank, UNCTAD, and the OECD. In most instances, 85–90 percent of a country's debt would be rescheduled under terms that provide a five-year grace period and a further five years for repayment. Agreement was always conditional upon the willingness of the debtor government to negotiate stabilization and structural adjustment programs with the IMF and World Bank (Lancaster and Williamson 1986, 42–43).

Economic reform in Africa has progressed at an uneven pace during the last 15 years. Some governments have successfully stabilized and implemented structural reforms, others have tried to do so but have failed to make much progress, and still others have made little concerted effort to reform. As a consequence, the foreign debt that African governments have accumulated continues to impose a constraint on economic growth. This constraint is evident in the fact that per capita incomes in Sub-Saharan Africa have fallen steadily since the early 1980s. Responding to pressure from a coalition of nongovernmental organizations and religious groups, the World Bank and IMF launched The Debt Initiative for Heavily Indebted Poor Countries in September of 1996 in an attempt reduce the weight of this debt. Under this program, Heavily Indebted Poor Countries, known by the acronym HIPCs, are eligible for substantial debt reduction provided by the multilateral financial institutions and the advanced industrialized countries. The goal under this program is not to eliminate foreign debt in these countries, but to reduce it to sustainable levels, which is defined as a position that allows a government to meet its debt service obligations without the need for additional debt relief or further rescheduling (Van Trotsenberg and MacArthur 1999). To date, this program has committed about $40 billion to 25 HIPCs, 22 of which are located in Sub-Saharan Africa (World Bank 2002). Access to this debt reduction program is not automatic, however. A government qualifies for debt reduction on the basis of its total indebtedness and by demonstrating its commitment to macroeconomic stabilization and structural adjustment over a three-year period. According to the World Bank, the program will reduce the foreign debt of the 25 countries that currently are participating by between one-half and two-thirds and will cut these same countries' debt-service ratios in half (World Bank 2002).

Many nongovernmental organizations have argued that the HIPC initiative is an inadequate response (see Rowden 2001). These groups are disappointed that the initiative does not aim to fully cancel foreign debt in the poorest countries. Moreover, they claim that the World Bank and IMF have financial resources sufficient to forgive all debt. Critics also object to the conditionality element of the HIPC initiative, arguing that structural adjustment policies will only aggravate poverty. Finally, critics claim that the program fails to incorporate provisions for countries that fall back into debt problems in the future. The World Bank and IMF argue in response that full debt relief is not a feasible solution (see World Bank n.d). On the one hand, the international financial institutions claim that they do not have the financial resources that would enable them to wipe this debt off their books. On the other hand, using what resources they do have to fully cancel debt would simply reduce the funds they have available to lend in the future. Fully canceling the debt of the HIPCs, therefore, would come at the expense of other poor countries not in the HIPC program.

Continued

capital that they so desperately needed allowed the creditors to shape the debt regime in line with their interests. Yet, debtor governments also controlled something that was vitally important to the creditors—debt service. The combined debt of all Latin American debtors equaled 170 percent of the capital of the nine largest American commercial banks (Cline 1995, 74–75). If Latin American governments were to default on this debt, American banks would suffer a serious blow, perhaps sufficient to force many to exit the industry, with potentially severe repercussions for the American economy. A credible threat of default could have provided an effective source of leverage in negotiations with creditors. Yet, debtor governments failed to exploit this power. Why were creditors better able to exploit their advantage than the debtor governments? Exploiting potential power required each group to act collectively, and the members of the creditors coalition were better able to overcome the collective action problem they faced than were the debtor governments.

Creditor power. The potential power of the creditors' coalition lay in its ability to control debtor governments' access to new finance. Control over the flow of funds to the indebted countries allowed the creditors to induce debtor governments to make the policy changes required to service their debt in exchange for fresh funds. Creating and maintaining a creditor coalition that could take advantage of this power was not a simple task, however (see Lipson 1985). It was certainly easy to deny new financial flows to the debtor governments. Commercial banks were unwilling to lend voluntarily to developing countries after 1982, and the IMF would lend only in conjunction with a stabilization agreement. The real difficulties lay in providing new funds to the indebted nations. The provision of new funds was complicated by a free rider problem. Each individual creditor recognized that continued debt service in the short run required additional finance and they recognized that debt service in the long run required structural reform that would not occur unless additional finance was provided. But, each individual member of the creditors' coalition also preferred that the other members of the coalition provide the necessary financial resources. Thus, each creditor had an incentive to free ride on the contributions of the other members of the coalition.

This free-rider problem affected the creditor coalition in two places. First, commercial banks had an incentive to free ride on IMF lending. Loans from the IMF to debtor governments would provide the dollars that debtor governments needed to make their scheduled debt payments. If the IMF carried the full burden of new lending, commercial banks would be repaid without having to put more of their own funds at risk. The ability of commercial banks to free ride on IMF lending was strengthened by the importance of these banks to the American financial system. The large American commercial banks had loaned so heavily to Latin American governments that default by three or more of the largest debtors would erase their capital. The collapse of the largest U.S. commercial banks could in turn generate a financial and economic crisis in the United States. Because the economic consequences of the collapse of the large commercial banks would be so severe, large commercial banks were "too large to fail." As a result, government officials would not allow such failures to occur. This made it easier for the large commercial banks to free ride: they could refuse to provide additional funds, confident that the U.S. government would provide funds, either by itself or through the IMF, because it was unwilling to risk the consequences of widespread defaults. Opportunities for free riding were present also within the group of commercial banks involved in the loan syndicates. The smaller banks had much less at stake in Latin America than the large commercial banks because they had lent proportionately less to Latin American governments as a share of their capital. Consequently, default by Latin American governments would not necessarily imperil their survival. Whereas the large commercial banks could not walk away from the debt crisis, the smaller banks could (Devlin 1989, 200–201). This asymmetric exposure allowed the smaller banks to free ride on the efforts of the large banks. Small banks could refuse to put up additional funds confident that the large banks had to do so. Once the large banks provided new loans to Latin American governments, the small banks would benefit from the debt service these funds made possible.

If small banks were allowed to free ride on large banks, and if large banks could free ride on the IMF, the creditors' approach to the crisis would unravel. Latin American governments would lack the financial resources needed to service their debt and would have little incentive to adopt far-reaching policy reforms. The effectiveness of the creditor coalition, therefore, hinged upon preventing free riding. The IMF played an important role in doing so. To prevent commercial banks from free riding on the IMF, the IMF refused to approve stabilization agreements, and advance IMF credit to a particular government until commercial banks had pledged new private loans to the same government. This linkage between IMF and private lending encouraged the large commercial banks to prevent free riding by the small commercial banks. Because the large commercial banks were unable to free ride on the IMF, they sought ways to compel the small commercial banks to provide their share of the new private loans. Large banks threatened to exclude smaller banks from participation in future syndicated loans—a potentially lucrative activity for the smaller banks—and threatened to make it difficult for the smaller banks to operate in the inter-bank market. American and European central bank officials also pressured the small banks. Free riding thus became a costly proposition for the small banks.

The ability to solve the free riding problems produced a unified creditors' coalition that controlled financial flows to Latin America. The IMF and the commercial banks advanced new loans to Latin American governments—though the commercial banks did so quite reluctantly—and all accepted a share of the risks of doing so. Creditors could therefore reward those debtor governments that adopted a cooperative approach to the crisis with new finance and deny additional finance to those unwilling to play by the creditors' rules.

Debtor power. The potential power of the debtor governments lay in the threat of a collective default. While each of the large debtors owed substantial funds to American banks—in 1982, for example, Mexico's debt to the nine largest American commercial banks equaled 44.4 percent of these banks' combined capital—no single government owed so much that a unilateral default would severely damage American banks or the American economy (Cline 1995, 74–75). Collective action could provide power, however. If all debtor governments defaulted, the capital of the largest American commercial banks would be eliminated, creating potentially severe consequences for the American economy. A credible threat to impose such a crisis might have compelled the creditors to provide more finance on easier terms, to demand less austerity, and perhaps to forgive a portion of the debt. Yet, debtor governments never threatened a collective default (Tussie 1988). Latin American governments held a series of conferences in the early years of the crisis in order to discuss the possibility for a coordinated response to the crisis. Governments used these conferences to demand that the creditors "share responsibility in the search for a solution" and demanded "equity in the distribution of the costs of adjustment," but they did not go so far as to threaten a collective default (Tussie 1988, 291). Argentina was the only country to adopt a noncooperative stance toward the creditors' coalition, and it tried hard to convince other Latin American governments to follow suit. The other Latin American governments were unwilling to take a hard line with the creditors' coalition; in fact, they encouraged Argentina to adopt a more cooperative stance (Tussie 1988, 288). Thus, instead of threatening collective default, debtor governments played by the creditors' rules.

The debtor governments failed to exploit the power that lay in the threat of a collective default because they found themselves in a prisoners' dilemma. While the threat of a collective default could yield collective benefits, each government had an incentive

to defect from a collective threat in order to seek a better deal on its own. The incentive to seek the best deal possible through unilateral action rather than a reasonably good deal through collective action was a product of two factors. First, each debtor government believed that it possessed unique characteristics that would enable it to negotiate more favorable terms than would be available to the group as a whole. The Mexican government, for example, believed it could exploit its proximity to the United States and its close ties with the U.S. government to gain more favorable terms. Brazil, which by 1984 was running a current account surplus, believed it had achieved an economic position it could exploit to its advantage in negotiations with its creditors (Tussie 1988, 288). Second, the bilateral approach embodied in the IMF and London Club framework heightened governments' fears that others would defect. Creditors negotiated with each debtor government independently. This bilateral approach allowed the creditors to adopt a "divide and conquer" strategy under which they could offer "special deals" to induce particular governments to defect from any debtor coalition that might form. If one government were to defect, it would gain favorable treatment from the creditors while the others would be punished for their uncooperative strategy. Punishment could include fewer new loans, higher interest rates and larger fees on rescheduled loans, and perhaps more stringent stabilization agreements. Thus, even though coordinated action could yield collective gains, each individual government's incentive to seek a unilateral agreement dominated the strategy of a collective threat of default.

The debt regime reflected creditors' interests, therefore, because the creditors were better able than the debtor governments to solve the collective action problem and develop a coordinated approach to the debt crisis. The creditors used this power advantage to create a regime that pushed most of the costs of the debt crisis onto the heavily indebted countries. The debt regime was based on the dual premises that all debt would be repaid in the long run, but debt service would require the indebted governments to implement far-reaching economic policy reforms. Conditionality provided a powerful lever to induce developing countries to adopt economic reforms. Few developing countries could afford to cut themselves off completely from external financial flows. After 1982, these governments found that the price of continued access to international finance was far-reaching economic reform.

The Domestic Politics of Economic Reform

While the creditors' coalition established the structure for managing the debt crisis, used conditionality to promote economic reform, and set the parameters on the range of acceptable policies that could emerge from the reform process, the pace at which debtor governments adopted stabilization and structural adjustment programs was determined by domestic politics. Governments initially delayed implementing stabilization programs and far-reaching structural reforms. Economic reform required governments to impose costs on societal groups, and these costs gave rise to distributive struggles among interest groups that delayed economic stabilization. Meaningful reform began only in the late 1980s, after the economic crisis became particularly severe and after all feasible alternatives to the Washington Consensus had failed to resolve the economic crisis.

Delaying reforms. Conflict between interest groups over the distribution of the adjustment costs caused governments to delay the implementation of reform. Distributive conflict revolved around the need to balance the budget to stabilize the economy. To balance their budgets, governments had to make choices about which programs in particular would be cut. Should the government reduce subsidies on basic consumption goods such as food or energy, or should the government reduce credit subsidies to industry? In addition, governments had to decide which taxes were to be raised and upon which domestic groups these increases would fall. Interest groups within the indebted countries were not indifferent between the many possible combinations of expenditure cuts and tax increases that each government could adopt. Instead, each interest group preferred that the government reduce expenditures on programs from which it did not benefit and raise taxes on other groups. This political dynamic generated a **war of attrition** between interest groups in which each group blocked meaningful policy reform because each believed that others would eventually agree to bear the costs of adjustment by accepting large cuts to their favored programs or higher taxes (Alesina and Drazen 1991).

This war of attrition dynamic drove the politics of stabilization in the years immediately following the onset of the debt crisis. The interest groups that had gained most from import substitution stood to lose most from the budget cuts that were necessary to stabilize the economy. Firms in the import-competing sector that had benefited from government credit subsidies would be hit hard by fiscal retrenchment. State-owned enterprises would be particularly hard hit, as they would lose the government infusions that had covered their operating deficits during the 1970s. Workers in the urbanized nontraded goods sector that had benefited from government subsidies of basic services, such as utilities and transportation, and essential food items would also be hit hard by budget cuts. Public sector employees would also suffer as budget cuts brought an end to wage increases and forced large reductions in the number of government employees. Unwilling to accept the reduction in income implied by fiscal austerity, members of the import substitution coalition blocked large cuts in government expenditures. In Brazil, for example, the military government attempted to implement an orthodox stabilization program in the early 1980s, but "both capitalists and labor in modern industry . . . demanded relief from austerity. So too did much of the urban middle class including government functionaries whose livelihood was imperiled by attacks on public spending" (Frieden 1991, 134). The ISI coalition responded to the military regime's efforts to stabilize by shifting their support to the civilian political opposition, allowing the civilian government to take power from the military. Once in office, the new civilian government abandoned fiscal austerity and resumed an expansionary fiscal policy. The Brazilian case was not unique; members of the import substitution coalition in most heavily indebted countries were well positioned to block large cuts in government expenditures.

The inability to reduce government expenditures resulted in high inflation throughout Latin America. The sharp drop in economic activity in Latin American countries caused government tax revenues to fall more rapidly than government expenditures, causing budget deficits to widen further. In Brazil, one of the worst cases in the region, the central government's fiscal deficit rose from 3 percent of GDP in 1982 to 12 percent of GDP in 1987 (Edwards 1995, 25). Facing widening deficits and unable to make substantial reductions in expenditures, many governments turned to their central banks to finance these deficits. Paying for deficits through central bank financing in turn sparked inflation. Inflation in Latin America rose from about 50 percent per year in the

years immediately preceding the crisis to over 115 percent per year in 1984 and 1985 (Table 8.7). Region-wide averages hide the most extreme cases. In Argentina, inflation averaged 787 percent per year during the 1980s. Brazil fared a little better, enduring average rates of inflation of 605 percent throughout the decade (Thorp 1998, 332). Bolivia's experience was the most extreme, as inflation rose above 20,000 percent in late 1985.

Even rapid inflation was insufficient to induce governments to cut expenditures in this period. In Argentina, Brazil, and Peru, governments responded to high inflation with **heterodox strategies** (see Edwards 1995, 33–37). Advanced as an alternative to the orthodox measures advocated by the IMF, which emphasized correcting the macroeconomic imbalances driving inflation by reigning in government expenditures, heterodox strategies attacked inflation with government controls on wages and prices. The Argentine and Brazilian plans illustrate the approach. In June 1985, the Argentine government announced a general price freeze to be achieved in part by government control of public service prices. In addition, the government froze wages in the public sector and fixed the exchange rate. The Argentine peso was replaced by a new currency, the austral, and a series of revenue-raising measures, including higher prices for public services, an increase in tariffs, and a compulsory savings plan for workers, were put in place. This **Austral Plan** initially delivered impressive results. Inflation fell from 350 percent in early 1985 to just above 20 percent in the second half of the year. The plan quickly began to unravel, however. With a fixed nominal exchange rate, 20 percent inflation caused the real exchange rate to appreciate which in turn caused the trade balance to deteriorate, creating new balance of payments problems. The government abandoned key elements of the plan in early 1986, shifting to a crawling peg and abandoning the price and wage freeze. By the end of the year the budget deficit had widened to 7 percent of GNP and inflation was rising once again.

The Brazilian **Cruzado Plan** was similar in design and similarly ineffective. Implemented in February 1986 as Brazilian inflation passed 450 percent, the Cruzado Plan introduced a new currency—the cruzado—and fixed it to the dollar. The government imposed a general price freeze, and nominal wage increases were linked to inflation. The government made no attempt to reduce its fiscal deficit, however. As had been the case in Argentina, the plan was initially effective. Inflation fell to 8.3 percent in the second quarter of the year and then to 2 percent in the third quarter. Inflation rebounded in early 1987, however, and by the middle of the year was running at 95 percent. Inflation refused to stay down because the lack of meaningful budget cuts generated too much demand in the Brazilian economy. As Edwards (1995, 37) notes, "Fiscal imbalances continued to put pressure on prices, and in September 1986 the fixed nominal exchange rate was abandoned. . . . Instead of reducing inflation to zero, as its designers had promised, the Cruzado Plan left Brazil a legacy of frustration, skepticism, and even higher inflation."

Implementing reforms. It wasn't until the late 1980s that Latin America governments began implementing far-reaching reforms. By 1990, most heavily indebted governments were implementing stabilization and structural adjustment programs. Most governments reduced fiscal deficits and brought inflation under control. Macroeconomic stabilization provided a base upon which to begin market-oriented structural reforms. Governments began to liberalize trade and to privatize state-owned industries. Many governments also began to reduce their role in domestic financial systems and liberalize capital accounts as well (Edwards 1995, 212).

Students of reform have pointed to three factors that finally induced governments to implement reforms. First, the severe economic crisis altered interest group politics in the heavily indebted countries. Deteriorating economic conditions weakened key members of the import substitution coalition and raised the cost to these groups of continuing to oppose reform. As a result, groups that had once been able and willing to block reform increasingly lost the capacity to do so and eventually lost the desire to do so as well. The economic crisis also forced social groups to rethink their strategy of blocking reform. Economic crisis caused "individuals and groups to accept that their special interests need[ed] to be sacrificed . . . on the altar of the general good" (Williamson 1994, 19). Economic crisis thus created a new political consensus that the old order had failed and that reform was necessary. By weakening key interest groups and by forcing many of these same groups to redefine their interests, the severity of the economic crisis itself removed the central political obstacles to far-reaching reform. Resistance to reform was further reduced through government social programs that cushioned the impact of structural change. In Mexico, for example, President Carlos Salinas launched the Solidarity Program in 1988 under which financial assistance was channeled to segments of Mexican society that were particularly hard hit by structural reform (see Cornelius, Craig and Fox, 1994).

Second, a new approach to the debt crisis initiated by the United States in 1989 gave developing countries greater incentive to adopt reform. In March of 1989, the secretary of the U.S. Treasury Nicholas J. Brady, advanced a plan to encourage commercial banks to negotiate debt reduction agreements with debtor governments. Under this **Brady Plan,** debtor governments could convert their existing commercial bank debt into bond-based debt with a lower face value. The precise amount of debt reduction that each government realized would be determined by negotiations between the debtor government and its commercial bank creditors. To make the proposal attractive to commercial banks, the advanced industrialized countries and the multilateral financial institutions advanced $30 billion with which to guarantee the principal of the **Brady Bonds,** as the new debt instruments came to be called. This government guarantee allowed commercial banks to exchange the uncertain repayment of a large bank debt for guaranteed repayment of a smaller amount of bond debt. The Brady Plan also strengthened debtor governments' incentives to embark on reform. In the absence of debt reduction, heavily indebted governments had little incentive to adopt structural reforms because many of the gains from reform would be dedicated to debt service. Reducing the debt allowed domestic groups to capture a larger share of these gains. Governments thus had a greater incentive to accept the short-term costs that stabilization and structural adjustment entailed.

Mexico was the first to take advantage of the Brady Plan and concluded an agreement in July 1989 that was typical of the agreements that followed (see Cline 1995, 220–221). Each commercial bank that had claims on the Mexican government could choose one of three options. First, each commercial bank could convert its claims on Mexico into bonds that paid a market interest rate, at a 35 percent discount of face value. Second, each bank could convert its claims into bonds at 100 percent of face value but at an interest rate substantially below prevailing market rates. Finally, each bank could retain all of its claims on Mexico and advance new loans over a three-year period equal to 25 percent of their current exposure. This deal between the Mexican government and its

creditors reduced Mexico's net transfers by about $4 billion, an amount equal to about 2 percent of Mexico's GDP. Reducing debt service allowed the Mexican economy to grow by 2 percentage points more than would have been possible without debt reduction (Edwards 1995, 81). By 1994, Brady Plan agreements covered about 80 percent of the commercial bank debt that had been continuously rescheduled during the 1980s. These agreements reduced debt service payments by about $50 billion—roughly one-third (Cline 1995, 232).

Finally, as the economic crisis progressed, heavily indebted governments became more willing to recognize that the East Asian model offered lessons for Latin America. The Economic Commission on Latin America (ECLA) played an important role in prompting this recognition (see Economic Commission for Latin American and the Caribbean 1985). ECLA had begun to look closely at East Asia in the mid-1980s, and was able to foster a new consensus among Latin American governments about the relevance of the East Asian model of development. As an ECLA study recommended in the late 1980s, "the debt problem requires a structural transformation of the economy in at least two senses: the growth strategy needs to be *outward oriented* and largely based on a domestic effort to raise savings and productivity" (cited in Edwards 1995, 148). ECLA's transformation "was like 'Nixon in China.' When the one institution that had for decades defended import substitution expressed doubts about its validity and recognized that there were lessons to be learned from the East Asian experience with outward-oriented policies, it was difficult to dismiss those doubts as purely neo-liberal propaganda" (Edwards 1995, 52).

By the mid-1990s the Latin American debt crisis was over (Cline 1995, 39). In hindsight, it is clear that the debt crisis was more than a financial crisis; it was a crisis of economic development strategy. The accumulation of foreign debt during the 1970s reflected developing countries' efforts to rejuvenate the waning energies of import substitution industrialization. Moreover, the crisis itself, and the debt regime through which the crisis was managed, had far-reaching consequences for developing countries' development strategies. The short-term economic costs of the crisis were substantial for the heavily indebted countries. Most failed to raise standards of living during the 1980s and in many countries the standard of living fell. The management of the crisis through the debt regime brought about, and some would say forced, a fundamental reorientation of development strategies in most countries. Governments abandoned import substitution industrialization and adopted in its place market- and export-oriented development strategies. As a consequence, developing countries fundamentally altered their relationship with the international economy. The full implications of these changes are still not perfectly clear.

The Resumption of Capital Flows and the Return of Financial Crises

Developing countries attracted little new foreign capital in the years following the debt crisis. In fact, it was not until the end of the decade, and after the reform process had begun to take root, that private capital began flowing again to developing countries. Capital flows to middle-income developing countries rose sharply in the early 1990s

and peaked in mid-decade at more than $200 billion per year, about 3 percent of these countries' GDP (see Figure 8.5). Capital flows then declined to less than $100 billion at the end of the decade (IMF 2000, 45). Asia was the largest recipient of capital inflows prior to 1997, accounting for almost 50 percent of total flows to all developing countries in the first half of the decade. Latin America was the second largest recipient, receiving between one-quarter and one-third of all flows to developing countries (IMF 2000). The composition of these capital flows was quite distinct from earlier periods (see Figure 8.5). For the middle-income developing countries as a group, **portfolio flows,** which are essentially connected to the purchase of stocks and bonds, were more important than commercial bank loans throughout the 1990s. The relative importance of portfolio flows and commercial bank lending varied across the regions, however (see Figures 8.6 and 8.7). In Latin America, portfolio flows were more important than commercial bank lending throughout the decade (except in 1995), as commercial banks remained reluctant to lend heavily to the governments that had struggled to repay the debt they had incurred during the 1970s. In Asia, portfolio flows were more important than commercial bank lending in the early 1990s, but commercial bank lending became the more important source of funds during 1995 and 1996. Perhaps the most interesting trend, visible for the developing world as a whole and in each region individually, is the growing importance of foreign direct investment. Foreign direct investment rose in absolute terms throughout the decade, and at the turn of the century was the single most important source of foreign capital for Latin America and Asia.

The resumption of capital flows has raised fresh concerns. Such concerns focus primarily upon how the short-term nature of these capital flows will affect economic performance in the developing world. The growing importance of short-term capital,

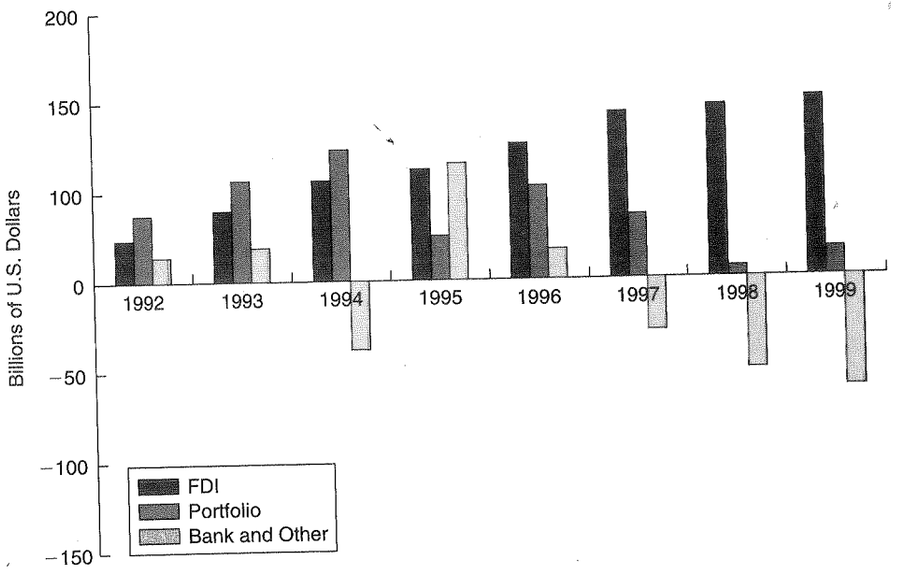

Figure 8.5 Net Capital Flows to Developing Countries, 1992–1999.
Source: World Bank 2001c.

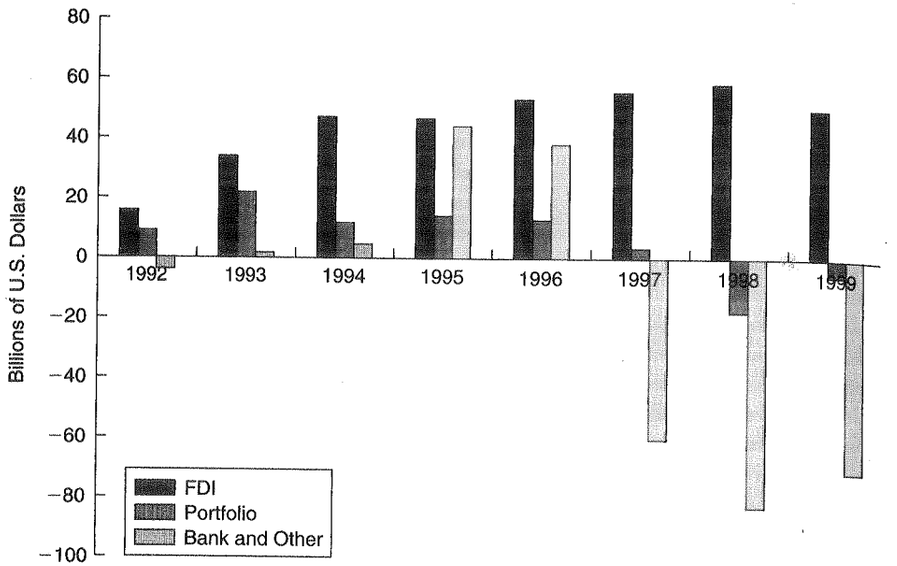

Figure 8.6 Net Capital Flows to Asia, 1992–1999.
Source: World Bank 2001c.

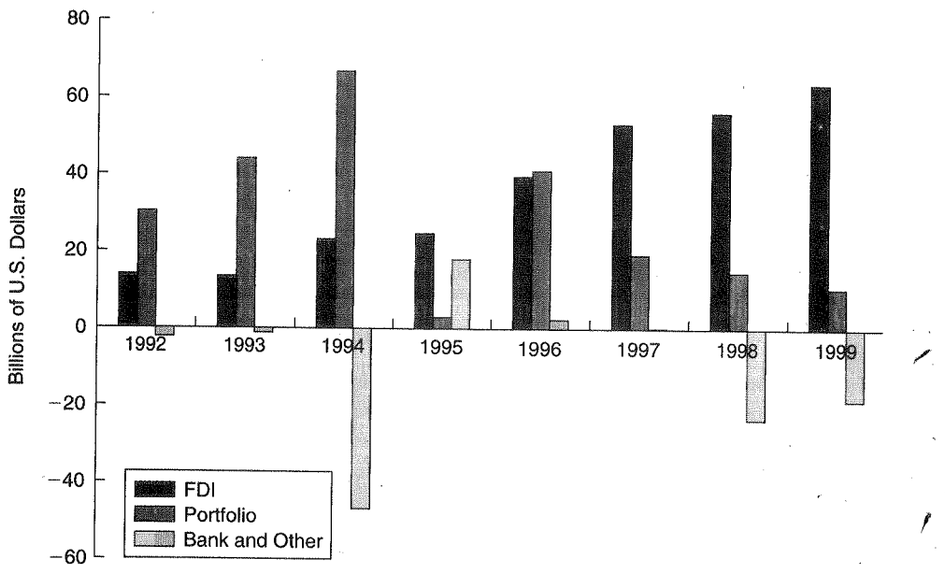

Figure 8.7 Net Capital Flows to Latin America, 1992–1999.
Source: World Bank 2001c.

often referred to as **hot money** because it can move into and out of a country so rapidly, has increased the volatility of financial flows to developing countries. While developing countries have struggled with such volatility throughout the last 100 years, volatility increased during the 1990s compared to earlier periods (IMF 2001, 163; World Bank 2001a). Volatility appears to have a negative impact on economic performance. Historical evidence suggests that more volatile capital flows have been associated with lower economic growth rates over the long run (World Bank 2001a, 73). In addition, the lesson of the 1990s is that the recent increase of volatility has been associated with more frequent financial crises that substantially reduce economic growth for a year or two. Many such financial crises struck developing countries during the 1990s. Mexico experienced the first crisis in late 1994. Four Asian countries—Indonesia, Malaysia, South Korea, and Thailand—experienced severe crises in the summer and fall of 1997. Brazil and Russia both experienced crises in 1998. Turkey and Argentina were struck by crises in 2000 and 2001. The resumption of capital flows to developing countries therefore raises new challenges for developing countries and for the advanced industrialized countries.

The causes and consequences of the Asian financial crisis of 1997 provide the clearest illustration of these challenges. The Asian crisis represented a new kind of international financial crisis in at least three ways. First, the causes of the Asian crisis differed from the underlying causes of previous international financial crises. In contrast to the Latin American debt crisis, the Asian crisis had little to do with government borrowing, but originated instead in weak domestic banking sectors that had recently been liberalized and encouraged to intermediate between domestic and international markets. Second, the Asian crisis differed in scale from prior crises. The volume of capital outflows that Asian countries experienced and the size of the IMF-centered rescue packages that were provided to the crisis countries were both unprecedented. Finally, the economic and political consequences of the crisis were far more severe than previous crises, with some countries experiencing economic contractions worse than any experienced by any country since the Great Depression. What is most worrying about the Asian crisis is the possibility that we will view it not as unique, but as the first of a new kind of international financial crisis that periodically threatens the stability of the international financial system. We examine the Asian crisis in detail in this section, looking first at its origins and management, and then turning to its impact on the broader international financial system.

The Causes and Consequences of the Asian Financial Crisis

The Asian crisis originated in political and economic dynamics within the four Asian countries that were hardest hit: Thailand, Indonesia, South Korea, and Malaysia. During the late 1980s and early 1990s, these Asian governments liberalized their financial markets to make it easier for domestic banks and firms to borrow on international financial markets. In Thailand, for example, the government created the Bangkok International Banking Facilities in 1992 in an attempt to make Thailand a banking center in Asia. The government hoped that Thai banks would borrow on international markets and then lend these funds to borrowers throughout Asia. Financial liberalization throughout Asia thus enabled Asian banks to intermediate between international

lenders and domestic borrowers. The incentive for such intermediation was powerful. Interest rates in international markets were considerably lower than interest rates inside Asian economies. Asian banks could thus borrow money at a relatively low rate of interest, such as 9 percent, from foreign commercial banks and then lend it to domestic borrowers at a much higher rate of interest, such as 12 percent.

This type of intermediation was risky. Asian banks contracted short-term loans denominated in dollars and other foreign currencies from foreign banks and then offered these funds as long-term loans denominated in the domestic currency to local borrowers. Such transactions meant that Asian banks were exposed to two distinct kinds of risk. First, they faced **exchange rate risk,** which arose from the possibility that the government would devalue the local currency. Were this to happen, the cost of servicing the dollar-denominated loans in the domestic currency would rise substantially. At the extreme, the domestic currency cost would rise above the payments that Asian banks were receiving from the businesses to which they had loaned money. Asian banks were also exposed to the risk that foreign lenders would stop rolling over their short-term loans. Because Asian banks had borrowed on a short-term basis and then made long-term loans, they needed foreign commercial banks to renew the loans they had previously made. Each time a short-term loan was due, the foreign commercial bank would simply extend the loan for an additional 6 or 12 months. If foreign commercial banks suddenly became unwilling to continue this practice, the Asian banks would be forced to repay all of their short-term debt at once. Yet, because these funds were tied up in the long-term loans that the Asian banks had made to local borrowers, the Asian banks would be unable to raise the funds needed to repay their debts to foreign banks. Both risks proved important as the crisis unfolded.

The ability of Asian banks to safely intermediate between international and domestic financial markets was compromised by flaws in Asian countries' financial regulations. The central weakness was a problem called moral hazard. **Moral hazard** arises when banks believe that the government will bail them out if they suffer large losses on the loans they have made. If banks believe that the government will cover their losses, they have little incentive to carefully evaluate the risks that are associated with the loans they make. If the loans are repaid, banks earn money. If the loans are not repaid, the government, and society's taxpayers, pick up the tab. In such an environment, banks have an incentive to make riskier loans than they would make in the absence of a guarantee from the government. This incentive arises because banks charge higher interest rates to high-risk borrowers. As a result, higher-risk loans, when they are repaid, yield higher returns than low-risk loans. A government guarantee thus creates a one-way bet for banks: lend heavily to risky borrowers and profit greatly if the loans are repaid, and yet suffer little if they are not because the government will bail them out. The danger is that the practice of lending heavily to high-risk borrowers makes a system-wide financial crisis more likely. Banks will lend too much to risky borrowers, and too many of these high-risk borrowers will default on their debt. Banks will lose money, forcing the government to step in and bail them out. The government guarantee thus makes a financial crisis more likely.

Moral hazard was particularly acute in many of the Asian crisis countries. Financial institutions had close ties to governments, sometimes through personal relationships and sometimes through direct government ownership. In Indonesia, for example, seven

state-owned banks controlled half of the assets in the banking system (Blustein 2001, 94), and relatives and close friends of Indonesian President Suharto controlled other financial institutions. In the past, such relationships had led governments to rescue banks and other financial institutions in distress. In Thailand, for example, the government rescued the Bangkok Bank of Commerce in 1996–1997 at the cost of $7 billion (Haggard 2000, 25). In Indonesia, two large corporate groups rescued Bank Duta (which held deposits from President Suharto's political foundations), after it had lost $500 million in foreign exchange markets. The corporate rescuers were in turn rewarded by the Suharto regime (Haggard 2000, 26). Given this history, foreign and domestic financial institutions participating in the Asian market had reason to believe that Asian governments would not allow domestic financial institutions to fail. This in turn led international investors to loan more to Asian banks, and Asian banks to loan more to Asian businesses, than either would have been willing to loan had Asian governments not rescued banks in the past.

In principle, governments can design financial regulations to prevent the risky lending practices to which moral hazard so often gives rise. Banking regulations established and enforced by government agencies can limit the activities that financial firms engage in and thereby limit the overall risk in lending portfolios. In the Asian crisis countries, however, such financial regulation was under-developed. Where such regulation did exist, it was not effectively enforced. In Indonesia, for example, any regulator "who attempted to enforce prudential rules . . . was removed from his position" (Haggard 2000, 33). Such treatment was not restricted to civil servants; the managing director of the central bank was fired in 1992 and the minister of finance was fired in 1996 (Haggard 2000, 33). As Haggard notes, the more general problem lay in the "influence that business interests exercised over legislation, regulation, and the legal process" (Haggard 2000, 38). In other words, the same network of business-government relations that created the moral hazard problem in the first place also weakened the incentives that governments had to develop and enforce effective prudential regulations. As a consequence, there were few regulatory checks on the lending practices of Asian financial institutions.

This regulatory framework enabled Asian banks to accumulate financial positions that could not easily withstand the deteriorating economic conditions that Asian countries began to encounter in late 1996 and early 1997. Deteriorating economic conditions created domestic debt service problems in two ways. First, Asian countries' exchange rates began to appreciate against the Japanese yen in the mid-1990s. Most Asian governments pegged their currencies to the dollar. When the dollar began to appreciate against the Japanese yen in the mid-1990s, Asian currencies rose in value along with it. Exchange rate appreciation made it difficult for domestic firms to export to Japan, one of their major export markets, which in turn created debt service problems for export-oriented firms. Second, real estate prices began to fall in late 1996, creating debt service problems for real estate developers. In March, the Thai government purchased $4 billion of debt that property developers owed but were unable to pay to domestic banks. By 1997, therefore, many of the Asian banks' largest domestic borrowers were struggling to service their debt. As a consequence, the number of **nonperforming loans,** loans on which interest payments had not been made for six months or more, held by Asian banks began to grow. Because domestic borrowers

could not repay domestic banks, the domestic banks could not easily repay foreign banks. Domestic debt service difficulties thus began to generate international debt service difficulties.

Weaknesses in Asian financial systems became a source of general concern in the spring of 1997 when one of Thailand's largest financial institutions, Finance One, was discovered to be **insolvent,** that is, its total liabilities were greater than the value of its assets. The discovery that such an important financial institution was insolvent caused foreign banks to look much more closely at banks throughout Asia. Close inspection indicated that Finance One's situation was not unique; banks throughout Asia were facing similar problems. In Thailand, the government suspended the operations of 16 of the nation's largest financial institutions, all of which are unable to raise the cash needed to continue operations. Deteriorating conditions in Asian financial systems and shifting international market sentiment combined to produce a panicked withdrawal of funds from Asian markets beginning in the summer of 1997. Foreign banks that had loaned heavily to Asian banks refused to roll over existing loans and demanded repayment of whatever loans they could. Funds also started flowing out of Asian stock markets. The panic began in Thailand in May 1997, where it quickly consumed the Thai government's foreign exchange reserves and forced the government to float the Baht. The panicked withdrawal of funds from Asia over the next six months struck practically every country in the region. Following Thailand, financial markets shifted their attention to the Philippines, forcing the government to abandon its fixed exchange rate after only ten days. Attention then shifted to Indonesia and Malaysia in July and August, and governments in both countries responded to massive capital outflows by abandoning their fixed exchange rates and allowing their currencies to float. From there, speculation targeted Taiwan, forcing a devaluation of the Taiwanese dollar, and Hong Kong, where capital flight caused the Hong Kong stock market to lose about one-quarter of its value in only four days. The crisis moved to South Korea in November, forcing the government to float the won by the middle of the month. A total of $60 billion was pulled from the region in the second half of 1997, roughly two-thirds of all the capital that had flowed in the year before. An additional $55 billion was pulled out in 1998 (IMF 1999, 92).

As the crisis struck, Asian governments turned to the IMF for financial assistance. The Philippines was the first to do so, gaining a $1.1 billion credit on July 14. The Thai government turned to the Fund two weeks later and was provided $16 billion from the IMF and other Asian countries. Indonesia was able to hold out longer, turning to the IMF only in October and receiving a $23 billion package. South Korea received the most support from the international community, acquiring $57 billion from the IMF and other governments in early December. The size of these financial packages was historically unprecedented. The financial support offered by the IMF, other international financial institutions, and the advanced industrialized countries to the four countries most severely affected by the crisis, South Korea, Indonesia, Thailand, and Malaysia, totaled $117.7 billion.

As in earlier crises, financial assistance from the IMF was conditional upon economic reform. The reforms incorporated in IMF conditionality agreements in the Asian crisis targeted three broad areas: macroeconomic stabilization, financial sector reform, and structural reform. Macroeconomic stabilization programs were necessary,

the IMF argued, to restore market confidence in the crisis countries and to stem the outflow of capital. Governments were urged to tighten monetary policy by raising interest rates in order to stem the depreciation of their currencies. Tighter fiscal policies were required in order to generate the financial resources needed to pay for restructuring of the financial sector. Financial sector reforms were based on three interacting components. First, governments were required to close insolvent financial institutions. In Thailand, for example, the government shut down 56 insolvent finance companies; the South Korean government closed nine large merchant banks; the Indonesian government was required to close 16 insolvent banks. Second, governments were asked to recapitalize weak financial institutions. Third, Asian governments were required to restructure their financial systems to improve the quality of financial intermediation. Restructuring entailed redesigning financial regulations to promote better oversight, ending close relationships between government officials and financial institutions, and opening the domestic financial services industry to foreign financial institutions. Finally, the IMF required Asian governments to implement structural reforms. Structural reforms included trade liberalization, the elimination of domestic monopolies and other uncompetitive practices and regulations, and privatization of state-owned enterprises. In Thailand, structural reforms targeted the civil service and state-owned enterprises. In Indonesia, the IMF pressed the government to deregulate agriculture and reduce the monopoly position of the national agriculture marketing board. The Indonesian government was also pressed to privatize 13 state-owned enterprises and to suspend the development of auto and commercial aircraft industries.

The crisis had severe economic and political repercussions. The financial crisis and the implementation of IMF reform packages precipitated severe economic recessions throughout Asia (see Table 8.8). Indonesia experienced the most severe downturn, with economic output contracting by more than 13 percent in 1998. In most countries, the economic crisis hit the poor the hardest, and as a consequence poverty rates throughout the region rose sharply. In Indonesia, the number of people living below the poverty line rose from 11 percent of the population prior to the crisis to

Table 8.8
Economic Growth and Current Account Balances in Asia

	1995	1996	1997	1998
		Economic Growth (percent annual change)		
Thailand	8.8	5.5	−0.4	−5.0
Indonesia	8.2	8.0	4.6	−13.7
South Korea	8.9	7.1	5.5	−5.8
		Current Account Balance (percent of GDP)		
Thailand	−7.8	−7.9	−2.0	6.9
Indonesia	−3.2	−3.3	−1.8	1.6
South Korea	−1.9	−4.7	−1.9	7.3

Source: IMF Annual Report, 1999.

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As the crisis struck, Asian governments turned to the IMF for financial assistance. The Philippines was the first to do so, gaining a $1.1 billion credit on July 14. The Thai government turned to the Fund two weeks later and was provided $16 billion from the IMF and other Asian countries. Indonesia was able to hold out longer, turning to the IMF only in October and receiving a $23 billion package. South Korea received the most support from the international community, acquiring $57 billion from the IMF and other governments in early December. The size of these financial packages was historically unprecedented. The financial support offered by the IMF, other international financial institutions, and the advanced industrialized countries to the four countries most severely affected by the crisis, South Korea, Indonesia, Thailand, and Malaysia, totaled $117.7 billion.

As in earlier crises, financial assistance from the IMF was conditional upon economic reform. The reforms incorporated in IMF conditionality agreements in the Asian crisis targeted three broad areas: macroeconomic stabilization, financial sector reform, and structural reform. Macroeconomic stabilization programs were necessary,

the IMF argued, to restore market confidence in the crisis countries and to stem the outflow of capital. Governments were urged to tighten monetary policy by raising interest rates in order to stem the depreciation of their currencies. Tighter fiscal policies were required in order to generate the financial resources needed to pay for restructuring of the financial sector. Financial sector reforms were based on three interacting components. First, governments were required to close insolvent financial institutions. In Thailand, for example, the government shut down 56 insolvent finance companies; the South Korean government closed nine large merchant banks; the Indonesian government was required to close 16 insolvent banks. Second, governments were asked to recapitalize weak financial institutions. Third, Asian governments were required to restructure their financial systems to improve the quality of financial intermediation. Restructuring entailed redesigning financial regulations to promote better oversight, ending close relationships between government officials and financial institutions, and opening the domestic financial services industry to foreign financial institutions. Finally, the IMF required Asian governments to implement structural reforms. Structural reforms included trade liberalization, the elimination of domestic monopolies and other uncompetitive practices and regulations, and privatization of state-owned enterprises. In Thailand, structural reforms targeted the civil service and state-owned enterprises. In Indonesia, the IMF pressed the government to deregulate agriculture and reduce the monopoly position of the national agriculture marketing board. The Indonesian government was also pressed to privatize 13 state-owned enterprises and to suspend the development of auto and commercial aircraft industries.

The crisis had severe economic and political repercussions. The financial crisis and the implementation of IMF reform packages precipitated severe economic recessions throughout Asia (see Table 8.8). Indonesia experienced the most severe downturn, with economic output contracting by more than 13 percent in 1998. In most countries, the economic crisis hit the poor the hardest, and as a consequence poverty rates throughout the region rose sharply. In Indonesia, the number of people living below the poverty line rose from 11 percent of the population prior to the crisis to

Table 8.8
Economic Growth and Current Account Balances in Asia

	1995	1996	1997	1998
	Economic Growth (percent annual change)			
Thailand	8.8	5.5	−0.4	−5.0
Indonesia	8.2	8.0	4.6	−13.7
South Korea	8.9	7.1	5.5	−5.8
	Current Account Balance (percent of GDP)			
Thailand	−7.8	−7.9	−2.0	6.9
Indonesia	−3.2	−3.3	−1.8	1.6
South Korea	−1.9	−4.7	−1.9	7.3

Source: IMF Annual Report, 1999.

19.9 percent in 1998. In South Korea, the poverty rate rose from 8.6 percent of the population prior to the crisis to 19.2 percent in 1998. Deteriorating economic conditions sparked protest and political instability. Political unrest was most severe in Indonesia. Economic crisis sparked large-scale opposition to the corruption, nepotism, and cronyism that had long characterized the Suharto government. As the economic crisis deepened, opposition to the Suharto regime grew, demanding fundamental political reforms and a reduction of basic commodity prices, particularly energy and rice. Protests and opposition peaked in May 1998. Four students were killed by the military during an anti-Suharto demonstration at Triskati University on May 12, sparking even larger protests during the following days. By May 18, some of Suharto's close associates were asking that he step down from office, and on May 21 he did so. B.J. Habibie assumed the presidency following Suharto's resignation and began the task of economic and political reform.

The economic crisis sparked political change in Thailand as well. Thailand had begun constitutional reform in the early 1990s. Reform had stalled under competing visions of how the new political institutions should be structured. A new constitution had been drafted in 1997 before the crisis, and its acceptance by the major societal groups was "propelled forward" by the economic crisis. As Haggard (2000, 94) notes, it is "highly doubtful that [this political reform] would have occurred in the way that it did in the absence of crisis circumstances." In addition, the government that had presided over the economy in the years leading up to the crisis was unable to maintain a majority coalition. It was replaced in November 1997 by a new government based on a five-party coalition dominated by the Democrat Party. The Democrat Party is the oldest political party in Thailand and was "free of the more egregious patronage, pork-barrel spending, and corruption of its opponents" (Haggard 2000, 94). In Indonesia and Thailand, therefore, the economic crisis provoked a reaction against the corruption of previous governments, mobilized societal support for far-reaching constitutional reform, and brought to power groups committed to economic and political reform.

The years since the crisis have been characterized by political stabilization, gradual economic recovery, and mixed progress on the implementation of structural reform. Economic growth has resumed and the most severe political instabilities had ended by 1999. What remains, however, is the daunting task of restructuring the domestic financial and corporate sectors (see Lane et al. 1999). This requires governments to recapitalize weak banks and close the insolvent ones. In addition, governments must find some way to reduce the burden of large debt loads on the corporate sector and to help banks cope with large burdens of nonperforming loans. Because of the close relations between business and government in many of these countries, this process of restructuring requires governments to impose substantial costs on politically important domestic actors. As a consequence, structural reform has progressed at different speeds, and with varying degrees of success across the region.

The Asian crisis was unprecedented in many ways. Its origins in the weaknesses of domestic banking systems in Asia differed sharply from the causes of previous crises, most of which originated in government budget deficits. The amount of international financial support offered to the crisis countries was also unprecedented. Finally, the economic and political consequences of the crisis, consequences that included severe recessions and political instability, were also unprecedented. What is most worrying about the Asian crisis,

however, is what it may hint about the future. The crisis suggests that the opening of developing country financial systems to international capital flows has posed new challenges to the international financial system. The Asian crisis suggests that the stability of the contemporary international financial system depends in part upon the strength of banking systems in the developing countries that are tapping international financial markets. The Asian crisis also highlights weaknesses in the way that the advanced industrialized countries and the international financial institutions manage financial crises. These weaknesses raise concerns about the ability of governments and the IMF to effectively manage future crises, and have given rise to extensive discussion about systemic reform.

Reforming the International Financial System?

The long-term impact of the Asian crisis on the international financial system remains unclear. What is clear is that the crisis has forced governments, in developing countries and in the advanced industrialized countries alike, to reexamine their prior beliefs about the benefits that developing countries realize from unrestricted capital flows and to reevaluate how financial crises are managed. How the Asian crisis will ultimately affect the international financial system depends upon what conclusions are drawn from this process of reevaluation, which is not yet complete. We conclude our discussion by examining the aspects of reform that have most clearly emerged since the Asian crisis.

The Asian crisis caused many academics and policymakers to reevaluate the benefits that developing countries realize from complete financial liberalization and unrestricted integration into the international financial system. As former World Bank chief economist Joseph Stiglitz has suggested, financial liberalization might expose developing countries to "unnecessary risks without commensurate returns" (Wessel and Davis 1998). Such concerns have been most strongly asserted by economist Jagdish Bhagwati of Columbia University (see Bhagwati 1998b). While the ability to draw on foreign savings can be beneficial, these critics argue, these benefits must be weighed against the costs that result from the crises that unrestricted capital flows seem to generate. Once one performs this balancing, Bhagwati and others find that there is little net gain from eliminating all capital controls and opening developing economies to increasingly volatile short-term capital flows. As a result, both "the weight of evidence and the force of logic," Bhagwati argues, "point . . . toward restraints on capital flows" (Bhagwati 1998b, 12).

This reevaluation of the costs and benefits of financial integration has led policymakers in two directions. First, governments and, to a lesser extent, the IMF, have begun considering whether capital controls might help reduce the volatility of financial flows to developing countries. Policymakers have looked closely at the experience of some developing country governments that adopted capital controls designed to discourage short-term inflows without discouraging less volatile long-term lending and foreign direct investment (see Ariyoshi et al. 2000; Velasco and Cabezas 1998). In Chile, for example, the government requires a deposit with the central bank equal to 20 percent of the total investment and a stamp tax of 1.2 percent on inflows with maturities of less than one year. Medium- and long-term flows face no such deposit requirements or taxes (Velasco and Cabezas 1998, 147). Malaysia used similar measures in the early 1990s, limiting the amount of foreign deposits held by domestic banks, prohibiting the sale of short-term financial instruments to foreigners, and raising the

cost of borrowing from foreigners. It re-implemented these controls as the crisis struck Malaysia in 1997 (Eichengreen and Fishlow 1998, 63). Supporters of this approach argue that capital controls can reduce the likelihood of financial crises, in part because they reduce the total volume of capital inflows, and in part because they discourage the more volatile short-term flows while encouraging long-term inflows and foreign direct investment. Others are more skeptical, suggesting that the capital controls used by the Chilean government have had little impact on capital flows into and out of this country (Edwards 1999). Second, policymakers have become much more aware of the importance of sound banking practices in developing countries. Thus, the IMF and the World Bank have been working with developing country governments to reform banking regulation and to promote greater transparency in bank accounting practices. The hope is that such reforms will make it more difficult for banks in other developing countries to develop the financial positions that so weakened banks in Asia.

The Asian crisis has also sparked extensive discussions about reform of the international financial system. Reform discussions emerged in response to criticisms of the way the IMF responded to the Asian crisis (see Sachs, 1997; Krugman 1998; Stiglitz 2000; Stiglitz 2002; Blustein 2001). The IMF was criticized for the specific contents of the conditionality agreements it negotiated with the crisis countries. Many observers argued that macroeconomic stabilization programs were inappropriate for the Asian crisis countries. Macroeconomic imbalances were not at the base of the crisis; the crisis countries were running budget surpluses and had low inflation. In this context, macroeconomic stabilization not only failed to address the cause of the crisis, but, the critics contend, also pushed the crisis countries into deep recessions (Krugman 1998). Rather than austerity measures, the crisis countries should have been encouraged to adopt "stable or even slightly expansionary" macroeconomic policies to counteract the macroeconomic consequences of the financial crisis (Sachs 1997). Critics also argued that the IMF erred in forcing governments in the crisis countries to close banks. Forced closures, critics contend, exacerbated fears about financial weaknesses in the crisis countries and by doing so precipitated additional financial panic. This problem was particularly acute in Indonesia, where bank closures led to banking crises as local depositors rushed to withdraw their funds. Finally, critics argue that many of the structural reforms that the IMF required had little direct bearing on the immediate problems that the Asian countries faced. As Paul Volcker, former chairman of the Federal Reserve Board, inquired after learning that the IMF had demanded that the Indonesian government dismantle its clove monopoly, "What [do] spice monopolies have to do with restoring financial stability" (cited in Blustein 2001, 212)? In short, critics argued that practically every aspect of IMF programs was inappropriate. The programs worsened the economic situation rather than restoring market confidence and cushioning the domestic economic fallout from the financial crisis.

Other critics advanced a more fundamental critique of the IMF, based on the logic of moral hazard. These critics claim that IMF financial assistance to countries in crisis makes future financial crises more likely (see e.g. International Financial Institution Advisory Commission 2000; Calmoris 1998; Meltzer 1998). At the core of this critique lies the recognition that IMF financial assistance to crisis countries allows governments to service foreign debt. "The IMF and the principal governments lend money to the Asian governments so that they can pay the interest on their existing banks loans or repay the principal. Extending credit helps the Asian banks avoid default, but the money goes to the foreign banks" (Meltzer 1998). IMF financial assistance, therefore, encourages foreign banks to believe that they can lend to developing countries without having to fear that borrowers in these countries will default. The expectation that the IMF will bailout crisis countries to prevent defaults in turn reduces the incentive of foreign banks to limit their lending to high-risk countries. In fact, the critics contend, the expectation of a bailout may even increase the incentive to lend to high-risk countries. Over time, foreign lending under the shadow of IMF bailouts will lead to more frequent financial crises grow in scale. The Mexican crisis of 1994, critics point out, required a $40 billion bailout; the Asian crisis of 1997 required a $117 billion bailout. Critics contend that the next crisis is likely to be even larger (Meltzer 1998).

Widespread criticisms of the IMF's role in managing financial crises sparked a reform process christened "strengthening the international financial architecture" (see Eichengreen 1999; Goldstein 2000). As one component of this reform process, advanced industrialized countries have been examining possible changes in two broad areas of IMF practices. First, discussion has focused on whether to reduce the scope and the detail of IMF conditionality agreements. There is widespread agreement that the IMF has over-extended itself in developing structural reform packages; the typical IMF agreement contains about 50 such reforms (Goldstein 2000). Policymakers are discussing whether the IMF should "return to the basics" in designing conditionality agreements, focusing on macroeconomic stabilization and limiting structural reforms to clearly related areas. Second, discussions have focused on reducing the potential for moral hazard. The size of, and the interest rates attached to, IMF credits have been at the center of these discussions. There appears to be a general agreement that the size of IMF loans must be reduced. Smaller loans would make it more difficult for private creditors to expect to be bailed out in the event of a crisis. There also appears to be agreement that the charges attached to IMF loans should be increased. Higher charges would raise the cost of turning to the IMF for assistance, perhaps giving governments greater incentive to manage their financial systems so as to avoid crises. While discussions about strengthening the international financial architecture have been continuing since 1998, they have yet to produce substantial results.

At the beginning of the twenty-first century, therefore, developing countries face new challenges in managing their relationship with the international financial system. On the one hand, international financial integration over the last 20 years has greatly expanded developing countries' opportunities for attracting foreign capital. Developing countries are no longer constrained, as they were in the 1950s, to foreign aid and foreign direct investment in primary commodity sectors. On the other hand, however, the increased prominence of short-term capital flows to developing countries has raised the possible downside costs of financial openness. Portfolio flows are short-term in nature and therefore easily liquidated, and the international markets in which they are traded are susceptible to herd-like behavior that can precipitate severe financial crises. The economic consequences of such crises, as we saw in Asia, can be extremely large. This new world also poses challenges to the advanced industrialized countries. Foremost among these challenges is reform of the international financial system to reduce the frequency of crises and, because it is impossible to end crises altogether, the creation of a system for effective crisis management. Only time will tell how governments respond to these challenges.

Conclusion

Developing countries have had a difficult relationship with the international financial system. A cycle of over-borrowing, crisis, and adjustment lies at the center of these difficulties. As we have seen, this cycle typically starts with changes in international capital markets. Petrodollars increased the supply of foreign capital to many developing countries during the 1970s; the dynamics of international financial integration increased the supply of foreign capital to Asian countries during the 1990s. Developing countries have exploited the opportunities presented by changes in international financial markets with great enthusiasm. Foreign capital, by reducing the constraints imposed by limited savings and limited foreign exchange, allows developing countries to invest more than they could if forced to rely solely upon domestic resources. The problem, however, is that developing countries eventually accumulate large foreign debt burdens that they cannot service, and are pushed to the brink of default. Impending default causes foreign lenders to refuse additional loans to developing countries and to recall the loans they had made previously. Now shut out of international capital markets, developing countries experience severe economic crises and implement stabilization and structural adjustment packages under the supervision of the IMF and the World Bank. This cycle has repeated twice in the last 25 years, once in Latin America during the 1970s and 1980s, and once in Asia during the 1990s. And while the specific details of each cycle were distinctive, both cases were characterized by the same pattern of over-borrowing, crisis, and adjustment.

As we have seen here, these cycles are driven by the interaction between interests and institutions in the international system and within developing countries. The cycle is driven in part by interests and institutions in the international system over which developing country governments have little control. The volume and composition of capital flows from the advanced industrialized countries and the developing world have been shaped in large part by changes in international financial markets. The build-up of debt in Latin America during the 1970s was made possible by the growth of the Euromarkets and the large deposits in these markets made by OPEC members. The build-up of large foreign liabilities by many Asian countries resulted in part from the more general increase in international financial integration during the late 1980s. The ability to service foreign debt is also influenced by international developments. In the Latin American debt crisis, rising American interest rates and falling economic growth in the advanced industrialized world made it more difficult for Latin American governments to service their foreign debt. In the Asian crisis, the dollar's appreciation against the yen made it more difficult for Asian borrowers to service their debt. Finally, the advanced industrialized countries, the IMF, and the World Bank establish the conditions under which developing countries experiencing crises can regain access to foreign capital.

Interests and institutions within developing countries have also played an important role. Domestic politics influence how much foreign debt is accumulated and the uses to which it is put. In the 1970s, Latin American governments made poor decisions about how to use the foreign debt they were accumulating, thereby worsening their situation when the international environment soured. In Asia, governments failed to regulate the terms under which domestic banks intermediated between foreign and domestic financial markets. This regulatory failure weakened domestic financial systems and sparked the erosion of investor confidence in Asia. A country's ability to return to international capital markets following a crisis is contingent upon policy reform. Domestic politics often prevent governments from speedily implementing such reforms. Thus, while it might be tempting to place the blame for the cycle solely on the international financial system or solely on developing country governments, a more reasonable approach is to recognize that these cycles are driven by the interaction between international and domestic developments.

Key Terms

Austral Plan
Bilateral Development Assistance
Brady Bonds
Brady Plan
Concerted Lending
Concessional Lending Programs
Cruzado Plan
Debt Regime
Debt Service Capacity
Debt-Service Ratio
Development Assistance Committee
Exchange Rate Risk
Foreign Aid
Heterodox Strategies
Hot Money
Insolvent
Interest Rate Ceilings
International Bank for Reconstruction and Development (IBRD)
International Development Association (IDA)
Liquidity Problem
London Club
Macroeconomic Stabilization
Moral Hazard
National Development Banks
Net Transfers
Nonconcessional Lending Programs
Nonperforming Loans
Paris Club
Petrodollar Recycling
Portfolio Flows
Regional Development Banks
Reserve Requirements
Savings-Investment Gap
Specialized Credit Agencies
Structural Adjustment
Syndicated Loan
The Washington Consensus
War of Attrition

Web Links

Perhaps the most useful site for the Asian crisis and the issues it raises is the one maintained by Nouriel Roubini at the Stern School of Business at New York University. It can be found at *http://www.stern.nyu.edu/globalmacro/*.

The World Bank Website on the Debt Initiative for Heavily-Indebted Poor Countries (HIPC) can be found at: *http://www.worldbank.org/hipc/*.

The IMF website on the HIPC initiative is at *http://www.imf.org/external/np/exr/facts/hipc.htm*.

The Jubilee2000 website can be found at *http://www.jubileeusa.org/jubilee.cgi*.

Suggestions for Further Reading

For a comprehensive history of the World Bank's first 20 years see Edward S. Mason and Robert E. Asher, *The World Bank Since Bretton Woods* (Washington, D.C.: The Brookings Institution, 1973) and Devesh Kapur, John P. Lewis, and Richard Webb, *The World Bank: Its First Half Century* (Washington, D.C.: Brookings Institution, 1997). For a critical perspective, see Kevin Danaher, ed., *50 Years is Enough: The Case Against the World Bank and the International Monetary Fund* (Boston: South End Press, 1994).

On the 1980s debt crisis and the politics of economic reform see Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton: Princeton University Press, 1989), Stephan Haggard and Robert Kaufman, eds., *The Politics Of Economic Adjustment: International Constraints, Distributive Conflicts, and The State* (Princeton: Princeton University Press, 1992) and Robert Bates and Anne O. Krueger, eds., *Political and Economic Interactions in Economic Policy Reform* (Oxford: Blackwell, 1993).

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CHAPTER 9

Political Economy of Socialist and Post-Socialist Societies

The most dramatic change in the global economy has occurred not in the advanced industrialized countries, nor even in Latin America, but in the group of countries that once comprised the socialist world. Throughout most of the postwar period, these countries, which collectively incorporate about one-third of the world's total population, stood outside the global market economy. They created authoritarian political systems and economic systems dominated by the state. They traded little with the advanced industrialized countries, and attracted even less foreign direct investment. And while the socialist countries did trade some with each other, international economic linkages within the socialist bloc were also quite limited. Today, few remnants of this system remain. Throughout the former socialist world governments have restructured their economic systems along market lines, many overthrew authoritarian rulers and replaced them with democratically elected governments, and most have begun to open themselves to international trade and investment. In some instances, such as in Eastern Europe, the transformation has been rapid and dramatic. In others, such as China, economic change has been less rapid but almost as far-reaching. In still others, particularly in many of the newly independent countries that have emerged from the disintegration of the Soviet Union in 1991, this transformation is moving very slowly.

In this chapter we explore the creation, operation, and transformation of these socialist systems. As we shall see, socialist governments held similar goals, created similar economic structures, and eventually confronted similar economic problems as a consequence of the structures they created. The socialist economic system was designed to promote rapid industrialization and, while reasonably successful in achieving this goal, the heavy industries it created were very inefficient. Moreover, the system created little incentive for changes that would improve performance. As a result, most socialist societies began to experience poor economic performance that created a compelling need for economic reform. Similar economic problems led to similar economic reforms in all

countries, but individual governments pursued such reforms at different times and at different speeds. In Eastern Europe, economic reform came only after the Soviet Union decided that it was no longer willing to bear the cost of imposing socialist rule in Eastern Europe. Once it did so in the late 1980s, reform was rapid and far-reaching, engulfing the entire region in political and economic change. In the former Soviet Union, reform was initiated by the Communist Party, but since 1992 has been pursued at different speeds in the countries that emerged from the Soviet Union's collapse. In China, the Communist Party initiated reform in 1978 following the death of the revolutionary leader Mao Zedong. Twenty-five years later, the reform process remains incomplete. Finally, domestic politics has played a powerful role in shaping the pace and extent of economic reform. Market reforms have been implemented most rapidly, and have progressed furthest, in countries that established competitive democracies; it has made less progress, and been associated with larger economic irrationalities, in countries that did not create democratic political systems.

The Rise and Fall of the Soviet Bloc

Two international economic systems were created in the late 1940s. As we saw in Chapter 2, it was in this period that the United States and Great Britain constructed the global economic system based on the principles of market-based capitalism and liberal international trade. In the same period, the Soviet Union created an alternative economic system to govern its relationship with Central and Eastern Europe. The system that the Soviet Union created to govern economic activity within and between the members of the Soviet bloc represented a fundamentally new type of political economic order. In place of private ownership and market-based exchange, the Soviet system emphasized state ownership and the concentration of most economic decision making in state bureaucracies. In place of liberal multilateral international trade, the Soviet system emphasized heavily regulated bilateral trade. This Soviet system was tightly insulated from the broader international economy. Until 1990, therefore, the international economy was partitioned into separate spheres corresponding to the two camps in the Cold War. This Soviet economic system collapsed between 1989 and 1991, ushering in a period of rapid political and economic change throughout the region. New governments throughout Eastern and Central Europe and in the former Soviet Union dismantled their one-party states and their centrally planned economies and began constructing new political and economic systems. While almost all of the new governments were rhetorically committed to democracy and capitalism, progress toward these twin objectives has varied considerably throughout the region. This section traces the creation, collapse, and transformation of this Soviet economic system.

Creating and Extending the Soviet System

The characteristic features of the socialist political and economic system were established in the Soviet Union during the 1920s and then extended into Eastern Europe following World War II. Initially, the Socialist economic bloc was tightly insulated from the broader global economy, but over time, problems internal to the Soviet economic model and the relaxation of Cold War tensions compelled and enabled the Socialist countries to begin to develop economic ties with the West. We examine these developments here, focusing first on the creation of the Soviet economic model and its extension into Eastern Europe. We then look at the role of international trade within the Soviet bloc and between the Soviet bloc and the West.

The Soviet System. The Communist Party took power in the Soviet Union in the November 1917 revolution. In the years following the revolution, the Communist Party established a distinctive political and economic system. The political system can be described simply as a one-party state. The Communist Party was the only legal political organization in the country. As a consequence, it enjoyed unrivaled control of all instruments of state power, a control that it secured by repressing all opposition and dissent. The Communist Party used its exclusive political control to create a distinctive economic system, called a command economy, in the second half of the 1920s. A **command economy** is an economic system in which the state makes almost all decisions about the allocation of resources and the production and distribution of goods. The Soviets created a command economy in an attempt to solve the most pressing economic problem they faced: industrialization. In the early twentieth century, Russia was primarily an agricultural society: about 72 percent of the population worked in agriculture (Jeffries 1993, 9). Russia had begun to industrialize in the late nineteenth and early twentieth centuries, but progress along these lines was relatively slow. So slow, in fact, that in the late nineteenth and early twentieth century, Russia was losing ground to Britain, Germany, and the United States (see Nove 1992, 1–8). In 1913, Russia produced only 4 percent of the world's industrial output, and its per capita income was only about 10 percent of per capita income in the United States (Jeffries 1993, 9). The problem, therefore, was how to transform the Soviet economy from a largely rural agricultural economy into a modern industrialized one. The solution that the Communist Party adopted was broadly similar to the solution adopted by many developing countries after the Second World War: labor and investment funds would be extracted from agriculture and re-employed in industry. Moreover, in its basic outline, the strategy the Soviet Union adopted contained many characteristics of import substitution industrialization: it was highly protectionist, and it assigned the state a very large role in economic activity.

Where the Soviet Union differed from most developing countries was in the degree to which the state exerted control over almost all aspects of economic activity in order to reallocate resources from agriculture to industry. The Communist Party nationalized all heavy industry, the banking system, transportation, and trade shortly after coming to power. By the late 1920s, private ownership of productive manufacturing enterprises as well as private trade was almost completely prohibited. Stalin then implemented a system of **central planning** in 1928 in order to promote rapid industrialization. Under central planning, state bureaucracies developed elaborate plans covering all aspects of economic production. The Central Planning Commission (*Gosplan*) developed a Five-Year Plan that set out medium-term economic objectives. Once approved by the Central Committee of the Communist Party, the Five-Year Plan was broken down into annual, quarterly, and even monthly plans. These plans specified exactly what each enterprise in the Soviet economy was to produce, how much it was to produce, from whom it would acquire the inputs necessary

to produce these goods, and to whom it was required to deliver its output. Such planning was obviously an extraordinarily complicated affair, as it involved coordinating the activities of thousands of individual enterprises to ensure that the outputs from one enterprise were available at the right time as inputs for other enterprises. Moreover, all of this had to be achieved within the constraints imposed by resources and existing production capacity. The complexity of the task gave rise to an ever-expanding bureaucracy. Market prices played no role in the system. All prices were set by the state, and they reflected political objectives rather than actual resource scarcities or consumer demand.

The nationalization of industry and the development of central planning was accompanied by the **collectivization of agriculture,** a rather innocuous term that refers to the brutal transformation of Soviet agriculture from a system based on small plots farmed by individual peasant households into a system based on large, state-owned farms. Until 1930, Soviet agricultural production remained a largely private-sector activity. Land was privately held, and peasants sold their crops to the state and in local and nationwide markets. The decision to collectivize Soviet agriculture was motivated by economic and political logics. The economic logic arose from the Communist Party's determination to industrialize. Resources had to be extracted from agriculture, but the peasants were not always willing collaborators in the process. One way to extract resources was to impose heavy taxes on peasants, but during the 1920s this approach had simply led to less agricultural production, with consequently fewer resources with which to finance industrialization and less food with which to feed the growing urban population. An alternative solution would have been to allow a capitalist form of agriculture in which farmers were paid the market price for their crops and the state then borrowed the resulting profits to finance industrialization. This solution was adopted during the 1920s under Lenin's New Economic Policy, but it seemed to imply that Soviet industrialization could be financed only through capitalism, an implication that sat somewhat uneasily with the regime's commitment to build a socialist society. Collectivization, Stalin believed, would force peasants to work on larger and more efficient farms under the pressure of state-determined production quotas sold to the state at state-determined prices. This in turn would provide the financial resources needed for industrialization, would release peasants for the industrial workforce, and would provide the food needed to feed a growing urban population. In practice, collectivization was a brutally coercive affair. At least 5 million of the wealthiest peasants (*kulaks*) were deported or jailed as enemies of the state. Poorer peasants were terrorized into abandoning their plots and joining state-owned farms. Agricultural production fell sharply producing a widespread famine in 1932–1933. By the late 1930s, however, more than 90 percent of Soviet agricultural production and just less than 90 percent of the peasant households had been collectivized (Nove 1992, 173).

In the following years the Soviet command economy was consolidated and dedicated to the task of building an industrialized economy. The system was successful in fundamentally transforming the structure of the Soviet economy (Table 9.1). The Communists emphasized the development of heavy industry at the expense of light industry, consumer goods, agriculture, and services. As a consequence, the production of electricity, coal, steel, and machine tools increased sharply. During the 1930s, the process transformed the Soviet Union "into a major industrial power . . . Mass unemployment was eliminated and millions of illiterate or poorly educated peasants were trained in industrial skills" (Brown et al. 1994, 394). This achievement in turn enabled the Soviet Union to become a strong military power capable of withstanding the invasion of Nazi Germany during World War II. The dramatic success made the Soviet model one that was "envied but often misunderstood in countries which were not yet industrialized" (Brown et al. 1994, 394). The achievements came at immense cost, however, particularly in terms of human suffering.

Table 9.1
Industrial Production in the Soviet Union, 1913–1965

	1913	1940	1965
Electricity (millions of MWh)	2	49	507
Oil (million tons)	10	31	243
Coal (million tons)	29	166	578
Steel (million tons)	4	18	91
Metal-cutting Machine Tools (thousands)	2	58	186
Tractors (thousands)	—	32	355

Source: Brown et al. 1994, 394.

Extending the system to Central and Eastern Europe. Following World War II the Soviet Union imposed its economic system on countries in Central and Eastern Europe. Between 1945 and 1949, Communist parties came to power in all countries in Eastern and Central Europe. In all but two cases (Yugoslavia and Albania), the emergence of Communist governments was the direct result of Soviet political and military intervention. The Soviet Union helped install Communist governments and supervised them as they created Soviet-style economic systems. As a consequence, most governments in the region nationalized industry between 1945 and 1949. In Czechoslovakia, for example, the state nationalized all industrial firms employing more than 50 people, all banks, as well as companies engaged in wholesale and foreign trade on April 28, 1948. Bulgaria enacted a similar decree in December 1947, and Hungary and Romania followed, in March and June of 1948 respectively (Berend 1996). By 1950 the state owned almost all industry in the region. Nationalization was followed by the adoption of constitutions that prohibited private ownership of productive enterprises. Individuals were allowed to have some private property, such as a car, for example, or furniture, but in most countries people were prohibited from using private property to generate income. Agriculture was collectivized in all countries except Poland. The new Communist regimes then began to create Soviet-style planning agencies. National bureaucracies were created, and central planning processes were implemented in 1948 and 1949. Initial plans were developed with direct Soviet participation, and following the Soviet model priority was given to the development of heavy industry at the expense of light industry, consumer goods, and agriculture. By 1950, the Sovietization of the economies of Central and Eastern Europe was largely complete.

Imposed from the outside and maintained by the force of Soviet power, the command economies created in central and Eastern Europe following World War II profoundly transformed the economies of Central and Eastern Europe during the 1950s

and 1960s (see Berend 1996, 190–191). Industrial output rose at more than 9 percent per year in Hungary, Romania, and Bulgaria. Even the relatively more advanced countries in the region, Czechoslovakia and Poland, saw industrial output grow at an average rate of 8 percent per year. As a consequence, employment in industry began to rise, while employment in agriculture fell. In Hungary, for example, industrial employment rose from only 18 percent prior to World War II to 35 percent by the end of the 1950s. Between 1950 and 1970, 40 to 50 percent of the agricultural workforce left the farm and entered industrial employment, a remarkable shift of the labor force in less than a single generation. Unemployment virtually disappeared, while access to health care and education improved substantially in most countries. By the late 1960s, all countries in the region, except Albania, had become industrialized. On average, about one-half of national income in each country was produced by industry—61 percent in Czechoslovakia—and on average only 20 percent came from agriculture. While the command economies were brutally oppressive and planted the seeds that would lead directly to their own political and economic collapse in the 1980s, one must also appreciate how profoundly they transformed the economic structure of the region.

Trade in the socialist system. International economic interactions played a small role in the centrally planned economies. This was partly the result of the belief, held by many of the communist governments, that hostile enemies surrounded them. Indeed, "from the moment the Soviet Union was born, it was ringed by a hostile political environment. During the years of civil war [in the Soviet union], the forces inside the country intent on overthrowing the system received foreign backing in money, arms, and even military might. Similar events took place in the early history of several other socialist countries. Even after civil war and open intervention cease, there are still frequent unfriendly or hostile acts, ranging from support for internal anticommunist forces to obstruction or cessation of economic relations through blockades, embargoes, or various forms of trade discrimination" (Kornai 1992, 335, 339). In addition, the Soviet economic system was essentially a strategy of import substitution industrialization that put primary emphasis on producing for the domestic market and required high tariffs to keep out imports. The perception of capitalist encirclement and the determined effort at industrialization translated into a policy of national self-sufficiency or autarkic development. During the 1920s and 1930s, this took the form of the Stalinist doctrine of "Socialism in one country" under which the Soviet Union attempted to industrialize in isolation from the rest of the world. Following World War II it led to a policy of bloc isolation, in which the Soviet bloc was insulated from the broader global economy.

Of course, the Socialist countries could not industrialize in complete isolation. While eventually they might be able to achieve national self-sufficiency, it was unlikely that they could industrialize rapidly without international trade. As we saw in Chapter 4, industrialization is facilitated by the ability to import capital goods and other essential inputs. Even in the Soviet Union, industrialization during the 1930s had been achieved in part with capital goods and technology imported from the capitalist countries. While some international trade was a necessary component of industrialization, the Socialist countries limited it as much as possible. Communist governments viewed exports as a means for financing imports, and imports were seen as necessary only to acquire goods and capital machines that were unavailable or in short supply at home (Jeffries 1993, 24). In the typical system, the plan would be established, the imports required to implement the plan would be calculated, and exports would then be adjusted to pay for the needed imports. As a consequence, the centrally planned economies were much less open to trade than the western countries. By one scholar's estimate, the centrally planned countries were about half as open to international trade as were western countries with similar income levels, industrialization rates, and populations. As a group, they accounted for only 4 percent of world trade even though together they produced about one-third of the world's total economic output. That trade which did occur took place within two distinct spheres: a system of intra-bloc trade and trade between the East and West. We look at each in turn.

Trade within the socialist bloc. The Soviet Union established a regional economic system during the late 1940s and early 1950s that created trade relationships between the Soviet Union and its satellites. Motivated by a desire to extract resources from Central and Eastern European countries to hasten postwar economic reconstruction in the Soviet Union and by the need to control Central and Eastern Europe as a security buffer, Stalin created a regional trade system that reoriented trade from West to East. Prior to World War II, Central and Eastern European countries had traded extensively with Western Europe, exporting primary commodities in exchange for manufactured consumer and capital goods. Following the War, these trade patterns were disrupted and trade was reoriented toward the Soviet Union and other centrally planned economies. As a consequence, Western Europe's share of Central and Eastern Europe's trade fell sharply, from about 60 percent in 1938 to about 4 percent in 1953, while the Soviet Union's share of their trade increased from about 1 percent in 1938 to about 23 percent in 1953 (Spulber 1968, 114).

Intra-bloc trade was characterized by the exchange of manufactured goods and capital equipment produced in Central and Eastern Europe for energy and raw materials produced in the Soviet Union. Under Stalin, the terms on which intra-bloc trade was conducted were highly disadvantageous to the Central and Eastern European countries. The Soviet Union paid "less than the world market prices for Eastern Europe's commercial exports," and extracted reparations payments from East Germany, Hungary, and Bulgaria. The net flow of resources from Central and Eastern Europe to the Soviet Union in this period has been estimated at about $14 billion, about the same amount the United States provided Western Europe through the Marshall Plan (Marer 1984, 156). After Stalin's death in 1953, the Central and Eastern European countries became the chief beneficiaries of intra-bloc trade. The manufactured goods they exported to the Soviet Union were typically of poor quality and over-priced when compared to similar items available in world markets. The energy and raw materials that Central and Eastern Europe imported from the Soviet Union were typically priced well below world market prices. As a consequence, intra-bloc trade provided a substantial subsidy from the Soviet Union to Central and Eastern European countries (see Marer 1984; 1974).

Most intra-bloc trade was conducted on a bilateral basis. Under a bilateral trade system, one government concludes an agreement with a second country that specifies the type and the amount of goods each country would export to the other. In most instances, these agreements were long-term agreements, typically covering the five years that corresponded to the plan. Bilateral trade was necessary in large part because

national currencies were inconvertible, that is, one country's currency could not be exchanged for another country's currency. Consequently, a government holding Polish zlotys that it had earned from exporting to Poland could not use them to pay for imports from, say, Hungary. More broadly, under a system of bilateral trade, the trade surpluses that one country has with some countries in the region cannot be used to pay for the trade deficits it has with other countries. Instead, each country has to balance each bilateral trade relationship; imports from one country have to be paid for by exports to that country. The bilateral trade system greatly reduced the volume of trade conducted within the Socialist bloc. To see why, consider the simple example presented in Figure 9.1. Look first at the multilateral case (panel A). We see that Poland runs a 40-unit deficit with Czechoslovakia (it exports 10 units and imports 50 units) that is offset by a 40-unit surplus with Hungary. Hungary in turn offsets its 40-unit deficit with Poland with its 40-unit surplus with Czechoslovakia. Finally, Czechoslovakia's 40-unit deficit with Hungary is balanced by its 40-unit surplus with Poland. Each country has balanced trade and the total volume of trade in system is 240 units. Now see what happens when we require that trade in each bilateral relationship be balanced (panel B). Because Poland exports only 40 units to Hungary, Hungary can export only 40 units to Poland. Because Poland exports only 10 units to Czechoslovakia, Czechoslovakia can export only 10 units to Poland. Finally, because Czechoslovakia exports only 10 units to Hungary, Hungary can export only 10 units to Czechoslovakia. Again, each country has balanced trade, but total trade in this system amounts to only 120 units. Thus, shifting from multilateral trade to bilateral trade cut the volume of trade in half, simply because the countries cannot use a surplus with one country to cover a deficit with another. While only a hypothetical example, it illustrates the point that the bilateral trade system based on inconvertible currencies imposed a powerful constraint on trade in the socialist bloc.

Intra-bloc trade was coordinated with an institutional structure called the Council for Mutual Economic Assistance (CMEA or Comecon). Established by the Soviet Union in 1949, ostensibly to "funnel aid to its members, coordinate their economic policies, and counter the political appeal of the [Marshall Plan]" (Stone 1996, 29), the initial purpose of the CMEA was to allow Stalin to extend control over economic policy in Central and Eastern Europe (Marer 1984, 159). Comecon played little role in the region until Stalin's death. During the late 1950s and early 1960s, however, the Soviet Union attempted to transform the CMEA into a vehicle through which to promote deeper regional economic integration and the creation of a "socialist division of labor." In 1962, Nikita Khrushchev proposed a program that would bring about the "gradual integration [of the socialist economies] based on the coordination of short-term and long-term investment plans" (Stone 1996, 34). In the early 1970s, Brezhnev proposed a "Comprehensive Program for Socialist Economic Integration" that was intended to promote large-scale industrial projects by pooling resources (Stone 1996, 36). These efforts bore little fruit. Some specialization of production did arise. Bulgaria became the principal supplier of forklifts to other bloc members, for example, while Hungary became the principal supplier of buses, and Czechoslovakia the principal supplier of trams (Jeffries 1993, 30). Governments also cooperated in the construction of oil pipelines and a united power grid (Ellman 1989, 285; Jeffries 1993, 30). Some joint investment projects were also created. In general, however, meaningful economic integration was quite limited (Kornai 1993, 358). The creation of a true regional division of labor would have required a shift to supranational planning, in which a bloc-wide plan would first be developed and then broken down into independent national components. National plans would then have to be developed to implement the various components of the supra-national plan. Such an exercise was both impractical, because it required even more complex forms of planning just as many

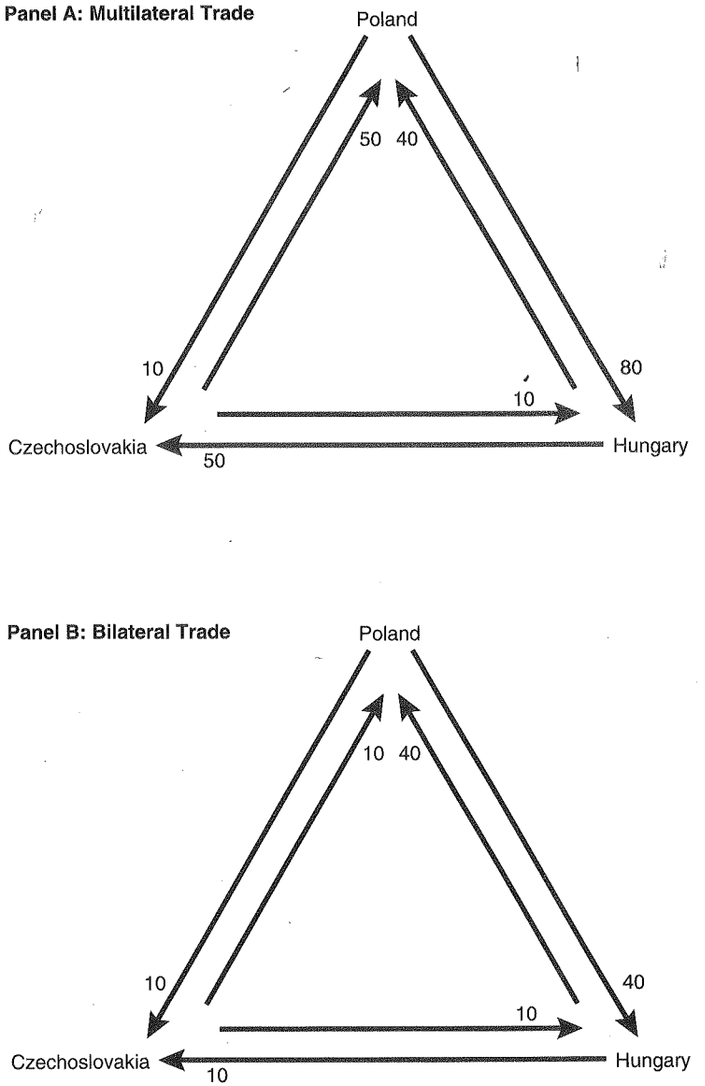

Figure 9.1 The Impact of Bilateralism on Intra-Bloc Trade.
Source: Adapted from Ellman 1989, 279.

socialist governments were beginning to recognize the limits of central planning, and politically infeasible because the Central and Eastern European countries were unwilling to subordinate their desire for national industrialization to the needs of regional integration. Romania, for example rejected proposals for closer coordination of plans when it learned that its role within the regional division of labor would be to supply primary commodities.

East-West trade. The intra-bloc trading system was strengthened in the early postwar period by policies that limited economic exchange between the East and West. In the early postwar period, the Soviet Union had little desire to participate in the global capitalist system being reconstructed by the United States and Great Britain. In part, this reflected the concern of hostile encirclement, in part this reflected the Soviet desire to maintain tight control over its East European satellites, and in part this reflected a stated belief that the Socialist system would pose an alternative that would eventually cause a crisis of the capitalist system. The Soviet Union did participate in the Bretton Woods conference, but it did not ratify the Articles of Agreement and did not become a member of the IMF and the World Bank. And while the Soviet Union was invited to Havana to participate in the negotiations of the International Trade Organization, it declined the invitation and never became a member of the GATT. Czechoslovakia and Poland initially joined the Bretton Woods institutions and the GATT, and both sought to take advantage of American aid provided by the Marshall Plan. However, they were forced by Stalin to withdraw from these international economic institutions in the late 1940s and to forgo participation in the Marshall Plan as the Soviet Union tightened its grip on Eastern Europe. Thus, very early in the postwar period the Soviet Union decided that the socialist bloc would not participate in the global capitalist economy.

The Soviet decision to stand outside the Western economic system was reinforced by Western policies that restricted trade with the Soviet bloc (see Mastanduno 1992; McDaniel 1993). American policy, and to a somewhat lesser extent European policy toward the socialist bloc in this period, was shaped by the emerging Cold War. By 1947, American policymakers were becoming increasingly concerned that trade with Eastern Europe and the Soviet Union would be detrimental to American national security. Moreover, a strategy of economic warfare through which the technologically superior United States denied the Soviet Union and its client states access to Western technologies and raw materials could greatly weaken Soviet power. In 1949, the United States passed the Export Control Act that tightly restricted all exports to the Soviet bloc. This act was further strengthened in the 1951 Mutual Defense Assistance Control Act, or the Battle Act. The United States then extended these restrictions to West European countries through a multilateral institution affiliated with the North Atlantic Treaty Organization (NATO). This institution, called the **Coordinating Committee** (CoCom), was created in 1949 for the purpose of coordinating the restrictions on western exports to the Soviet bloc. CoCom members compiled a common list of goods that all agreed to not export to the socialist countries. By 1952, this list included some 400 categories covering about 50 percent of all goods that enter into international trade. The United States attempted to enforce compliance with this list by linking the embargo to American aid: any government that did not effectively enforce CoCom's export restrictions would be denied American foreign and military aid.

The Soviet bloc began to deepen its economic linkages with the West after 1960. East-West trade grew rapidly between 1965 and 1980, and in fact grew much more rapidly than trade within the bloc. As a consequence, total trade with the OECD countries as a share of the Soviet bloc's total trade rose from an average of about 20 percent to about 30 percent. This trend was not restricted to Eastern Europe. The Soviet Union also expanded its trade with the West, whose share of Soviet trade expanded from 20 percent in 1960 to about 35 percent in 1980 (Koves 1985, 169). The commodity composition of East-West trade was characterized by the import of capital goods produced in the EU and the United States in exchange for raw materials, agricultural products, and energy produced in the Soviet bloc (Kornai 1992, 347). The deepening of East-West economic linkages reflected developments within the Soviet bloc and in the international system. Economic growth was slowing down in all of the countries in the Soviet bloc. As growth slowed, Communist governments throughout the region began to experiment with economic reform and turned to the West to acquire the technology that they believed was critical to resumed growth. We will examine the reasons for the growth slowdown in the next section. Within the international system, the 1950s brought a gradual easing of East-West tensions and West European pressure for the liberalization of trade with the Socialist bloc. Western European governments had never been convinced of the American strategy of economic warfare against the Soviet bloc (see Mastanduno 1992). Reluctance reflected in part the exigencies of postwar economic reconstruction. Western European countries needed to import raw materials and agricultural goods from Eastern Europe, but to do so they had to export to the East, which they could not easily do because of CoCom restrictions. In addition, many West European governments viewed the embargo as counter-productive. It simply drove Eastern Europe deeper into a Soviet sphere of influence by forcing greater economic integration between the Soviet Union and its satellites. Thus, as West European governments became convinced that war with the Soviet Union was not imminent, or even likely, they began to pressure the United States to agree to liberalize CoCom trade restrictions. In 1954, the list of restricted items was reduced by 50 percent, and the focus of the remaining restrictions was narrowed to items that were used principally in military production or that would have a clear impact on the Soviet defense industry (Mastanduno 1992, 94). A further revision of the CoCom list in 1958 liberalized trade still further.

The United States was slower to liberalize its exports to the Soviet bloc. Even as the number of items restricted by CoCom was reduced, the United States continued to maintain a fairly comprehensive embargo. As a consequence, American exports to the Socialist bloc were more tightly restricted than exports from Western Europe and Japan. American policy gradually shifted during the 1960s, however, as it became clear that a unilateral embargo was having little impact on Soviet economic and military power and as American business found itself unable to take advantage of the same opportunities that its competitors based in Japan and Europe enjoyed. The official change in American policy came with congressional approval of the 1969 Export Administration Act to replace the Export Control Act. This bill "explicitly advocated the expansion of peaceful trade with the Soviet Union and Eastern Europe" (Mastanduno 1992, 140). Trade between the United States and the socialist bloc was further liberalized during the 1970s.

While U.S. trade with the Soviet bloc was liberalized, it was not normalized. Instead, the United States adopted a linkage policy. Under this **linkage policy,** the United States offered trade concessions in exchange for what Washington saw as positive changes in Soviet behavior, and imposed trade restrictions in response to what Washington viewed as negative Soviet behavior. During the 1970s, for example, the Nixon Administration prohibited the export of gear-cutting machines to the Soviet Union until the Soviets had compromised in arms control negotiations. They prohibited the export of American equipment used to produce light trucks until the Soviets agreed to liberalize the flow of traffic between West Germany and West Berlin. They refused to grant the Soviet Union most favored nation status until there was concrete evidence that the Soviets were encouraging the Viet Cong to engage in negotiations to end the Vietnam War (see Mastanduno 1996, 146). Such linkage extended beyond efforts to influence Soviet foreign policy. The Jackson-Vanik amendment to the 1974 Trade Act linked access to American trade credits and the extension of MFN status to changes in Soviet migration policies that made it difficult for Soviet Jews to migrate to Israel. While perceptions of cooperative Soviet behavior were rewarded, uncooperative behaviors were punished. Following the Soviet invasion of Afghanistan in 1979, for example, the Carter Administration imposed a grain embargo in an attempt to deprive the Soviets of some 25 million tons of grain that it had planned to buy from the United States (Mastanduno 1996, 223). The grain embargo was accompanied by a tightening of American restrictions on the export of American technology to the Soviet Union. Thus, even though East-West trade was liberalized to some extent, the United States continued to view its economic relationship with the Soviet Union through the lens of the Cold War. Rather than emphasize the economic benefits from East-West trade, as the United States did in its economic relationships with Western nations, the United States always emphasized the potential political leverage that resided in the ability to control the flow of goods and technology to the Soviet bloc.

During the Cold War, therefore, the international economy was partitioned into two rival international economic systems. The United States and its allies constructed the GATT to manage world trade and the Bretton Woods system to manage the international monetary system; the Soviet Union constructed a socialist economic system to govern economic activity within and among the countries of the Soviet bloc. The Soviet system, characterized by state ownership of industry, central planning, and limited trade, was designed to promote rapid industrialization in order to transform the socialist countries from predominantly agricultural societies into modern industrial economies. While initially tightly insulated from the capitalist economic system, the Soviet bloc began to develop links to the international economy as Cold War tensions eased and as problems internal to their economies made such links necessary.

Stagnation, Crisis, and Collapse

The Soviet bloc collapsed in dramatic fashion between September 1989 and December 1991. In less than three years the East European satellites broke free from Soviet political and military domination, replaced single-party communist rule with multiparty democracy, and dismantled the command economies and began to construct market economies. The Soviet Union was dissolved and replaced by the 15 Republics

of which it had been comprised. The socialist bloc collapsed from the combination of mounting economic problems, which created widespread public dissatisfaction with the system and created a compelling need for far-reaching reform, and weakening Soviet power, which made such reforms possible.

Economic stagnation in the socialist economies. The socialist economies began to encounter internal problems as early as the mid-1950s. These problems became even more evident during the 1960s and weighed heavily on economic performance throughout the seventies and eighties. These problems arose from the central characteristics of the Soviet economic model. Governments had realized rapid industrialization during the 1950s and early 1960s based on a strategy of extensive growth. In an **extensive growth** strategy, industrialization is achieved by drawing labor that is unemployed or under-employed in agriculture into the industrial workforce. In combination with massive investments in industrial capacity, this strategy produced rapid rates of economic growth during the 1950s. By the early 1960s, however, the strategy of extensive growth had reached its limits. It became increasingly difficult to increase industrial output using this strategy because there were fewer under-employed workers to draw into the industrial economy, and fewer raw materials that could be easily dedicated to industrial production. In order to sustain growth governments had to shift to a strategy of intensive growth. In an **intensive growth** strategy, national income grows through productivity improvements. New technologies are used to increase labor productivity, thereby allowing a stable workforce to produce a larger volume of output.

It proved extraordinarily difficult to shift from extensive to intensive growth within the confines of the Soviet economic model. The adoption of new technology was key, but the centrally planned economy created few incentives for industrial enterprises to adopt new technology. Production in a centrally planned economy is based on quotas established by the plan, and wages and bonuses for management and workers are geared to meeting or surpassing the assigned production quota. In this context, introducing new technology is risky. Production lines would have to be stopped as old machines are removed and new ones installed. Once installed, the workforce would have to be trained to operate the new machines. This meant that production would likely fall in the short run, making it difficult to meet the assigned quota. Few enterprise managers were willing to embrace such risks. Moreover, there were few rewards for introducing new technology. The system placed no emphasis on product quality, and in the absence of a price system that accurately reflected resource scarcities, there were few incentives for managers to use inputs efficiently. Socialist enterprises faced no competition, and thus did not have to worry that a failure to adopt new technology would place them at a competitive disadvantage in the marketplace. In short, enterprises faced considerable risk and little reward when it came to adopting new technology. Consequently, few enterprises embraced technological change.

The socialist economies thus became stuck in heavily industrialized but low-productivity economies. Some international comparisons can illustrate the productivity gap between the East and West in the late 1960s (see Berend 1996, 197–198). Eastern European countries used two to four times as much steel to produce machine tools as West European countries. Czechoslovakia used three times as much fuel to produce 1,000 tons of industrial output as France, and five times as much as the

United States. The Soviet Union used seven times as much timber to produce a ton of paper as Finland (Åslund 1995, 45–46). More broadly, in many of the most advanced Socialist countries, such as East Germany, Czechoslovakia, and Hungary, labor productivity was one-third to one-half the level of West Germany. In addition, the socialist countries were very slow to incorporate the information revolution by integrating computers and telecommunications into their economic structure. In 1969 there were about 50,000 computers in use in the American economy, but only 650 were in use in the seven largest East European countries. The telecommunications system was also of poor quality. The number of phone lines was very low compared to the West, and the quality of the networks was quite poor. Thus, as the West entered the information revolution during the 1970s, the Soviet bloc lagged far behind. Because the socialist countries were unable to continue with the extensive growth strategy and unable to shift easily to an intensive growth strategy, economic growth slowed throughout the region (see Table 9.2).

The need to shift from extensive to intensive growth strategies and the difficulty of doing so within the confines of the Stalinist model led some Communist governments to attempt reform during the 1950s and 1960s. Poland and Hungary experimented with such reforms during the second half of the 1950s; Czechoslovakia did so during the late 1960s. The pace and the depth of these reforms, however, were largely determined by the Soviet Union. It proved difficult to move forward with meaningful economic reform without also experiencing far-reaching political reform. Meaningful economic reform would require governments to decentralize economic decision making, to allow prices to play a larger role in allocating inputs and guiding production decisions, and to reward the efficient use of inputs and hard work. It proved difficult to decentralize economic decision-making without also decentralizing political power. In the 1956 Hungarian reforms, for example, the Communist Party's efforts to introduce market-oriented reforms were quickly accompanied by the announcement of a return to a multi-party political system that would almost certainly push the Communist Party from power. In Czechoslovakia, economic reform escalated into far-reaching political reforms centered on the abolition of the one party state and the construction of multi-party government. In both instances, the Soviet army invaded, installed rigid Communist officials loyal to Moscow, purged the Communist Party of reformers, and then repressed reformers throughout society. The message was clear: meaningful economic reform could occur only once the Soviet

Table 9.2
Economic Growth in the Socialist Bloc

	1961–1970	1971–1980	1981–1988
Bulgaria	5.8	2.8	1.2
Czechoslovakia	2.9	2.8	1.4
East Germany	3.1	2.8	1.8
Hungary	3.4	2.6	1.0
Poland	4.2	3.6	0.8
Romania	5.2	5.3	–0.1
Soviet Union	4.9	2.6	2.0

Source: Kornai 1992, 200.

Union lost the ability or the desire to determine political and economic developments in the region.

As a consequence, socialist economic performance continued to deteriorate (see Berend 1996; Åslund 2002). Governments in many countries responded to economic stagnation with massive investment programs that they hoped would force a resumption of growth. In an attempt to update their obsolete technology, they began to deepen their economic relations with the West, exporting whatever goods they could in exchange for Western technology. Thus, the expanded East-West trade we discussed above was driven by the need to improve flagging economic performance. Few manufactured goods produced in the Socialist bloc were competitive in world markets, however. Consequently, many countries in the region ran current account deficits that they financed with foreign debt. Between 1974 and 1985, Poland accumulated about $40 billion of debt and Hungary about $14 billion. When foreign lending was shut off in the early 1980s in response to a Polish default and the emergence of the Latin American debt crisis, the socialist regimes found that their structural problems were now compounded by a foreign debt problem. By 1989, debt service was consuming between 40 and 70 percent of hard currency export earnings in Hungary, Poland, and Bulgaria (Berend 1996, 231). Economic growth declined even further. The Polish economy, perhaps the worst performer in the region, grew by only .2 percent between 1986 and 1989. Other socialist countries fared little better (Berend 1996). Thus, by 1988 the stagnation caused by structural problems inherent in the centrally planned economic model had progressed to a point of economic decline and crisis. This deteriorating economic environment set the stage for the dramatic political transformation that took place in 1989.

Economic Decline and Political Change

Change initiated in the Soviet Union. While the need for economic reform in the Soviet Union was apparent, it was not until the second half of the 1980s, and following the appointment of Mikhail Gorbachev to the position of General Secretary of the Communist Party in March 1985, that the Soviet Union embarked on reforms. Though considerably more reform-minded than his predecessors, Gorbachev never intended to dismantle Soviet-style socialism and construct a capitalist economy in its place. Instead, Gorbachev believed that Soviet socialism could be made to work better. He wanted to retain central planning, but conduct planning in a more decentralized fashion that would give greater autonomy and decision-making authority to enterprises. The market would play some role, but it would operate within the confines of the planned economy. Nor did Gorbachev envisage an economy based principally on private ownership. Small private enterprises were perhaps to be encouraged, but the state would retain ownership of most enterprises. In short, Gorbachev's objective was to reform Soviet-style socialism, not to preside over a transition to capitalism. What distinguished Gorbachev from previous Soviet reformers, however, was his recognition that successful economic reforms would require a degree of political liberalization. Thus, one of Gorbachev's first initiatives was **glasnost,** a policy oriented toward opening the Soviet political system to greater freedom of expression.

Perestroika, which means restructuring, was the banner under which Gorbachev pursued economic reform. **Perestroika** included a number of reforms designed to decentralize economic decision-making. The centerpiece was a 1987 State Enterprise Law, which came into effect in January 1988. Under this law, an initial effort was made to shift economic decision-making authority away from state planners to enterprises themselves. The principle of workforce management was instituted, under which the workers in an enterprise selected their own managers. Enterprises were put on a full-accounting principle, which meant that their operating costs and investments were to be financed from their revenues. Enterprises were relieved of the obligation to sell all of their output to the state. Instead, they were obligated to sell only 50–70 percent of their production to the state; they could sell the remainder to whomever they wished at whatever price they could negotiate. The purpose of the reform was to create market-type incentives in a system of state owned industry (Goldman 1991, 120). Because profitability, and hence wages and management bonuses, would be directly linked to the ability to sell production, enterprise managers would have an incentive to improve the efficiency of production and the quality of the goods produced. Moreover, the retained profits would finance investment in the production of goods that consumers wanted to buy. Gorbachev also implemented limited foreign trade reforms, allowing some enterprises to engage in direct international transactions and retain a portion of any foreign exchange they earned from exports.

Gorbachev's economic reforms were accompanied by a fundamental shift in Soviet policy toward Eastern Europe. Throughout the postwar period, Soviet policy toward its satellites had been shaped by the Brezhnev Doctrine. The **Brezhnev Doctrine,** first formally enunciated in 1968 following the Soviet invasion of Czechoslovakia, declared that the Soviet Union had the right to intervene, militarily if necessary, in any socialist country where developments threatened Communist Party rule. In practice, this meant that economic and political reform in Central and Eastern Europe was blocked by the threat of Soviet military intervention. This threat discouraged domestic opposition groups within the socialist bloc from challenging Communist Party rule and encouraged the Communist Party leadership within these countries to disregard societal demands for change because they believed they could always count on the Soviet Union to keep them in power in the event of a societal uprising. The Brezhnev Doctrine thus imposed a strong external constraint on political and economic reform in Central and Eastern Europe during the seventies and eighties. Gorbachev effectively rescinded the Brezhnev Doctrine in December 1988 in a speech to the United Nations. Declaring that "freedom of choice is a universal principle" to which there could be no exceptions, Gorbachev made it clear that the Soviet Union was no longer willing to use military power to stop political and economic change in Eastern Europe (Brown 1996, 225).

Political change began in Poland. It is not surprising that Poland would be first, as the Polish economic crisis was the deepest in the region, and the Polish opposition movement was the most fully organized. The Polish economy teetered on the brink of economic crisis throughout the 1980s. A wave of strikes between 1979 and 1981 had disrupted economic activity and contributed to a severe reduction in economic output. The Polish economy never recovered. Average growth in the first half of the decade was −1.8 percent, and the economy managed only about .2 percent annual growth

rates between 1985 and 1988. Inflation also rose, peaking at 250 percent in 1989. Poland had the largest foreign debt in the region, which it was forced to reschedule throughout the decade. Poor economic performance was in turn partially the consequence of—and partially the motivation for—the development of an organized opposition to the ruling regime in the late 1970s. The opposition movement drew together Polish intellectuals, workers, and the Catholic Church in support of political and economic reform. In 1980, the opposition movement coalesced around the Solidarity trade union movement led by Lech Walesa that had been founded in the Lenin Shipyard in Gdansk. Using strikes as their weapon, Solidarity pressed for far-reaching economic and political reform. In response to Solidarity's growing social power, the Communist government legalized the trade union movement and hoped to harness it as a partner in implementing economic reform. However, the ensuing political struggle between Solidarity and the ruling regime deepened the economic crisis. Economic output fell by 12 percent in 1981, and the regime began to ration many consumer goods such as meat, sugar, butter, cigarettes, and soap. The crisis also prompted a change in political leadership, as General Wojtech Jaruzelski was appointed General Secretary in early 1981. Under his lead, and under considerable pressure from the Soviet Union, the regime imposed martial law, outlawed the Solidarity movement, and arrested the Solidarity leadership. Throughout the next seven years, the Polish regime sought to appease the opposition movement with economic reforms that it hoped would raise the standard of living. Partial reforms were ineffective, however. As the economy continued to decline, strikes began to re-emerge and then grew in scale during 1988. Workers' demands were initially restricted to economic issues, but quickly incorporated political demands, including the legalization of Solidarity. In an attempt to bring this crisis to an end, the rulers turned to Walesa and struck a deal: if Walesa would use his influence with the workers to end the strikes, Solidarity would be legalized and negotiations about the transition to a competitive political system would take place (Mason 1996, 54–55).

"Roundtable" negotiations between Solidarity and the ruling party began in February 1989. They concluded in April with an agreement to hold partially free parliamentary elections. The agreement stated that opposition parties, including Solidarity, would contest 35 percent of the seats in the *Sejm,* the Polish parliament. The other 65 percent of the seats were reserved for the Polish United Workers' Party (the communist party) and its allies. In addition, a new upper house was created, and all 100 seats in this new Senate would be selected in open competitive elections. The Communist leadership never intended these concessions to remove them from power. Instead, they expected to maintain control over the parliament and the presidency. Yet, the elections, held in June of 1989, produced a stunning victory for Solidarity and represented a clear public rebuke of the ruling regime. Solidarity won 99 of the 100 Senate seats and all of the freely elected seats in the *Sejm.* While Jaruzelski was elected president by the new parliament, the communist party could not gain majority support for its candidate for prime minister. For even though it controlled a majority of the *Sejm* with the help of its allied parties, the allied parties refused to support the communist party's candidate. They shifted their support to Solidarity, leading to the formation of a coalition government led by Tadeusz Mazowiecki, a member of Solidarity. On August 4, 1989, a non-Communist prime minister took office for the first time since the 1940s.

Opposition movements and wary communist regimes in other East European countries followed the developments in Poland closely. When Solidarity's victory in 1989 did not prompt Soviet intervention (in fact, when queried about the changes in Poland, Gorbachev's spokesman jokingly referred to the Soviet Union's new "Sinatra Doctrine," a reference to Frank Sinatra's song "I Did it My Way"), political change swept through the rest of Central and Eastern Europe (Mason 1992, 56). In Hungary, roundtable discussions between the Communist Party and the opposition began in June of 1989. They concluded with an agreement to hold parliamentary elections in March 1990. As part of the Hungarian liberalization, the government opened the border with Austria. This move prompted East Germans to begin to exit to the West, traveling from East Germany to Hungary, from Hungary to Austria, and then into West Germany where they gained citizenship. The mass exodus sparked mass demonstrations inside East Germany. On November 9, the East German Communist Party opened the Berlin Wall, allowing free travel between East and West Berlin. By the end of 1989, the East German Communist Party had fallen from power; by October 1990, the German Democratic Republic had become part of a reunified Germany. From Germany, political change swept into Bulgaria. An anti-Communist coup occurred on November 10, the day after the Berlin Wall was opened. The coup was followed by roundtable negotiations in the first months of 1990 that in turn led to parliamentary elections in June. From Bulgaria, the revolution swept into Czechoslovakia. Students began to protest against the regime on November 17, and were met by a brutal police response. Violence against the students sparked larger demonstrations led by the opposition movement Civic Forum. By December 10, protest against the regime had forced the Communist Party from power. On December 29, Vaclav Havel was elected president of Czechoslovakia. Parliamentary elections followed in 1990. The dramatic political changes were concluded by an uprising in Romania. Romania experienced the only violent revolution in the region in which the police fired on public as they protested the regime. The revolution ended with the execution of the Communist leader, Nicolae Ceausescu, on Christmas Day 1989. Thus, in less than a year, the Soviet bloc had disappeared. Newly elected governments set to work on the process of market-oriented economic reform.

Political change was not restricted to Central and Eastern Europe, but extended into the Soviet Union itself. Rather than stem economic decline and invigorate the Soviet economy, Gorbachev's reforms merely pushed the Soviet Union into economic and political crisis. *Perestroika* dismantled the central planning apparatus but failed to create the components of a market economy to take its place. Consequently, by 1990 the Soviet Union had neither a planned economy nor a market economy. What it did have was an economic system in crisis, characterized by acute shortages of consumer goods, a growing government budget deficit which by 1990 stood at 20 percent of GDP, and rising inflation (Åslund 1995, 48). The deepening economic crisis polarized the political debate over reform, sparking a confrontation between hard line communists who wanted to return to the command economy and radical reformers who advocated a rapid transition to a market economy. The crisis came to a head in August 1991 when Communist Party hard liners launched a coup against Gorbachev. The coup failed, but it represented the last gasp of the Communist Party of the Soviet Union. Gorbachev resigned as General Secretary and the Communist Party itself suspended operations. Power quickly shifted away from the central government to the individual republics. Boris Yeltsin, who had been elected president of Russia in June of 1991, began to take the Russian Republic out of the Soviet Union. He banned the Communist Party in Russia, refused to give tax revenues collected in Russia to the central government, and ignored laws and decrees passed by the central government. Many of the other republics adopted similar policies and began to secede from the Soviet Union. Estonia and Latvia declared their independence on August 20, 1991. Ukraine, Belarus, Moldavia, Azerbaijan, Uzbekistan, and Tajikistan declared their independence in the following two weeks. On January 1, 1992, the Soviet Union was dissolved into its 15 constituent republics, each of which became an independent nation state.

Thus, in less than three years the Soviet bloc and the Soviet Union itself disappeared. These dramatic changes resulted from the erosion of the political structure that had supported the socialist bloc. Publics had tolerated exclusive Communist Party rule because they were powerless to alter political arrangements in the face of Soviet military superiority. Public acceptance of the oppressive system was facilitated, however, by the ruling party's commitment to consistently deliver a rising standard of living. The inability of the planned economies to deliver a rising standard of living generated widespread public dissatisfaction. As one author has noted, "The deepening economic crisis undermined the legitimacy of the regime . . . The emerging economic disaster became a comprehensive crisis of the regime" (Berend 1996, 232). When the Soviet Union declared that it was no longer willing to use its military power to prop up communist rulers in Eastern Europe, dissatisfaction erupted into revolutionary movements that overthrew Communist regimes throughout the region.

Market Reform in the Former Soviet Bloc

The destruction of one-party-rule political systems and centrally planned economies represented only the first step in the revolution. The more difficult second step entailed the construction of democratic institutions and functioning market economies. The magnitude of the task that the new governments faced is almost beyond imagination. The state owned the majority of productive enterprises, many of which were uncompetitive monopolies. The structure of protectionism and state intervention meant that most economies lacked any meaningful relative price relationships. Few countries had the legal and administrative systems necessary to support a market economy.

Table 9.3
Countries of the Former Soviet Union

Armenia	Lithuania
Azerbaijan	Moldova
Belarus	Russian Federation
Estonia	Tajikistan
Georgia	Turkmenistan
Kazakhstan	Ukraine
Kyrgyz Republic	Uzbekistan
Latvia	

There was no recent history of entrepreneurialism. Further complicating the situation, there was no guidebook on how to make the transition from a socialist to a capitalist country. Thus, while most governments in the region had a clear end goal in sight, to construct market economies, improve economic efficiency, and raise the average standard of living, few were clear, at least initially, on how to achieve these objectives. In this section we look at how governments approached market reform, how domestic politics shaped the implementation of these reforms, and how much progress had been made by 2001.

Strategies of Market Reform

The transition to a market economy requires governments to implement numerous policies that fall into four broad categories: stabilization, liberalization, privatization, and institutionalization. Stabilization refers to the creation and maintenance of a macroeconomic environment characterized by low inflation and a sustainable government budget position. Liberalization has two dimensions, internal and external. Internal liberalization refers to allowing the interplay of supply and demand rather than bureaucratic decisions to determine prices in the domestic economy. External liberalization refers to relaxing the controls on trade, and is most often associated with the introduction of currency convertibility for current account transactions, the dismantling of quantitative restrictions on imports, and tariff reductions. Privatization refers to the removal of the state "from ownership of and decision-making within enterprises" (European Bank for Reconstruction and Development 1999, 32). Obviously, the state owned a large percentage of productive enterprises. In Russia, for example, private firms accounted for only 5 percent of GDP in 1990. Even in Hungary, where some market reforms were implemented during the 1980s, private firms accounted for only 18 percent of GDP (World Bank 2002, 6). Finally, institutionalization incorporates the creation of an administrative, legal, and financial framework to support the market economy. This includes such things as tax reform, the creation of rules governing property rights and contracts, as well as a wide range of other regulatory policies such as antitrust regulation, corporate governance, and the financial system.

While there was broad agreement on what needed to be done, there was much less agreement on the pace at which it should be done. Some politicians, the International Monetary Fund and World Bank, as well as many academic economists in the United States and Eastern Europe advocated rapid reform, an approach often referred to as shock therapy. Proponents of **shock therapy** argued that governments had to introduce most of the central components of a market economy as quickly as possible. Governments should move rapidly to create a stable macroeconomic environment by reducing budget deficits and tightening monetary policy. Simultaneously, domestic prices should be quickly liberalized, subsidies to enterprises eliminated, and the country opened to international trade. Finally, the government should remove most restrictions on private enterprise. All of these measures were to be introduced quickly, within a year, two at the most. Shock therapy embodied much of the neo-liberal Washington Consensus developed in connection with the Latin American debt crisis.

In fact, one of the staunchest proponents of shock therapy in Eastern Europe, Jeffrey Sachs, had first developed the approach when asked to help the Peruvian government stabilize its economy in the late 1980s. In 1989, Sachs helped the Polish Solidarity government design its transition strategy (Sachs 1993). Shock therapy was also advocated for reasons specific to Eastern Europe, however. Many of the new East European politicians had concluded that reforms in the old socialist systems had failed because they were not radical enough, that is, they had not crossed the threshold of necessary changes rapidly enough (Balcerowicz 1995, 341–342). If reform was to work, it had to change the way people and businesses behaved in order to "break the hold of the old system." To do so, reforms "had to be radical, comprehensive, and fast" (Åslund 2002, 79). In addition, many of the new governments believed that moving rapidly would reduce political obstacles to reform. On the one hand, newly-elected democratic governments enjoyed a period of "extra-ordinary politics" during which public enthusiasm about the political and economic transition would make voters willing to accept the short-term economic costs of reform. Once "normal" politics returned, voters would be much less likely to tolerate costly reforms. On the other hand, rapid reform would enable governments to create a market economy before societal interest groups could organize in opposition to liberalization (see Balcerowicz 1995, 311–312).

Others called for a more gradual transition to a market economy (see e.g., Amsden et al. 1994). They did so for a variety of reasons. Some advocates of a gradual approach argued that the economic consequences of neo-liberal shock therapy were unnecessarily harsh. They argued that tight fiscal and monetary policies would cause economic activity to drop too sharply. They called for expansionary fiscal and monetary policies in order to offset the economic downturn associated with the transition. In addition, gradualists argued that rapid trade liberalization would be too disruptive, and should be attempted only after domestic prices had been liberalized. Gradualists were also critical of rapid privatization, claiming that state enterprises had to be encouraged to respond to market signals and make the necessary adjustments before they were privatized. Some critics argued that shock therapy would generate a public backlash against democracy and market reform (see Przeworski 1991). Because rapid reform would precipitate a sharp drop in economic activity, the public would rise up in opposition to reform and the political leaders that imposed it upon them. Such a backlash could undermine the legitimacy of the democratic process and bring authoritarian regimes back into power. Rather than shock therapy, the gradualists advocated a slower progression to a market economy. They argued that governments should first implement popular measures in order to build public support, and only then begin to implement the more costly components of reform. Moreover, the more costly components should be implemented one at a time so that the negative economic impact was limited.

The debate over the pace of reform was reflected in the transition strategies individual governments adopted. Most of the governments in Central and Eastern Europe adopted rapid reform strategies. Poland introduced shock therapy in one big bang in January 1990 (Sachs 1993; Balcerowicz 1995). Hungary implemented essentially the same set of measures over the course of the year. Czechoslovakia followed in 1991, while Estonia and Latvia adopted rapid reform programs in 1992 and 1993. The pace of reform in these countries can be appreciated by looking at an index of market reform developed by the European Bank for Reconstruction and Development (EBRD)

A Closer Look

Shock Therapy in Poland

Shock therapy was applied first in Poland. The Solidarity government came to power without a fully developed reform agenda and facing an economy in crisis. Inflation had surged to an annual rate of 640 percent in the fall of 1989, and was threatening to rise further. The economy faced severe shortages of consumer goods, and these shortages were adding additional inflationary pressures to the economy. Poland could not service its foreign debt, and its trade balance was in deficit as imports rose. These macroeconomic problems lay on top of deep structural problems generated by 40 years of Socialism—too many uncompetitive state-owned enterprises, few small and medium-sized enterprises, an inefficient agricultural sector, and a very interventionist state. To address this crisis, Prime Minister Mazowiecki selected Leszek Balcerowicz to be his deputy Prime Minister and Finance Minister. Working with Polish economists and a team of Western advisors led by Jeffrey Sachs, a Harvard University economist, Balcerowicz spent the fall designing a reform strategy.

Balcerowicz and his team of advisors believed that the Polish reform program would have to be "far more comprehensive and radical than in any other previous case" because the Polish economic situation was far more serious than previous cases (Balcerowicz 1995, 296). The team agreed that the crisis could not be solved until the government had achieved macroeconomic stabilization. Moreover, the team harbored serious doubts that a gradual approach to inflation would be successful (Balcerowicz 1995, 320). Having observed many Latin American governments struggle to control hyperinflation during the late 1980s with gradual strategies, Balcerowicz and his team of advisors were convinced that only a radical approach would succeed. Yet, ending Polish inflation would require not only tight macroeconomic policies, but also measures to end shortages that were pushing prices up. The simplest way to end shortages was to open the Polish economy to trade. Finally, the only way Polish enterprises could compete against imports once the economy had been opened to trade was to liberalize the domestic economy. Thus, once the decision was taken to give priority to stabilization, and once it had become clear that ending shortages was a necessary component of ending inflation, it became clear that stabilization and liberalization had to be implemented simultaneously and rapidly.

The reform program, called the Balcerowicz Plan, was based on six central components that were implemented beginning in January 1990 (see Orenstein 2001, 35).

- *Tight Macroeconomic Policies:* the government budget was to move from a deficit of 3 percent of GDP to a surplus in the course of the year. Monetary policy was tightened, with interest rates rising to 36 percent in January.
- *Wage Policy:* a tax on excessive wage increases (called the *popiwek*) was instituted in order to stem the rapid growth of nominal incomes. This was designed to prevent wages from rising in response to price increases and sparking an inflationary wage-price spiral.
- *Trade Liberalization:* the zloty was devalued, made fully convertible for current account transactions, and pegged at a fixed exchange rate. Quantitative restrictions on imports were eliminated, and tariffs were reduced to an average of 10 percent.

Continued

- *Price Liberalization:* Ninety percent of domestic prices were deregulated and allowed to find their own level.
- *Reduced subsidies:* Production and consumption subsidies were scaled back sharply.
- *Privatization:* The sale of large state enterprises was to be initiated in mid-year.

Thus, in the course of a single year, the Polish government dismantled the remaining elements of the centrally planned economy, removed state restrictions on business activity, and opened Poland to the international economy.

Shock therapy had an immediate impact on the Polish economy. Inflation rose sharply, to about 80 percent in January, as prices were liberalized. The tight macroeconomic policies pushed the Polish economy into recession. Industrial production fell by 24 percent in 1990, and the broader GDP fell by 11.6 percent during the year. Unemployment began to rise, reaching 13 percent of the labor force by 1991. The recession was larger than most economists had expected but it was relatively short-lived. Price liberalization rapidly ended the shortages of consumer goods—by February farm produce markets had emerged in the major cities. "Suddenly, it was possible to buy fresh fruit on the street corners in the middle of winter for the first time since 1939" (Sachs 1994, 59). The rate of inflation fell steadily throughout the year, and by August monthly inflation was only 1.8 percent. Exports grew sharply, producing a $3.8 billion hard currency trade surplus. More than 700,000 small businesses and 40,000 large private corporations were created between the end of 1989 and the middle of 1991 (Sachs 1994, 63). Together, these new private businesses created 1 million new jobs that helped reduce the extent of unemployment resulting from adjustment (Slay 1994, 102). By early 1992, signs of a broad economy recovery were apparent, and Poland recorded positive economic growth throughout the remainder of the decade (Sachs 1994).

Sachs, one of the architects of the plan, argues that the recession of the early 1990s did not greatly reduce the standard of living in Poland. Average consumption of meat and fresh fruits rose in 1991 compared to 1989, while the number of Polish households owning televisions, radios, VCRs, cars, and other consumer durable goods rose substantially (Sachs 1993, 69–71). Sachs concludes that once these additional gains in consumption are taken into account, "average living standards in Poland were higher in 1991 than in 1989" (Sachs 1993, 71). Which is not to say that the costs and benefits were evenly distributed, as some social groups clearly lost from reform. Farmers lost as state subsidies for farming were withdrawn. Workers in heavy industry also lost as privatization and restructuring eliminated their jobs. Within industry, older workers probably lost relative to young workers, and unskilled workers probably lost relative to skilled workers.

and the World Bank (see Table 9.4). This reform index measures the extent to which governments have implemented the reforms required "to make markets the main mechanism for allocating resources" (World Bank 2002, 14). The index incorporates a number of reform components, including the degree to which central planning has been disbanded, stabilization achieved, trade liberalized, and antimonopoly policies adopted. The index ranges from a score of zero, which indicates an unreformed centrally planned economy to a score of one, which represents a free market economy. A country with a score of .7 or higher is a market economy, a country with a score

Table 9.4
The Pace of Reform in the Former Soviet Bloc

	1990	1991	1992	1993	1994	2000
Slovakia	0.16	0.79	0.86	0.83	0.83	0.89
Czech Republic	0.16	0.79	0.86	0.9	0.88	0.93
Bulgaria	0.19	0.62	0.86	0.66	0.63	0.85
Poland	0.68	0.72	0.82	0.82	0.83	0.86
Hungary	0.57	0.74	0.78	0.82	0.83	0.93
Estonia	0.2	0.32	0.64	0.81	0.83	0.93
Lithuania	0.13	0.33	0.55	0.78	0.79	0.86
Latvia	0.13	0.29	0.51	0.67	0.71	0.82
Kyrgyzstan	0.04	0.04	0.33	0.6	0.71	0.79
Romania	0.22	0.36	0.45	0.58	0.67	0.82
Russia	0.04	0.1	0.49	0.59	0.67	0.64
Moldova	0.04	0.1	0.38	0.51	0.54	0.75
Uzbekistan	0.04	0.04	0.26	0.3	0.5	0.49
Armenia	0.04	0.13	0.39	0.42	0.46	0.72
Kazakhstan	0.04	0.14	0.35	0.35	0.42	0.71
Belarus	0.04	0.1	0.2	0.33	0.42	0.43
Tajikistan	0.04	0.11	0.2	0.26	0.42	0.61
Georgia	0.04	0.22	0.32	0.35	0.33	0.79
Azerbaijan	0.04	0.04	0.25	0.31	0.33	0.65
Ukraine	0.04	0.1	0.23	0.13	0.33	0.68
Turkmenistan	0.04	0.04	0.13	0.16	0.29	0.35

below .5 remains a nonmarket economy, and countries that score between .5 and .7 are in an intermediate category (Åslund 2002, 163). The index shows quite clearly the rapid pace at which the Central and Eastern European governments introduced market-oriented reforms. All had crossed the market economy threshold by 1993. Governments in the countries of the former Soviet Union moved much more gradually. Only one country, the Kyrgyz Republic, had crossed the market economy threshold by 1994. Russia did so only in 1996. Perhaps even more telling, only five of the CIS countries had passed this threshold by 2000, although three more were quite close. In many cases it may be inaccurate to characterize many of the FSU countries as gradual reformers; it might be more accurate to call them "stalled reformers" (Havrylyshyn and Odling-Smee 2000).

Politics of market reform. Why have some governments moved farther along the reform path than others? The market reform index clearly highlights the large cross-national differences in the extent of reform that remain more than ten years after the collapse of the Soviet bloc. Hungary, Poland, and the Czech Republic have made the greatest progress toward market economies, followed quite closely by the Baltic countries (Latvia, Estonia, and Lithuania) and countries in Central and Eastern Europe. In contrast, the countries that emerged from the former Soviet Union have implemented far fewer market reforms. Indeed, some of these countries, including Belarus, Turkmenistan, and Uzbekistan have yet to launch any serious reforms (World Bank 2002, 14). The two largest successors to the Soviet Union, Russia and the Ukraine, have implemented some reforms, but appear to have become stuck in a situation of partial reform. Overall, therefore, there is a clear demarcation between successful market reformers in Central and Eastern Europe and much less successful reformers in the countries of the former Soviet Union. The differences become even more puzzling when we compare economic performance in the gradual and rapid reformers. Figures 9.2 and 9.3 present economic growth rates—perhaps the broadest indicator of economic performance—for a number of countries in each group. The figures reveal two basic trends. All countries

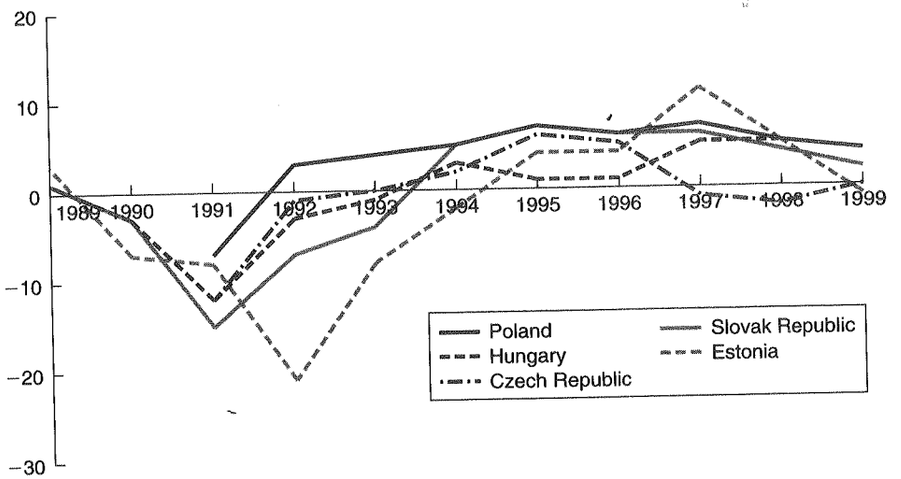

Figure 9.2 Growth in Rapid Reformers.
Source: World Bank 2001c.

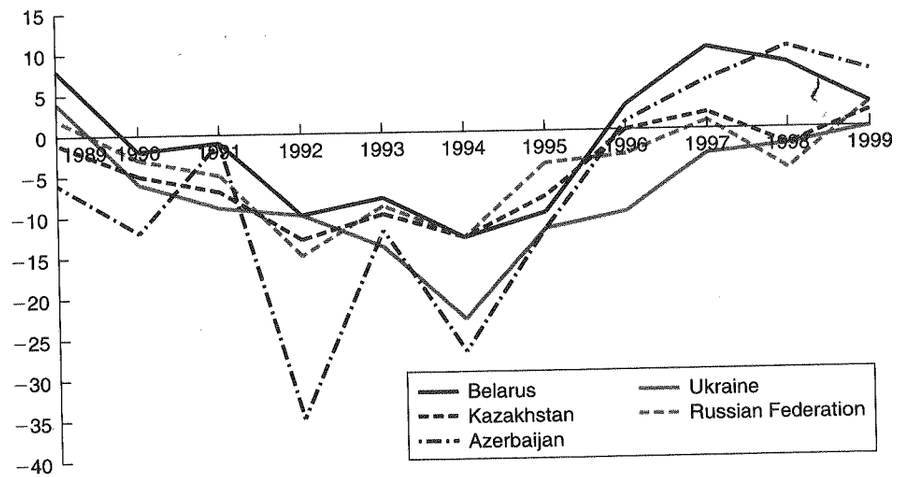

Figure 9.3 Growth in the Gradual Reformers.
Source: World Bank 2001c.

experienced sharply negative economic growth rates in the early stages of economic reform. While the magnitude of the economic crisis varied substantially within each group, the rapid reformers as a group did not experience a more severe collapse than the gradual reformers. There is little evidence, therefore, that gradual strategies reduced the short-term cost of the transition. Second, the rapid reform countries experienced positive economic growth much sooner than the gradual reformers. Poland began to experience positive economic growth in 1992, and all but one rapid reformer was enjoying positive growth by 1994. In contrast, the gradual reformers endured a much longer period of negative growth. No gradual reformer experienced positive economic growth until 1996, and it was not until the end of the decade that all of the gradual reformers recorded positive growth rates. Thus, countries that rapidly created market economies enjoyed a much more rapid return to growth than did those that moved more gradually (see Havrylyshyn 2001).

While a number of factors have been suggested to account for these different trajectories, including such things as the number of years under communism, proximity to the European Union, and the severity of the initial economic crisis, domestic politics have played perhaps the central role. At the broadest level, there has been a strong relationship between the early establishment of competitive democratic political institutions and successful market reform. The relationship between democracy and economic reform is illustrated in Figure 9.4. The figure plots an index of civil liberties and political rights for each country against progress on market reform. The democracy index measures political freedoms on a seven-point scale. A seven indicates a very low level of political freedoms, and thus little democracy, while a one indicates a high level of political freedoms and thus more democracy. I have averaged the scores each country received on this index for each year between 1990 and 2000. The scatter plot reveals a very strong relationship between democracy and market reform. Highly democratic countries have progressed farthest down the path toward market economies. Nondemocracies have ventured the shortest distance toward market economies. We could construct similar plots using different indicators of democracy and find almost identical patterns (see e.g. EBRD 1999; World Bank 2002). There seems to be a very strong relationship, therefore, between the early establishment of democratic political systems and subsequent rapid creation of a market economy.

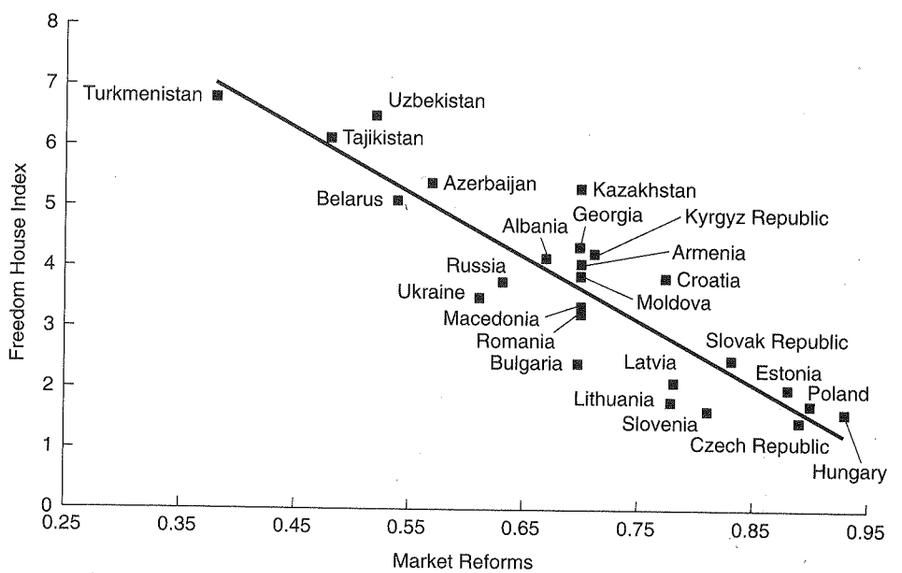

Figure 9.4 Democracy and Market Reform.
Source: World Bank and Åslund 2002, 161.

Whether a country established democratic or nondemocratic political systems mattered because the two political systems have generated very different political dynamics of reform. The pace of market reforms has been influence by the way political institutions have shaped political competition between the winners and losers from economic reform. The losers from reform include workers in state-owned enterprises that lack the skills to find employment in new private industries and political insiders from the old regime who lose their ability to profit from state-owned assets. The potential beneficiaries of reform include the individuals and groups that can create, or find employment in, new private businesses. Reform has been blocked in countries where the losers have been able to maintain control of the political system, while reform has proceeded more rapidly in countries where the potential beneficiaries from reform gain political influence (see Fish 1998; European Bank for Reconstruction and Development 1999). In countries that established competitive democracies, the first post-socialist elections brought new leaders into the political system and removed the communist party from power. In Poland, for example, the Solidarity movement took power from the communists in 1989. In countries that did not create competitive political systems, the old elite was able to reestablish its control in the new system. In Albania, for example, the Party of Labor, the communist party's successor, won 68 percent of the seats in elections held in early 1991 (Fish 1998, 50). In Bulgaria, the successor to the old Communist Party, the Bulgarian Socialist Party, won 53 percent of the seats in the 1990 elections. In Ukraine, the former Communist Party leader Leonid Kravchuk was elected in the 1991 presidential election, capturing 62 percent of the vote (Fish 1998, 50). Thus, rather than bringing to power new political leaders representing societal interests that could gain from rapid political and economic reform, elections in these countries merely allowed the communist party elite to consolidate its power under new institutional framework.

The result of the initial elections in turn exerted a powerful influence on the subsequent trajectory of economic reform. In the democracies, the old communist elite was quickly removed from positions of influence as the state planning apparatus was dismantled, state enterprises sold, and the government's role in the economy greatly reduced. Moreover, electoral competition had two consequences for economic reform. First, competitive elections helped to reduce political polarization within these countries. The old communists were forced to confront the fact that they either had to reconstruct themselves as more moderate social democratic parties or disappear from the political arena altogether. The extreme left, therefore, moved toward the political center in order to become a viable contender for government. As a viable political left emerged, the radical reformers were forced to moderate their positions or lose power to the left in elections. In Poland, for example, the first Solidarity-led government lost

power in the second post-socialist election and was replaced by a left-oriented coalition that included the reconstructed communist party. Thus, the dynamics of electoral competition forced the major parties to move toward the political center, and as a consequence all of the major parties embraced pro-reform agendas. In addition, because the political system was highly competitive, governments could not afford to ignore the social costs of economic reform. Instead, they found it necessary to create a social safety net to protect those most vulnerable to economic reform. This helped reduce the societal backlash against reform predicted by many proponents of gradualism.

Non-democracies have seen the emergence of a rent-seeking dynamic. Many of the old guard remained in power, and many who left used their political connections to acquire newly privatized state enterprises. Once they had done so, they then used their political connections to block full market reforms in order to capture the rents available from partial reform. **Partial reform,** which refers to instances in which governments introduce some features of a market economy such as privatization and macroeconomic stability, but refrain from others, such as domestic price and trade liberalization, can generate rents in a number of ways (Hellman 1998, 219). Suppose, for example, that the state privatizes the oil industry and liberalizes oil exports, but continues to subsidize oil production. The new private owners of the oil firm can thus sell their subsidized production at world market prices. Or suppose that the government privatizes a monopolistic steel mill and liberalizes domestic steel prices, but then retains high tariffs on imported steel. The new owner of the steel mill can thus earn monopoly rents. In such cases, the beneficiaries from partial reform have a clear incentive to block additional reforms that would cause these rents to disappear. The owner of the oil industry will try to block cuts in government subsidies; the owner of the steel mill will try to block reductions of steel tariffs. While opportunities to earn rents will almost always be present in the reform process, in these non-democracies, the people who gain these rents have been closely allied with the ruling elite and have used this alliance to influence government decisions about further reform. Moreover, because these regimes did not have a well-organized opposition, there were few forces within society that could effectively prevent such rent-seeking behavior. The result has been what one scholar has called a "partial reform equilibrium" in which the political and economic elite capture high rents while the rest of society suffers the high costs of partial reforms (Hellman 1998, 203–204).

While economic reform has progressed therefore furthest in the democratic countries that opted for a rapid reform strategy, it is not the case that slower progress in the other countries reflects a gradualist strategy designed to cushion the population from the hardships of rapid reform. Instead, reform has progressed more slowly in the non-democratic countries because rent-seeking dynamics have imposed real limitations on the reform process. Thus, competitive democracy-produced governments that have emphasized the broad social gains available from comprehensive market reform and imposed a powerful check on rent-seeking activity. In the nondemocratic countries, the absence of electoral competition has enabled governments to pursue partial reform agendas that benefit small segments of society at the expense of the broader public.

Post-socialist countries in the global economy. Many of the post-socialist countries have become more deeply integrated into the global economy during the last ten years. Again, however, integration into the global economy has shown considerable

variation, with the Central and East European countries developing deeper linkages with the advanced industrialized countries than the countries of the former Soviet Union. Almost without exception, all of the countries have become more open to international trade since 1989 (Table 9.5). And while there are differences across countries, there do not appear to be large differences between the East European countries and the countries of the former Soviet Union. Such differences do appear, however, when we examine the destination of exports. The East European countries have almost completely reoriented their trade from east to west. With only two exceptions, two-thirds or more of these countries' total exports are shipped to the advanced industrialized countries. The former Soviet Union countries have had less success breaking into Western markets. Among these countries, none ship more than half of their exports to advanced industrialized countries, and most ship less than one-third of their exports to these markets. Thus, the Central and East European countries have been better able to capture markets in the advanced industrialized countries than have the countries of the former Soviet Union. Multinational corporations have also begun to invest heavily in the

Table 9.5
Trade in Post-socialist Countries

	Trade as a Percentage of GDP	Exports to Industrialized Countries as Share of All Exports
Central and Eastern Europe		
Albania	41	94.1
Bulgaria	96	59.0
Czech Republic	129	69.3
Estonia	159	71.3
Hungary	108	81.5
Macedonia	97	65.5
Poland	59	75.5
Romania	64	71
Slovak Republic	128	59.2
Slovenia	109	70.7
Countries of the Former Soviet Union		
Armenia	71	34.9
Azerbaijan	84	20.0
Belarus	127	11.0
Georgia	73	25.9
Kazakhstan	85	29.6
Kyrgyz Republic	99	44.0
Moldova	115	31.3
Russia	74	49.4
Ukraine	104	23.3

Source: Trade Openness from World Bank 2001. *World Development Indicators on CD-Rom.* Trade with Industrialized Countries from World Bank 2002.

region (Figures 9.5 and 9.6). Here too, however, a clear difference emerges between the CEE and the FSU countries. In the CEE countries, the presence of MNCs increased steadily throughout the 1990s, though the bulk of this investment went to Poland, Hungary, and the Czech Republic. The FSU countries have attracted less foreign direct investment. Only four countries have received an appreciable amount of FDI, but the largest recipient—Russia—has attracted less than half of the amount that has flowed into Poland. Central and East European countries, therefore, have proven more adept at developing trade and investment linkages with the advanced industrialized countries than have the countries in the FSU. To a large extent, this difference reflects the fact that the CEE countries have made more progress on reform than the FSU countries.

The post-socialist countries have also sought membership in the most important international economic institutions. By the mid-1990s all countries from the region had become members of the IMF and the World Bank. Membership in the IMF enabled the governments to seek financial assistance in connection with macroeconomic stabilization programs and the introduction of currency convertibility. Many have also acquired membership in the WTO, and those that do not yet belong have applied for membership (Table 9.6). Moreover, in the early 1990s most Central and East European governments decided that EU membership was one of their top foreign policy objectives. In the early 1990s, these governments negotiated and signed **Association Agreements** with the EU (Table 9.7). The Association Agreements established a framework for the progressive integration of East and West Europe. Through these agreements the EU and the country in question removed barriers to trade in manufactured goods with the goal of creating a free trade area by 2002. In March 1998, five

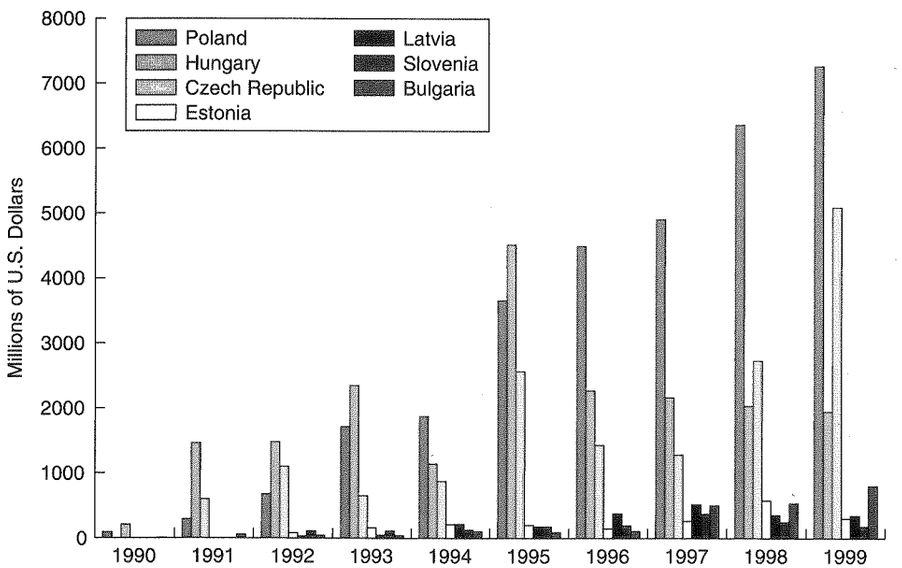

Figure 9.5 Foreign Direct Investment In Eastern Europe.
Source: World Bank 2001c.

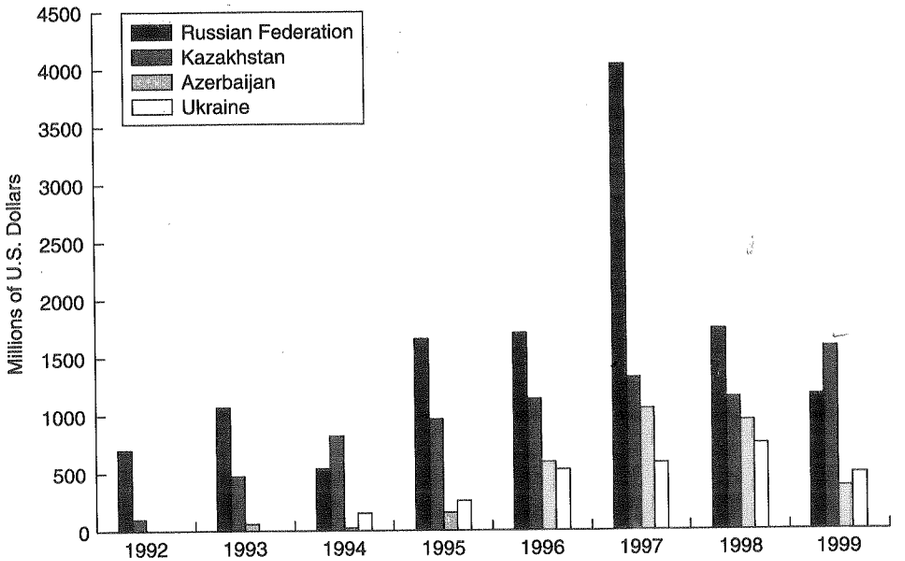

Figure 9.6 Foreign Direct Investment in the Former Soviet Union.
Source: World Bank 2001c.

Table 9.6
The Post-socialist Countries and the WTO

New Members of WTO	Year	Currently Negotiating Membership
Albania	2000	Armenia
Bulgaria	1996	Azerbaijan
Estonia	1999	Belarus
Georgia	2000	Bosnia and Herzegovina
Kyrgyz Republic	1998	Kazakhstan
Latvia	1999	Republic of Macedonia
Lithuania	2001	Russian Federation
Moldova	2001	Tajikistan
Slovak Republic	1995	Ukraine
Slovenia	1995	

East European countries began negotiating with the EU on the terms under which they would become full members of the EU. Five more countries began negotiations in October 1999. In order to join the EU, the East European countries must have stable political institutions that guarantee democracy, the rule of law, human rights and minority protection. They must have a functioning market economy that can cope with free-market competition with producers in the EU. In addition, they must be willing to adopt the EU's **acquis communitaire,** which is essentially the accumulated body of EU laws and regulations. Negotiations over entry focus on the time period under

Table 9.7
Eastern Europe and the European Union

	Date of Europe Agreement	Applied for Membership in the EU	Negotiations on EU Membership Began
Bulgaria	March 1993	December 1995	October 1999
Czech Republic	October 1993	January 1996	March 1998
Estonia	June 1995	November 1995	March 1998
Hungary	December 1991	March 1994	March 1998
Latvia	June 1995	October 1995	October 1999
Lithuania	June 1995	December 1995	October 1999
Poland	December 1991	April 1994	March 1998
Romania	February 1993	June 1995	October 1999
Slovakia	October 1993	June 1995	October 1999
Slovenia	June 1996	June 1996	March 1998

which the *acquis* will be implemented in each country. Currently, the EU estimates that negotiations with the ten applicants will be completed by 2004. The EU has no plans to encourage FSU countries to apply for membership. Thus, by the middle of the decade the clear demarcation between central and eastern Europe on the one hand and the FSU countries on the other that is evident in so many indicators of the transition is likely to be reinforced by the institutional status of EU membership.

The last 20 years have thus brought far-reaching changes to the former Socialist countries. These societies dismantled their command economies and the authoritarian political regimes that ran them. They have begun to create in their place democratic political systems and market-based economies. Many have reduced the barriers that had insulated them from the broader global economy and begun to engage in trade and attract foreign investment. In every country this transition has been painful, and in only a few countries, most in Central and Eastern Europe, have per capita incomes return to the level that had prevailed in 1989 (Åslund 2002, 119). As we have seen, however, the pace of reform, as well as the extent of the recovery from the economic crisis that followed the collapse in the early 1990s, has been uneven. In many countries it remains incomplete. While the Central and Eastern European countries appear to have established solid political and economic foundations, many of the FSU countries have made much less progress and consequently continue to confront large challenges.

Economic Reform in China

The Chinese Communist Party (CCP), led by Mao Zedong, took power in China in October 1949. China was a very poor and largely agricultural society. Agriculture accounted for 68 percent of national income, while industry accounted for only 12.5 percent. Determined to modernize and industrialize China, Mao turned to the Soviet Union for assistance. With the help of Soviet advisors, the CCP quickly socialized

China's economy. Industry was nationalized, private ownership of land was prohibited, and agricultural production was collectivized. A central planning system based on the Soviet model was established in the early 1950s and the first five-year plan was promulgated in 1953. Like the Soviet Union and its East European satellites, China emphasized the rapid development of heavy industry at the expense of consumer goods and agriculture. As in the Soviet Union, industrialization was to be financed through the extraction of resources from agriculture. Finally, as with other socialist countries, China had few linkages with the international economic system, as the government emphasized national self-sufficiency. The strategy transformed the Chinese economy in a remarkably short period of time. Between 1949 and 1981, heavy industry grew at an annual rate of 15.3 percent (Lin, Cai, and Li 2001, 61). As a consequence, the share of industry in economic output had risen to 46.8 percent by the mid-1970s, while agriculture's share fell to 35.4 percent (ibid. 61). Yet, the strategy also displayed the problems evident in other socialist countries. Agricultural output grew very slowly, depriving authorities of the resources needed for industrialization. The new heavy industries were inefficient, using substantially more energy and raw materials to produce a given quantity of goods than in other developing countries at similar levels of economic development. Moreover, as was the case in the Soviet Union and Eastern Europe, the central planning system created few incentives for innovation and productivity improvements. Problems inherent in the command economy model were further exacerbated by politics. A reformist movement, led by Deng Xiaoping, emerged within the Communist Party in the early 1960s. Fearing that economic reform was reintroducing material incentives into the Chinese economy, Chairman Mao launched his cultural revolution in the mid-1960s and early 1970s to repress dissent, ending all discussion of economic reform and severely disrupting economic activity.

Economic reform began only after the conclusion of the power struggle among contending factions of the CCP that emerged after Mao's death in 1976. The power struggle pitted Communist Party elite loyal to Mao against a faction of the party led by Deng Xiaoping. By 1978 Deng had emerged in the leading position in the Communist Party and had ousted most of the party members that remained loyal to Mao's vision. Over the next 20 years, Deng and his successors implemented a series of economic reforms that gradually moved China toward a market-based economic system. We begin by looking at the content of these reforms and the extent to which they have moved China to a market economy. We then examine the political logic of economic reform in China and briefly consider the remaining challenges.

Economic Reform

Deng and his followers agreed that China faced an economic crisis that could be addressed only through a complete reorientation of development strategy. Whereas until 1978 Chinese policy had emphasized capital-intensive heavy industries, Deng declared that henceforth priority would be given to the light industries that produced consumer goods and to agriculture. Deng's reforms were not based on an over-arching design. Instead, the characteristic features of China's reforms have emerged slowly "from the interaction between government policy and the often unforeseen consequences of economic change. Only through this evolving process did the goal of a market economy gradually emerge as the generally agreed upon objective" of reform

(Naughton 1995, 7). Moreover, and again in contrast to the Soviet Union and Eastern and Central Europe, economic reform in China has not been accompanied by far-reaching political liberalization. The Chinese Communist Party has retained exclusive power and exhibits little indication that it is contemplating political liberalization in the near future.

China's reforms sought to reduce the importance of central planning, to decentralize economic decision-making authority, and to encourage the growth of market-based transactions. Thus, the Chinese economy has featured a dual-track economic system in which the traditional plan and a new market system coexist. The distinction between the two tracks has little to do with ownership (i.e., private versus state-owned enterprises). Instead, the dual track system means that all state-owned enterprises, about 115,000 enterprises in total, operate in two parallel economic systems. Each must acquire a portion of their inputs through the planning channel and sell a portion of their output to the state, and each must also acquire a portion of their inputs through market channels and sell a share of their output in markets. Over time, the share of inputs and outputs established by central plans has been reduced while the share acquired and sold through markets has increased. The government also reduced prohibitions on the activity of nonstate enterprises, a term that includes firms created and owned by local governments as well as private enterprises, thereby encouraging the growth of economic activity outside the state sector. Over time, growth in market-based transactions, within the state and within the nonstate sector, has gradually reduced the importance of the planned sector in the Chinese economy. In other words, China has gradually "grown out of the plan" (Naughton 1995). This dual-track system has in turn implied the need for two sets of prices, one set by the state for purposes of central planning, and a second set by the market. Initially, state-set prices were typically much lower than market prices. Over time, however, the gap between the two sets of prices has narrowed, and by 1991 stood at about 5 percent (World Bank 1994c).

The specific measures that brought this transformation about were based on three main components. Reform was initiated in 1979 with the implementation of agricultural reform through the Household Responsibility System. Under the **Household Responsibility System**, individual farming households were encouraged to lease farmland from their agricultural commune. Each household that took advantage of this opportunity would be obliged to sell a portion of its harvest to the state at state-set prices. They could sell the remainder in markets at market prices and retain the profits. Initially, peasant households were allowed to lease plots for three years. In the late 1980s, the lease term was extended to 15 years. In addition, trading of these lease rights was introduced. The Household Responsibility System, therefore, began to reverse the collectivization of agriculture and create market incentives for agricultural production. At the same time, state-set prices for agricultural commodities were raised, thereby ensuring a higher income for farmers, and the state committed to making consumer goods available to farm households. The hope was that the Household Responsibility System would provide incentives to which peasants would respond by increasing agricultural output. The reform was a dramatic success. The rate of growth of agricultural output rose sharply between 1979 and 1984. Whereas grain production rose by only 2 percent per year between 1957 and 1978, between 1979 and 1984 grain

production rose by 5 percent per year. As a direct result of the rising output, peasant incomes rose by 15 percent per year in the same period (Pyle 1997, 10).

Attention then shifted into the industrial sector. State enterprises were given the right to retain control of production above their plan-established targets and to retain a portion of their annual profits. In 1984, the government implemented the **Enterprise Responsibility System** under which enterprises gained the authority to manage themselves like firms in market economies. They were given greater freedom to acquire their inputs through the market and to sell their output in the market rather than to state agencies. In addition, state subsidies were reduced and enterprises were required to rely on bank loans for their working capital. Over time, contracts based on negotiations with suppliers and customers replaced plan targets as the basis for production, radically altering the relative importance of the plan and the market in shaping enterprise production. According to one estimate, the share of inputs purchased by Chinese enterprises through markets, and the share of output sold in markets increased from about 12 percent in 1980 to 66 percent in 1989 (Jefferson and Rawski 2001, 247). The state also began to eliminate restrictions that limited the ability of new firms to enter manufacturing industries. As they did, the number of non-state enterprises engaged in manufacturing increased sharply. These non-state enterprises operate wholly outside of the planned economy, acquiring all of their inputs and selling all of their output in the market. By 1996, about 9.4 million non-state enterprises were operating in the Chinese economy, accounting for about 75 percent of total industrial output (Shen 2000, 148).

The government also adopted an **open door policy** through which it began to open China to the global economy by encouraging foreign direct investment and partially liberalizing trade. Foreign direct investment was considered important because it could provide advanced technology and expand China's export potential. In order to attract foreign investment the government created four Special Economic Zones (SEZs) located along China's southern coast in 1979–1980. A **Special Economic Zone** is a geographic area within which economic activity takes place under more market-oriented conditions than are possible in other parts of China. The government offers reduced tariff rates on capital and input imports, provides a relatively free labor market, allows private ownership, and imposes lower tax rates than in other areas of China. The decision to locate the SEZs along the southern coast was based on the desire to induce investment in China by Chinese nationals living along China's periphery in Hong Kong, Macao, Taiwan, and Singapore. The SEZs in Guangdong province bordered Hong Kong, for example, while the SEZ established in Fujian Province faces Taiwan. In 1984, the government opened an additional 14 coastal cities to foreign investment. In 1988, the policy was extended to the entire coastal region and selectively extended into the interior as well. Many observers argue that SEZs were adopted because they could be reform laboratories in which officials could experiment with market reforms and apply the lessons thereby learned to the rest of the Chinese economy (Shen 2000; Grub and Lin 1991). Political considerations were also important, however, because concentrating foreign direct investment in a few areas that could be insulated from the rest of the Chinese economy helped reduce opposition from reform opponents within the Communist Party (Shirk 1994, 35). Many reform opponents "remained committed to the notion of national self-reliance . . . They argued that China's

experience with nineteenth-century Western imperialism proved that economic intercourse led to foreign domination and cultural pollution" (Shirk 1994, 35–36). The SEZs allowed the reformers to get around reform opponents by exempting certain provinces from the central planning system althogether (Shirk 1994, 36). The SEZs have attracted considerable amounts of FDI. Throughout the 1990s, China was the world's second largest recipient of foreign direct investment and the vast majority of this investment, 84 percent, flowed to the SEZs. Firms based in Hong Kong account for 60 percent, while Taiwanese firms account for another 12 percent. The United States has also been a large participant, accounting for 10 percent of the total. Japan accounts for an additional five percent (Fu 2000, 122–123).

Partial trade liberalization was a second component of the open door policy. The government reduced the role of the plan in determining imports and exports and began shifting the authority to trade to individual enterprises. In 1978, only 12 state-owned companies, each of which had a monopoly on specific commodities, conducted all of China's foreign trade. By 2001, the government had authorized about 35,000 companies to engage in foreign trade (Lardy 2002, 41). While this number still represents only a small fraction of all companies in the Chinese economy, companies that are not authorized to trade directly with foreign companies can do so through one of the licensed firms (ibid. 41). In connection with the decentralization of foreign trade the government created a new trade regime. Prior to reform, tariffs played little role because imports and exports were determined by the plan. As the importance of plan-determined trade diminished, the government created an administrative system through which to regulate trade based on tariffs and an import licensing system. Initially the system was quite restrictive. The average tariff was 56 percent and almost half of all items needed a license to be imported. Over the next 15 years, however, the government gradually liberalized trade. Tariffs fell to an average rate of only 15.3 percent by 2001, still higher than the advanced industrialized countries but in line with a typical developing country, and the number of items for which a license was required fell to less than 4 percent (see Lardy 2002, 33–40). The currency was made convertible for current account transactions in the mid-nineties. In December 2002, China became a member of the WTO after almost 15 years of negotiations.

In a little more than 20 years, therefore, the Communist Party engineered a two-fold transition of the Chinese economy. It engineered a gradual and ongoing transition from a centrally planned economy to a market-oriented economy, and it engineered a transition from an inward looking, import-substitution-based development strategy to a strategy that is much more akin to the export oriented development strategies pursued in other Asian countries. Have these reforms transformed China into a market economy? By some indications, they have. If one looks at the mechanism through which prices are determined and commodities and resources allocated, for example, China has become a market economy. By 1999, prices for 95 percent of retail goods, and about 85 percent of agricultural commodities and producer goods, were set by market forces rather than state agencies (Lardy 2002, 25). As one specialist notes, "The primacy of market forces in determining the pricing and distribution of commodities [in China] is beyond dispute" (Rawski 1999, 3). Moreover, the partial liberalization of trade has forced domestic prices for most commodities to converge toward world prices. By other measures, however, China is not yet a market economy. State-owned enterprises continue to play a large role in the Chinese economy. While the government began privatizing small state-owned enterprises during the 1990s, progress has been slow. Nor do truly private enterprises, apart from foreign owned enterprises, play an important role in the Chinese economy. A market-based financial system has not yet been created, and consequently the government and state-owned banks continue to influence the amount and direction of investment.

In spite of their partial nature, reforms have contributed to remarkable economic growth. China has been one of the world's fastest growing economies since 1979. While the poor quality of the statistical data collected and reported by the Chinese government makes it difficult to generate accurate growth rates, estimates of China's growth rates put annual economic growth between 1979 and 1995 somewhere between 6 and 9.4 percent (Lardy 1992, 12). Consequently, per capita incomes have risen sharply over the last 20 years, doubling between 1979 and 1990, and then doubling again during the 1990s. In addition, between 1979 and 1998, China attracted a total of $265.6 billion of foreign direct investment, and rose to be the world's second largest recipient of foreign direct investment. By the end of the 1990s, the total accumulated stock of FDI in China represented one-third of the total stock of FDI in the developing world and was larger than the stock of FDI in Brazil or Mexico (Lardy 2002, 4). China's foreign trade has also expanded rapidly, growing from only $15 billion in 1977 to $475 billion in 2000. During the same period, China's share of total world trade grew faster than any other country, expanding from 0.6 percent in 1977 to 3.85 percent in 2000 (Lardy 2002, 55). China's economic boom appears to be losing steam, however, and further growth will require the Chinese government to adopt additional reforms, particularly in the state-owned enterprises (see e.g. Lardy 1998; Shen 2000).

The Political Logic of China's Economic Reforms

Market-oriented reform was in no sense inevitable in 1978, nor, once adopted, was its successful implementation immune from political and bureaucratic resistance. Instead, Hua Guofeng, who led China in the years immediately following Mao's death, adopted a very traditional approach to the economic crisis precipitated by the cultural revolution. Market reforms were adopted only after Deng displaced Hua from the head of the CCP. Deng's preference for market reform was apparently based on two considerations. Deng, and his supporters, recognized that correcting China's economic situation would require some sort of change (Solinger 1991), and Deng himself believed that market reforms held the greatest potential. Of equal importance, however, was Deng's recognition that promoting a platform based on market reforms made him an attractive alternative to Hua in the competition for the leadership of the CCP. Proposing market reform also enabled Deng to provide selective benefits to provincial politicians in exchange for their support for him and market reform. As Susan Shirk (1993, 37) notes, "In exchange for special economic treatment, local and ministry officials pledged political loyalty to Deng and his platform of economic reform." In short, Deng advocated market reforms because they were politically as well as economically advantageous.

Proposing reform and successfully implementing reform are two very different things, however. To implement market reforms, Deng had to overcome resistance

from conservatives within the CCP and from the ministries responsible for central planning. Deng did so by exploiting the structure of the Chinese political system. The Chinese political system and its system of central planning are both relatively decentralized. While the CCP retains exclusive control of political power throughout the country, and while the central government sits at the top of the political system, provincial governments enjoy considerable political authority. One way in which they do so is by their membership in the Central Committee of the Communist Party, which selects the Communist Party leadership. This power structure presented an opportunity to pursue a strategy that could mobilize provincial support for market reform, a strategy that has been named "playing to the provinces," without running into substantial resistance from the central government's bureaucracies that controlled heavy industries (Shirk 1993). Deng exploited this opportunity. The decision to begin market reform in the areas where local governments would benefit, such as rural agriculture, the encouragement of rural enterprises engaged in manufacturing, and SEZs, was a direct consequence of the constraints and opportunities within Chinese politics. In encouraging the growth of rural manufacturing enterprises, for example, Deng allowed local governments, who owned and managed these businesses, to sell a portion of their output at higher market prices and keep a large portion of the resulting profits. The initial success, which produced higher incomes for local government officials, created a strong material interest for these officials to support the reform program. In other words, Deng's strategy successfully mobilized political support among local governments for the consolidation and extension of reform.

Moreover, by focusing initially on agriculture and small and medium rural enterprises, Deng's reforms did not directly threaten the prerogatives of the ministries that controlled heavy industry. In fact, economic reform progressed only because the reformers were willing to make compromises that protected the government ministries that controlled heavy industry (Shirk 1993, 138). These ministries, whose very existence depended upon the continuation of the central planning system, openly opposed market reforms. Their support was acquired only through compromises that preserved the position of state-owned industries. The impact of this need to compromise is evident in the contemporary Chinese economy. State-owned enterprises continue to produce most of China's heavy industrial goods such as steel, machines, autos, and petroleum (Steinfeld 1998, 16). Heavy industries continued to attract a large share of investment funds, continued to expand, and continued to provide the majority of employment in the urban centers. In the mid-1990s, state-owned enterprises employed about 110 million workers, accounting for about two-thirds of urban employment (Lardy 1998, 26). Few were allowed to go bankrupt, even though many have become increasingly unprofitable; in 1996 the state-owned industries as a group posted a net loss (Steinfeld 1998, 18). The political strength of the heavy industry ministries ensured that Deng's market reforms did not come at the expense of state-owned industries.

Deng's reform strategy therefore represented a classic example of a successfully implemented gradual approach. On the one hand he created a large number of winners, people and government officials engaged in agriculture, in rural manufacturing, and in the SEZs. On the other hand, his willingness to compromise with the heavy industry ministries ensured that the introduction of market reforms would generate few

losers among those with political power sufficient to undermine reform (Qian 1999, 34). This is not to say that economic reform has not generated social strains. Economic liberalization has widened income inequalities between the state and private sectors, and it has weakened employment security in state-owned enterprises. In addition, the government has struggled with inflation throughout the last 20 years as it found it increasingly necessary to finance its expenditures with seignorage. In addition, corruption has become a widespread problem as state officials have taken advantage of their positions in the political and economic system to extract bribes and rents from economic activity. In 1989, these strains generated mass protests throughout the country and a student-led, pro-democracy movement that culminated in the brutal government crack down in Tiananmen Square in June 1989.

Many of the social strains that generated the 1989 protests have not yet been resolved, but continue to pose large challenges that, if not addressed rapidly, could provoke an even larger economic and political crisis (see e.g., Lardy 1998; Steinfeld 1998; *The Economist* 2002). The contemporary challenge originates in the poor financial condition of state-owned industries. As noted above, state-owned enterprises have not been profitable for many years. In addition, the government has required them to provide many social services, such as pensions, housing, education, and health care, that perhaps should be provided by the government. In addition, the government has been reluctant to allow the state firms to lay off workers because it is unwilling to accept substantially higher unemployment. Such costs make it difficult for the state-owned businesses to operate at a profit, and to cover their losses many have borrowed from the state-owned banks. The state-owned enterprises are unable to repay these loans, causing the number of nonperforming loans held by the state-owned banks to rise. The banks themselves are now, or are close to becoming, insolvent, pushing the Chinese financial system toward crisis. Thus, because it has delayed meaningful reforms in the state-owned sector, the CCP now faces a set of severe economic problems.

Addressing this challenge will not be easy. The government must allow state-owned enterprises to shut down. Closing state businesses, however, will raise unemployment, particularly in urban areas, and rising unemployment can in turn provoke social unrest that will threaten political stability. Signs of such unrest are already evident in parts of China. Labor protests erupted in March 2002 in Fushun, Liaoyang, and Daqing, in "one of the biggest outbreaks of labour unrest in well over a decade" (*The Economist* 2002, 13). A report by the Chinese Academy of Social Sciences suggests that unemployment could rise to more than 15 percent in the coming years, a development that "could lead to social turmoil" (*The Economist* 2002, 13). Only time will tell whether the Chinese government can successfully address these problems.

Conclusion

The last 15 years have brought far-reaching change to the former Socialist world. Governments in the former socialist countries have dismantled the state-run economies that characterized the socialist model and have begun the task of creating market economies. Most governments have dismantled high protectionist walls and started to integrate their countries into the global economy. Many have replaced authoritarian

political systems with democratic forms of government. While these changes are dramatic, we have seen that they have progressed at different speeds in different countries, and remain incomplete in many. Central and Eastern European countries have clearly made the greatest progress, and with their integration into the European Union the security of their transition will be assured. And while China has made great progress, it continues to confront large challenges. Moreover, it remains unclear whether the communist leaders can either implement or survive the necessary solutions. Many of the newly independent countries of the former Soviet Union have made little progress in the construction of market economies, and few have become liberal democracies. The ultimate fate of reform in these countries will likely be decided over the next few years.

While the experience of the socialist countries in the twentieth century was unique in many respects, it is also important to recognize how similar it was, in broad terms, to the experience of the developing countries. In both cases, governments determined to transform rural and poor societies into modern industrialized ones erected political and economic systems through which they extracted resources from agriculture and allocated them to heavy industry projects. In both cases, governments implemented this policy behind thick walls that insulated the national economy from the global economy and limited trade to goods deemed critical to industrialization. Moreover, in both cases, these policies created domestic industrial structures that were inefficient, uncompetitive in world markets, and imposed a persistent claim on state revenues and broader economic performance. And finally, in both instances it was the accumulated weight of poor economic performance that resulted from this development strategy that ultimately compelled national leaders to adopt market-oriented reforms. In other words, the differences between a command economy and a strategy of import substitution industrialization were of degree, rather than fundamental differences of kind. That is, the two systems differed in the degree of state control over economic activity, and in the degree of political oppression. Both, however, sought to use state power to promote rapid industrialization by shifting resources to heavy industry.

Key Terms

Acquis Communitaire
Association Agreements
Brezhnev Doctrine
Central Planning
Collectivization of Agriculture
Command Economy
Coordinating Committee (CoCom)
Enterprise Responsibility System
Extensive Growth
Glasnost
Household Responsibility System
Intensive Growth
Linkage Policy
Open Door Policy
Partial Reform
Perestroika
Shock Therapy
Special Economic Zone (SEZs)

Web Links

The World Bank maintains a website with information about the transition process in Eastern Europe and the former Soviet Union at *http://lnweb18.worldbank.org/eca/eca.nsf*.

Current information on the status of the accession of Eastern European countries to the EU can be found on the EU website at *http://europa.eu.int/pol/enlarg/index_en.htm*.

Suggestions for Further Reading

Perhaps the best economic history of the Soviet Union is Alec Nove, *An Economic History of the USSR 1917–1991*, 3rd edition (London: Penguin Books, 1992). A highly readable account of Eastern Europe's experience under socialism is Ivan T. Berend, *Central and Eastern Europe, 1944–1993: Detour from the Periphery to the Periphery* (Cambridge: Cambridge University Press, 1996). For a more theoretical discussion of the political economy of socialist system see Janos Kornai, *The Socialist System: The Political Economy of Communism* (Princeton: Princeton University Press, 1992).

For an overview of the politics and economics of transition in the former Soviet bloc, as well as the remaining challenges see the World Bank, *Transition: The First Ten Years* (Washington, D.C.: The World Bank 2002) and Anders Åslund, *Building Capitalism: The Transformation of the Former Soviet Bloc* (Cambridge: Cambridge University Press, 2002). Also valuable is The European Bank for Reconstruction and Development, *Transition Report*, (published annually).

On China's economic reforms see Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978–1993* (Cambridge: Cambridge University Press, 1995) and Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998). The most comprehensive account of the politics of reform in China is Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993).

GLOSSARY

Absolute Advantage The principle upon which Adam Smith first claimed that free trade benefits all countries. It holds that a country benefits from trade when it produces a particular good at a lower cost (in terms of labor input) than any other country. By specializing in the production and export of this good and importing goods in which its production costs are higher than other countries, the country can consume more of both goods. This principle was later replaced in trade theories by the principle of comparative advantage. (See comparative advantage, principle of.)

Accelerationist Principle A central component of monetarist theories and first stated by Milton Friedman in the 1960s, it claims that a government can keep unemployment below the natural rate of unemployment only if it is willing to accept a continually increasing rate of inflation. That is, it claims that there is no long run Phillips Curve tradeoff between inflation and unemployment. Such a tradeoff only exists in the short run. This principle became widely accepted by governments and central bankers in the advanced industrialized countries during the 1980s, leading to the demise of Keynesian strategies of macroeconomic management. (See Keynesianism; Phillips curve.)

Antidumping Government investigations to determine whether a foreign firm is selling its products in international markets at a price that is below its cost of production. Under the rules of the international trade system, a positive finding in such an investigation allows the government to impose tariffs to offset the margin of dumping. (See dumping.)

Association Agreements Agreements between East and Central European countries and the European Union following the collapse of the Soviet bloc in 1989. They removed barriers to trade in manufactured goods and established a framework for the progressive integration of East and West Europe.

Backward Linkages A term applied to the industrialization process that refers to instances when the creation of one domestic industry increases demand in domestic industries that supply inputs to this industry. For example, the creation of a domestic auto industry may increase the demand for domestic auto parts such as batteries, glass, tires, etc.

Baker Plan Proposed in 1985 by the secretary of the U.S. Treasury James A. Baker III, this plan attempted to resolve the developing country debt crisis through a combination of economic adjustment and additional lending. Of particular significance, this plan linked access to financial assistance from the IMF, World Bank, and private lenders to the willingness of debtor governments to adopt structural adjustment programs.

Balance of Payments Adjustment Using government policies to correct a balance of payments deficit or surplus.

Balance of Payments An accounting device that records a country's international transactions. The balance of payments is divided into two broad categories: the current account and the capital account.

Brady Plan Proposed in 1989 by the secretary of the U.S. Treasury Nicholas J. Brady, this plan attempted to bring the developing country debt crisis to a close. It encouraged commercial banks to negotiate debt reduction agreements with debtor governments. To make the proposal attractive to commercial banks, the advanced industrialized countries and the multilateral financial institutions advanced $30 billion with which to guarantee the principal of the Brady Bonds, as the new debt instruments came to be called.

Bretton Woods System The international monetary system that was created in 1944 at Bretton Woods, New Hampshire. It was based on fixed-but-adjustable exchange rates in an attempt to provide a stable international monetary system and at the same time allow governments to use monetary policy to manage the domestic economy. The system collapsed in 1973. It is thus the last time that governments attempted to create and maintain an international monetary system based on some form of fixed exchange rates.

Calvo Doctrine Named after the Argentinean legal scholar Carlos Calvo, who first stated it in 1868, this doctrine argues that no government has the right to intervene in another country to enforce its citizens' private claims. The doctrine was invoked by Latin American governments during the late nineteenth and early twentieth century to challenge the right of governments to use diplomatic pressure and military force to protect foreign investments made by their citizens.

Capital Account One of the two principle components of the balance of payments, it records all financial flows into and out of a particular country. Such financial flows include bank loans, equities (stocks and bonds), and foreign direct investment.

Central Bank Independence The degree to which a country's central bank can set monetary policy free from interference by the government. Typically considered to be a function of three things: the degree to which the central bank is free to decide what economic objective to pursue, the degree to which the central bank is free to decide how to set monetary policy in pursuit of this objective, and the degree to which central bank decisions can be reversed by other branches of government. Contemporary economic theory argues that independent central banks are better able to deliver low inflation than are central banks controlled by the government.

Central Planning The mechanism used by command economies to determine all aspects of the country's economic production. Typically, a central planning commission would develop a Five Year Plan establishing medium-term economic objectives that was then broken down into annual, quarterly, and monthly plans. Plans specified exactly what each enterprise in the economy was to produce, how much it was to produce, from whom it would acquire the inputs necessary to produce these goods, and to whom it was required to deliver its output. The inherent difficulty of central planning was an important contributing factor to economic decline in and eventual collapse of the socialist countries.

Collective Action Problem Applies to instances where the action of a number of individuals is required to achieve a common goal. It states that people will not voluntarily invest time, energy, or money to achieve a common goal, but will instead allow others to bear these costs. Because all members of the group act in the same way, insufficient time, energy, and money are dedicated to the achievement of the goal, and the goal is therefore not achieved. In international political economy, it has been used to understand interest group formation, and in particular, why consumer interests are under-represented in trade policy.

Command Economy An economic system in which the state makes most decisions about the allocation of resources and the production and distribution of goods. The Soviet Union was the world's first command economy, but the Soviet model was extended into Eastern and Central Europe following World War II. The extreme emphasis on state involvement that characterizes this system reflected a desire to achieve very rapid industrialization.

Common Agricultural Policy (CAP) A set of policies used by the European Union to protect European farmers from farm products produced outside the EU. These policies include production and export subsidies to support European farmers, and tariffs and quotas to limit imports of foreign agricultural products. The CAP is one of the most controversial aspects of the U.S.-EU trade relationship.

Comparative Advantage First fully stated by David Ricardo in the early nineteenth century, it states that a country has a comparative advantage in a good if it can produce that good more cheaply than it can produce other goods. By specializing in the production of goods in

which it holds a comparative advantage and importing the other goods, the country can consume more of all goods. In contrast to Adam Smith, therefore, this principle states that a country need not have an absolute advantage in any good to benefit from trade. This principle provides a powerful justification for liberal international trade by stating that all countries benefit from such trade.

Conditionality Applied to the terms governing transactions between the International Monetary Fund and member governments. In order to gain access to IMF financial resources, a government must agree to a set of policy changes designed to correct their balance of payments deficit. Typically, governments must tighten the money supply and reduce government spending. In more extreme cases, governments are also required to undertake structural reforms. (See macroeconomic stabilization; structural adjustment.)

Coordinating Committee (CoCom) Created by the United States and Western European countries in 1949 in order to coordinate national restrictions on exports to Soviet bloc countries. CoCom members compiled a common list of goods that all agreed to not export to the socialist countries.

Countervailing Duty Investigation A government investigation used to determine whether a foreign government is subsidizing its national firms' exports directly or indirectly. Under the rules of the international trade system, a positive finding in such an investigation allows the government to impose tariffs to offset the subsidy.

Current Account One of the two principal components of the balance of payments. It records all payments between the country in the rest of the world in connection with goods, services, income earned on foreign investments, royalties, and licenses, unilateral transfers by private individuals, and government expenditures on foreign aid and overseas military spending international transactions.

Customs Union A form of regional trading arrangement in which member governments eliminate all tariffs on trade between members of the union and create a common tariff that is imposed on goods entering all members of the union from countries outside the union.

Debt Service Capacity Refers to the ability of a country to make payments of interest and principal on foreign debt. Because debt service, especially in developing countries, must be made with foreign currencies, export earnings are a good measure of a country's debt service capacity.

Debt-Service Ratio Expresses the percentage of a country's export earnings that must be devoted to payments of interest and principal on foreign debt. A large debt-service ratio means that a large share of the country's total export revenues must be used to make debt payments.

Devaluation A reduction in a currency's value within a fixed or fixed-but-adjustable exchange rate system. Should be distinguished from a depreciation, which is a change in a currency's value caused by foreign exchange market transactions. Thus, a floating currency may depreciate, but cannot be devalued.

Dispute Settlement Mechanism A quasi-judicial tribunal that is used to resolve trade disputes between WTO member governments.

Domestic Safeguards Clauses in the GATT that allow governments to temporarily suspend tariff reductions they have made previously when a domestic industry is being threatened by a sudden surge of imports.

Dumping The act of selling a good in a foreign market at a price that is either below the cost of production or below the price at which the good sells for in the home market. Dumping is illegal under GATT rules, and governments are allowed to counter this practice by raising tariffs. (See antidumping investigation.)

East Asian Model A model in which economic development is conceptualized as a series of distinct stages of industrialization. In the first stage, industrial policy promotes labor-intensive

light industry, such as textiles and other consumer durables. In the second stage, the emphasis of industrial policy shifts to heavy industries such as steel, shipbuilding, petrochemicals, and synthetic fibers. In the third stage, governments target skill and research and development intensive consumer durables and industrial machinery, such as machine tools, semiconductors, computers, telecommunications equipment, robotics, and biotechnology. Governments design policies and organizations to promote the transition from one stage to the other.

Economies of Scale Occur when the unit cost of producing a good falls as the number of goods produced increases. Economies of scale often arise from the knowledge acquired in production. The existence of economies of scale in certain industries can provide a justification for welfare-enhancing industrial policy, and provides the rationale for strategic trade theory.

Enforcement Problem In the anarchic international state system governments cannot be certain that other governments will comply with the trade agreements that they conclude. As a consequence, governments are reluctant to enter into such agreements. This problem complicates all forms of international cooperation, and has been used to understand the need for the World Trade Organization.

Engel's Law Holds that people spend smaller percentages of their total income on food and other primary commodities as their incomes rise. It was a central component of the Singer-Prebisch theory that formed a part of structuralism.

Enterprise Responsibility System Chinese economic reform introduced in 1984 under which state enterprises gained the authority to manage themselves like firms in a market economy. They were given greater freedom to acquire their inputs through the market and to sell their output in the market rather than to state agencies. In addition, state subsidies were reduced and enterprises were required to rely on bank loans for their working capital.

Eurodollars Literally, dollar-denominated bank accounts and loans managed by banks outside of the United States. More broadly, the term refers to bank accounts denominated in currencies other than the currency issued by the government in the country in which the account is held.

European Monetary System (EMS) Established by European Community governments in 1979, the EMS was a fixed-but-adjustable exchange rate system in which governments established a central parity against a basket of EU currencies called the European Currency Unit (ECU). Central parities against the ECU were then used to create bilateral exchange rates between all EU currencies. EU governments were required to maintain their currency's bilateral exchange rate within 2.25 percent of its central bilateral rate. In January 1999, monetary union replaced the EMS.

Exchange Rate System A set of rules that specify the amount by which currencies can appreciate and depreciate in the foreign exchange market. Under a fixed exchange rate system, the rules require governments to restrict currency movements to a narrow range around some central rate. In a floating exchange rate system, governments can allow their currencies to move by as much as they desire.

Exchange Restrictions Government regulations governing the private use of foreign exchange. Used extensively by governments in the advanced industrialized countries under the Bretton Woods system to limit capital outflows.

Exon-Florio Amendment An amendment to the United States 1988 Omnibus Trade Act, it allows the executive to block foreign acquisitions of American firms for reasons of national security. More broadly, it highlights government concerns about the role foreign corporations play in the domestic economy.

Export Processing Zones Industrial estates where the government provides land, utilities, transportation infrastructure, and in some cases buildings to the investing firms, usually at subsidized rates. They are often established by developing countries to attract foreign direct investments by MNCs.

Export-oriented Strategy A development strategy in which emphasis is placed on producing manufactured goods that can be sold in international markets. Adopted by the East Asian NICs in the late 1950s to early 1960s after the gains from easy ISI had been exhausted. During the late 1980s, this strategy, and the apparent Asian success based on this strategy, provided the foundation for the "Washington Consensus."

Extensive Growth Economic growth generated by an increase in the amount of labor, physical capital, and inputs involved in industrial activity. Growth occurs because more factors and more inputs are being used, rather than because factors and inputs are being used more productively. The rapid rates of economic growth in the Soviet Union during the 1930s and 1950s, and in Central and Eastern Europe after World War II, were largely a product of extensive growth. Growth in the region declined after 1960 because its physical limits made it impossible to continuously increase the number of workers, inputs, and physical capital engaged in industrial activity. (See also intensive growth.)

Factors The basic tools of production, they include labor, land, and capital.

Factor Endowments The amount of land, labor, and capital a country has available. Countries have different relative factor endowments, and in the Hecksher-Ohlin model of international trade, these differences are the source of comparative advantage.

Factor Mobility The ease with which factors of production can move from one industry to another. All factors are mobile in the long run, but many are relatively immobile in the short run. Different assumptions about the mobility of factors underlie two different political theories of trade politics. The factor model assumes a high degree of factor mobility, while the specific factors model assumes that at least one factor is immobile in the short run.

Factor Model A political model that argues that the politics of trade policy is characterized by competition between labor and capital. Each group has a distinct trade policy preference because international trade has a differential effect on their incomes. The scarce factor will be harmed by trade and therefore lobby for protection. The abundant factor will benefit from trade and therefore lobby for trade liberalization.

Factor Price Equalization (Stolper-Samuleson Theorem) International trade will cause the price of the factors of production in open economies to equalize. In a two-country world, the price of each country's scarce factor will fall, while the price of each country's abundant factors will rise. Eventually, the price of labor will be the same in both countries and the price of capital will be the same in both countries.

Fast Track The domestic political process setting the terms under which the United States participates in international trade negotiations and ratifies the resulting agreements. Congress first grants the executive the authority to negotiate international trade agreements. Congress must then approve (by simple majority and within 90 days) any trade agreement the executive concludes before the agreement can become law. Congress cannot amend the trade agreement. The 1974 Trade Act first instituted this procedure.

Fiscal Policy The use by the government of tax and spending policies to manage domestic demand. An expansionary fiscal policy will boost domestic demand, thereby raising economic output; a restrictive fiscal policy will reduce domestic demand, thereby lowering economic output.

Fixed Exchange Rate System A system in which governments establish a central or official rate for their currency, usually expressed in terms of some standard such as gold or another currency. Governments are required to use monetary policy and foreign exchange market intervention to maintain their currency within a band around this official rate.

Fixed-but-adjustable Exchange Rate System A system in which governments establish a central or official rate for their currency against some standard, as in a fixed exchange rate system, but are also allowed to change this official rate occasionally, usually under a set of well-defined circumstances.

Floating Exchange Rate System A system in which governments do not establish a central or official rate for their currency, and are under no obligation to engage in foreign exchange market intervention to influence the value of their currency. The value of one currency in terms of another is determined purely by the interaction between supply and demand in the foreign exchange market.

Foreign Aid (Official Development Assistance) Financial assistance provided to developing countries' governments by the advanced industrialized countries and by multilateral financial institutions such as the World Bank and the regional development banks in order to finance development projects. Foreign aid can be supplied as a grant (no repayment) or a loan (repayment). Loans can be offered on concessional (below market rates of interest) or nonconcessional (market rates of interest) terms.

Foreign Direct Investment A form of cross-border investment in which a resident or corporation based in one country owns a productive asset located in a second country. In most instances, such investments involve multinational corporations. Such investments can involve the construction of a new or the purchase of an existing plant or factory.

Foreign Exchange Market The market in which national currencies are traded. It is through transactions in this market that the market exchange rates of the world's currencies are established. According to the Bank of International Settlements, more than $1 trillion worth of currencies are traded each day.

Foreign Exchange Reserves Government holdings of other countries' currencies.

Free Trade Area A regional trading arrangement in which governments eliminate all tariffs on goods imported from other members, but retain independent tariffs on goods imported from nonmembers. (See also customs union and regional trade arrangements.)

GATT Part IV Added to the GATT in 1964 in part as a result of developing countries' pressure, it contains three articles that focus on developing countries' trade problems. These three articles called upon the advanced industrialized countries to improve market access for commodity exporters, to refrain from raising barriers to the import of products of special interest to the developing world, and to engage in "joint action to promote trade and development."

General Agreement on Tariffs and Trade (GATT) An international agreement concluded in 1947 establishing rules that regulate national trade policies. Between 1947 and 1995, the GATT also was the principle international trade organization, providing a forum for trade negotiations, administering trade agreements, helping governments settle trade disputes, and reviewing national trade policies. In 1995 this latter role was taken over by the World Trade Organization. Today, the GATT continues to provide the core rules regulating national trade policies.

Generalized System of Preferences (GSP) Part of the GATT concluded in the late 1960s under which advanced industrialized countries can allow manufactured exports from developing countries to enter their markets at preferential tariff rates. The GSP is therefore a legal exception to the GATT principle of nondiscrimination.

Global Division of Labor One of the economic consequences of an open international trade system. Over time, trade will cause countries to specialize in producing goods that make intensive use of their abundant factors of production. Eventually, each country will produce goods in which it has a comparative advantage and shed industries in which it has a comparative disadvantage.

Group of 77 A coalition of developing countries established at the conclusion of the first UNCTAD conference in the early 1960s. Seventy-seven developing countries' governments signed a Joint Declaration that called for reform of the international trade system. The Group of 77 subsequently led the campaign for reform of the multilateral trade system during the next twenty years. (See UNCTAD and NIEO.)

Haberler Report A study conducted under GATT supervision in the late 1950s, it suggested that the GATT-based trade system was relatively unfavorable to developing countries. The report altered the political dynamics of the international trade system by forcing the advanced industrialized countries to take the demands for reform made by developing countries more seriously.

Hecksher-Ohlin Model A model of the determinants of comparative advantage, it argues that comparative advantage arises from cross-national differences in factor endowments. A country's comparative advantage will lie in goods produced through heavy reliance on its abundant factors. Capital abundant countries have a comparative advantage in capital-intensive goods and labor abundant countries have a comparative advantage in labor-intensive goods. (See factor endowments.)

Hegemony A particular distribution of power in the international state system characterized by the existence of one country (a hegemon) whose power capabilities are substantially greater than the next most powerful country or countries. The relevant power capabilities include economic power, measured as the size and technological sophistication of the economy and military power. A prominent hypothesis, called hegemonic stability theory, links the openness and stability of the international economic system to the presence or absence of a hegemon.

Heterodox Strategies An approach to macroeconomic stabilization adopted by some Latin American governments during the 1980s. Seen as an alternative to the orthodox approach to advocate by the IMF, this strategy attempted to reduce inflation with government controls on wages and prices rather than by restricting aggregate demand by reducing government budget deficits and slowing the rate of growth of the money supply. In most instances, they failed to stabilize the economy.

Horizontal Integration A form of industrial organization that occurs when a corporation creates multiple production facilities, each of which produces the same good or goods. Many MNCs are horizontally integrated firms, producing the same product or product line in multiple factories based in different countries. Firms integrate horizontally to capture the full value of the intangible assets they control.

Household Responsibility System The first stage of China's economic reforms launched in 1979. Under this program, individual farming households were encouraged to lease farmland from their agricultural commune. Each household that did so was required to sell a portion of its harvest to the state at state-set prices. The remainder could be sold in markets at market prices and households could retain the profits. Represented the first step toward marketizing the Chinese economy.

Import Substitution Industrialization An economic development strategy adopted in many developing countries after World War II in which states attempted to industrialize by substituting domestically produced goods for manufactured items that had previously been imported. The strategy proceeded in two stages. Under easy ISI the focus was on creating simple consumer goods. In the second stage, the focus shifted to consumer durable goods, intermediate inputs, and the capital goods that are needed to produce consumer durables. Most governments have abandoned this approach since the mid-1980s in favor of an export-oriented strategy.

Industrial Policy An assortment of government policies including tax policy, government subsidies, traditional protectionism, and government procurement practices used to channel resources away from some actors and industries and directs them toward those actors and industries that the government wishes to promote. The use of such policies is typically based on long-term economic development objectives defined in terms of boosting economic growth, improving productivity, and enhancing international competitiveness. The specific goals often are determined by explicit comparisons to other countries' economic achievements.

Infant Industry Case for Protection A theoretical justification for protection that applies to cases in which a country's newly created firms (infants) could not *initially* compete against foreign producers in an established industry, but would be able to do so eventually if they were given time to mature.

Intangible Asset Something whose value is derived from knowledge or from "a set of skills or repertory routines possessed by the firm's team of human (and other) inputs." An intangible asset can be based on a patented process or design, or it can arise from "know-how shared among employees of the firm." The inherent difficulty of selling or licensing these assets provides an important rationale for horizontal integration.

Intellectual Property Creations of the mind such as inventions, literary and artistic works, as well as symbols, names, images, and designs used in commerce. The protection of intellectual property is the subject of the Trade Related Intellectual Property Rights agreement negotiated as part of the Uruguay Round.

Intensive Growth Economic growth generated by productivity improvements. It was the inability of the command economies to achieve intensive growth that many see as the root cause of the collapse of these economies in the late 1980s. (See extensive growth.)

International Bank for Reconstruction and Development (IBRD or World Bank) Established in 1944 at the Bretton Woods conference, the IBRD extends long-term loans to developing countries to finance the creation of "the physical and social infrastructure necessary for poverty reduction and sustainable development." These loans are financed by bonds that the IBRD sells in private bond markets.

International Development Association (IDA) Part of the World Bank group, the IDA was established in the early 1960s as a separate development lending agency. The IDA is a concessional loan agency; its loans have a longer maturity than standard IBRD loans, and carry 0 percent interest rates. These loans are financed by member government contributions. To be eligible for IDA lending, a country must have a per capita income of less than $885 per year.

International Monetary Fund (IMF) Established at the Bretton Woods conference in 1944, the IMF was initially charged with helping governments finance and ultimately eliminate balance of payments deficits in order to maintain stable exchange rates. Since the shift to floating exchange rates in 1973, the IMF has become increasingly focused on the management of debt and balance of payments crises in developing countries. (See conditionality.)

Keynesianism An approach to macroeconomic policy that places primary emphasis on using fiscal and monetary policies to manage domestic demand in order to maintain full employment. Named after John Maynard Keynes who was the first to demonstrate that governments could use macroeconomic policies for this purpose. This approach was widely adopted by governments in the advanced industrialized countries following World War II, but lost favor during the 1980s.

Locational Incentives Concessions offered by governments to MNCs that are designed to reduce the costs of and thereby increase the return from a particular investment. Governments offer them to induce MNCs to invest in their country rather than another.

London Club A private association established and run by the large commercial banks engaged in international lending. Developing countries' governments that want to reschedule their commercial bank debt must work out the terms of a rescheduling agreement with the London Club.

Macroeconomic Policy The use of fiscal policy and monetary policy to influence aggregate economic activity in the national economy, such as the rate of economic growth, the rate of inflation, and the level of unemployment. (See Keynesianism.)

Macroeconomic Stabilization Policy programs designed to correct macroeconomic imbalances that are producing high and rising inflation. Most programs involve the reduction of a

government budget deficit and a tight monetary policy. Most conditionality agreements with the IMF contain such a program.

Managed Float A form of floating exchange rate system in which governments occasionally intervene in foreign exchange markets to try to influence the value of their currency. Such interventions are voluntary and sometimes involve coordinated intervention by more than one country.

Maquiladora Program An export processing zone in northern Mexico established by the Mexican government in an attempt to encourage American manufacturing MNCs to create assembly operations.

Monetary Policy Changes in the country's money supply undertaken in an attempt to manage aggregate economic activity. An expansionary monetary policy is typically associated with rising inflation while a restrictive monetary policy is typically associated with falling inflation and rising unemployment.

Monetary Union An exchange rate system in which governments permanently fix their exchange rates and introduce a single currency. The European Union created a monetary union on January 1, 1999, and introduced the single currency, the euro, on January 1, 2002.

Moral Hazard Arises when banks believe that the government will bail them out if they suffer large losses on the loans they have made. If banks believe that the government will cover their losses, they have little incentive to carefully evaluate the risks that are associated with the loans they make. If the loans are repaid, banks earn money. If the loans are not repaid, the government, and society's taxpayers, pick up the tab. In such an environment, banks have an incentive to make riskier loans than they would make in the absence of a guarantee from the government, thereby raising the likelihood of a crisis.

Most Favored Nation The central principle upon which the WTO is based, this rule requires that any advantage extended by one WTO member government to another WTO member also be extended to all other WTO members. The principle therefore prevents trade measures that discriminate between countries.

Multilateral Agreement on Investment (MAI) A document negotiated by the advanced industrialized countries in the OECD between 1995 and 1997 that laid out international rules governing the treatment of MNCs by governments. Was designed to promote investment liberalization based on the principles of national treatment and most favored nation. Negotiations proved fruitless, however, and the MAI was never concluded.

Multinational Corporation (MNC) An "enterprise that controls and manages production establishments—plants—in at least two countries." There are approximately 63,459 parent firms that together own a total of 689,520 foreign affiliates. These parent firms and their foreign affiliates account for about 25 percent of the world's economic production and employ some 86 million people worldwide.

Natural Rate of Unemployment The economy's long-run equilibrium rate of unemployment, or the rate of unemployment to which the economy will return after a recession or a boom. The natural rate of unemployment is never zero, and can in fact be substantially above zero.

New International Economic Order (NIEO) A reform effort driven by the Group of 77 and adopted by the UN General Assembly in December 1974. It embodied a set of reform objectives that, if implemented, would have radically altered the nature and the operation of the international economy by creating "development friendly" trade rules and giving developing countries a larger role in the decision-making processes of the World Bank and International Monetary Fund. The NIEO was abandoned in the early 1980s.

Nontariff Barrier (NTB) Any of a number of policy or structural impediments to trade other than tariffs. They include such things as health and safety regulations, government purchasing practices, and retail and distribution networks. As quotas have been eliminated and tariffs reduced, NTBs have become one of the most important remaining obstacles to international trade and have thus become an increasingly important issue in the WTO.

Nontraded Goods Sector All economic activities that do not enter into international trade, either because the good is too costly to transport, like houses or concrete, or because in some cases the good or service must be performed locally, such as the railway system, many public utilities, health care, auto repair, and the retail sector more generally. In addition, government employees, such as civil servants, teachers, and military personnel also work in the nontraded goods sector.

Official Development Assistance See foreign aid.

Paris Club An informal group composed of 19 permanent members, all of which are governments that hold large claims on other governments. Its primary role is to negotiate the rescheduling of these debts.

Performance Requirement A target imposed on the local affiliate of an MNC by the host country government in order to promote a specific economic objective. If the government is trying to promote backward linkages, for example, it will require the local affiliate to purchase a specific percentage of its inputs from domestic suppliers. The use of these measures was somewhat constrained by the agreement on Trade Related Investment Measures negotiated during the Uruguay Round.

Phillips Curve Posits a tradeoff between inflation and unemployment. Governments can reduce unemployment only by causing higher inflation and can reduce inflation only by causing higher unemployment. Named after British economist A.W. Phillips, who was the first to posit such a relationship in 1958. The tradeoff between inflation and unemployment is now seen to hold only in the short run. (See accelerationist principle.)

Plaza Accord An agreement reached in September 1985 under which the Group of Five agreed to reduce the value of the dollar against the Japanese yen and the German mark by 10 to 12 percent. This agreement is the most recent episode of a concerted attempt by the Group of Five to manage exchange rates.

Price Stability Now commonly considered by governments to be the appropriate objective for monetary policy, it connotes a low and stable rate of inflation—about 1–2 percent per year.

Prisoners' Dilemma A game theoretic model often used to depict the difficulties that governments face when trying to cooperate in the global economy. Emphasizes the incentives that governments have to "cheat" on any international agreements that they enter and shows how this incentive makes governments reluctant to enter into cooperative agreements.

Reciprocal Trade Agreements Act American trade legislation passed in 1934 under which Congress allowed the executive to reduce tariffs by as much as 50 percent in exchange for equivalent concessions from foreign governments. Created the institutional framework for reciprocal tariff reductions achieved under the GATT following World War II.

Reciprocity The central principle upon which bargaining within the WTO is based. The concessions that each government makes to its partners in multilateral trade negotiations are roughly the same size as the concessions it gains from its trading partners.

Regional Development Banks Created in the 1960s to provide concessional lending on the model of the International Development Association. They include the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank.

Regional Trading Arrangements (RTAs) Trade agreements in which tariffs discriminate between members and nonmembers. While inherently discriminatory, RTAs are recognized as a legitimate exception to this principle under GATT Article XXIV. Sometimes called preferential trade arrangements. (See also customs union and free trade area.)

Rent A higher than normal return on an investment. Rents are created by barriers to entry, which can result from monopolistic or oligopolistic market structures or government policies.

Rent Seeking Efforts by private actors to convince politicians to enact policies that create rents that they can capture. (See rent.)

Service An economic activity that does not involve manufacturing, farming, or resource extraction, such as financial services, transportation, consulting and accounting, and telecommunications.

Shock Therapy A strategy for transitioning from a command economy to a market economy in which most of the components of a market economy were introduced as quickly as possible. Within a year or two governments would create a stable macroeconomic environment liberalize domestic prices eliminate subsidies to enterprises and open the country to trade, and remove restrictions on private enterprise.

Singer-Prebisch Theory Developed during the 1950s by Raul Prebisch and Hans Singer, it claimed that because developing countries faced a secular decline in their terms of trade participation in the GATT-based multilateral trade system would hamper industrialization. It provided an intellectual justification for import substitution industrialization.

Smoot-Hawley Act Trade legislation passed by the U.S. Congress in 1930 that raised the average American tariff to an historic high of almost 60 percent. Widely regarded to have contributed to the collapse of the world trade and monetary systems and deepening the global depression during the 1930s.

Special Economic Zone (SEZs) Specific regions of China within which economic activity is allowed to take place under more market-oriented conditions than are possible in other parts of China. Firms operating in these regions receive lower tariff rates on capital and input imports, a relatively free labor market, private ownership, and lower tax rates than in other areas of China.

Specific Factors Model A political model that argues that the politics of trade policy is characterized by competition between import competing and export-oriented industries. Each industry has a distinct trade policy preference because international trade has a differential effect on their incomes. Industries that rely heavily on the economy's scarce factor will be harmed by trade and therefore lobby for protection. Industries that rely heavily on the economy's abundant factor will benefit from trade and therefore lobby for trade liberalization.

Speculative Attack Very large sales of one country's currency by private financial institutions sparked by the belief that the government is about to devalue the currency. The huge volume of currency sales in recent speculative attacks has led some officials to conclude that fixed-but-adjustable exchange rates are no longer a viable policy option. Instead, governments must choose between a permanently fixed exchange rate and a floating exchange rate.

Sterilized Intervention Foreign exchange market intervention that is not allowed to have an impact on the country's money supply. If a government sells foreign exchange to buy its own currency, thereby reducing the money supply, it will then buy government securities, thereby expanding the money supply. If a government sells its own currency and buys foreign currencies, thereby expanding its money supply, it will then sell government securities and buy its own currency, thereby reducing the money supply.

Stolper-Samuleson Theorem See factor price equalization.

Strategic Trade Theory Expands on the infant-industry case for protection, by asserting that government intervention can help domestic firms gain international competitiveness in high-technology industries by helping them overcome the competitive advantages enjoyed by established firms. It also suggests that governments can use trade policy to compete for valued industries. (See Infant Industry Case for Protection.)

Structural Adjustment Policy reforms designed and promoted by the World Bank and IMF that seek to increase the role of the market and reduce the role of the state in developing countries' economies. First emerged in connection with the Baker Plan, but have subsequently become a standard component of IMF conditionality agreements.

Structuralism A body of development economics that dominated the field in the early postwar period. It held that the shift of resources from agriculture to manufacturing associated with industrialization would occur only if the state adopted policies explicitly designed to bring it about. It provided the intellectual and theoretical justification for a large role for the state in the development process and for import substitution industrialization.

Syndicated Loan A loan in which hundreds of commercial banks each take a small share of a large loan to a single borrower. This allows commercial banks to spread the risk involved in large loans among a number of banks rather than requiring one bank to bear the full risk that the borrowing country will default.

Target Zone An exchange rate system in which all currencies have an official rate surrounded by very wide margins within which the exchange rate is allowed to fluctuate. When a currency moves outside the margins, the government would be obligated to intervene in the foreign exchange market or alter domestic interest rates in order to bring it back inside. Such a system was discussed in connection with the Plaza Accord, but never implemented.

Tariff Escalation The practice of imposing higher tariffs on goods containing more processing. The practice, common in the advanced industrialized countries, makes it difficult for developing countries to export processed food to the industrialized countries. This in turn makes it difficult for developing countries to diversify their exports away from commodities while still capitalizing on their comparative advantage.

Tariff Peaks Tariff rates above 15 percent. Such tariff peaks apply to about 5 percent of the advanced industrialized countries' imports from all developing countries, and to about 10 percent of their imports from the least developed countries.

Tariffs Taxes that governments impose on foreign goods coming into the country. This tax raises the price of the foreign good in the domestic market of the country imposing the tariff. While tariffs distort international trade, they are the least distortionary of all trade barriers.

Terms of Trade The ratio of the price of a country's exports to the price of its imports. An improvement in a country's terms of trade means that the price of the goods it exports is rising relative to the price of the goods it imports, while a decline in a country's terms of trade means that the price of the goods it exports is falling relative to the price of the goods it imports. An improvement in its terms of trade makes a country richer while a decline in its terms of trade makes it poorer.

Tobin Tax A small tax on foreign exchange market transactions that would be high enough to discourage short-term capital flows, but not high enough to discourage long-term capital flows or international trade. By discouraging short-term capital flows, countries would gain a degree of macroeconomic policy autonomy.

Trade Openness A standard measure of the degree to which a particular country is integrated into the world trading system. Openness is typically measured by dividing a country's total trade (its imports plus its exports) by its gross domestic product.

Trade Related Investment Measure (TRIMs) A government policy toward foreign direct investment or MNCs that has an impact on the country's imports or exports. For example, domestic content or trade balancing requirements force firms to import fewer inputs or export more output than it would in the absence of such regulations. The result would be a distortion of international trade. Such measures are regulated under the WTO.

Unholy Trinity Highlights the tradeoffs that governments face when making decisions about fixed exchange rates, monetary policy, and international capital flows. Governments have three policy goals, each of which is desirable in its own right: (1) maintaining a fixed exchange rate, (2) having the ability to use monetary policy to manage the domestic economy, which we will refer to as monetary policy autonomy, and (3) allowing financial capital to flow freely into and out of the domestic financial system, or capital mobility for short. The unholy trinity states that any government can achieve only two of these three goals simultaneously.

United Nations Conference on Trade and Development (UNCTAD) First established in March 1964 in response to developing countries' dissatisfaction with the GATT, it is a permanent UN body dedicated to promoting the developing countries' interests in the world trade system.

United Nations Resolution on Permanent Sovereignty over Natural Resources Adopted by the UN General Assembly in 1962, it recognizes the right of host countries to exercise full control over their natural resources and over the foreign firms operating within their borders extracting these resources. It affirmed the right of host country governments to expropriate foreign investments and to determine the appropriate compensation in the event of expropriation.

United States Trade Representative Established by Congress in the 1962 Trade Expansion Act as the Special Trade Representative and given its current name by Congress during the 1970s, it sets and administers U.S. trade policy, is the nation's chief trade negotiator, and represents the United States in the WTO and other international trade organizations.

Vertical Integration A form of industrial organization in which a single firm will control the different stages of the production process rather than rely on the market to acquire inputs and sell outputs. A single corporation, for example, might own oil wells, the oil pipeline, the oil refinery, and a chain of gas stations. Difficulties associated with long-term contracting create incentives for vertical integration.

Voluntary Export Restraints A form of protectionism under which one country (or a number of countries) agrees to limit its exports to the other country's market. Adopted by governments in order to circumvent GATT restrictions on the use of other types of protectionism such as tariffs and quotas.

Washington Consensus, The The collection of policy reforms advocated by U.S. officials and by the IMF and World Bank staffs as the solution to the economic problems faced by developing countries. The emphasis was on stabilization, structural adjustment, privatization, and market liberalization.

World Bank See International Bank for Reconstruction and Development.

World Trade Organization The principle international trade organization that began operation in 1995. Located in Geneva, Switzerland, the WTO is a relatively small international organization whose role includes administering trade agreements, providing a forum for trade negotiations, helping governments settle trade disputes, and reviewing national trade policies.

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