Global Political Economy

Understanding the International Economic Order

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WITH THE ASSISTANCE OF Jean M. Gilpin

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CHAPTER TWO

The Nature of Political Economy

THE STUDY of political economy is now very much in vogue among historians, economists, and social scientists.[1] This interest reflects a growing appreciation that the worlds of politics and economics, once thought to be separate (at least as fields of academic inquiry), do in fact importantly affect one another. The polity is much more influenced by economic developments than many political scientists have appreciated, and the economy is much more dependent upon social and political developments than economists in general have admitted. Recognition of the interrelationships between the two spheres has led to increased attention from historians and social scientists. I shall explore the nature of political economy and contrast it with economics before turning to the subject of international political economy itself.

During the last two centuries several different definitions of the term "political economy" have been set forth.[2] A brief summary of the changes in those definitions provides insight into the nature of the subject.[3] For Adam Smith in *The Wealth of Nations* (1776), political economy was a "branch of the science of a statesman or legislator" and a guide to the prudent management of the national economy, or as John Stuart Mill, the last major classical economist, commented, political economy was the science that teaches a nation how to become rich. These thinkers emphasized the wealth of *nations*, and the term "political" was as significant as the term "economy."

In the late nineteenth century, this broad definition of what economists study was narrowed considerably. Alfred Marshall, the father of modern economics, turned his back on the earlier emphasis on the

[1] The references to economists discussed in this section draw from the review of the varieties of political economy in David K. Whynes, ed., *What Is Political Economy?: Eight Perspectives* (Oxford: Basil Blackwell, 1984).

[2] An analysis of various approaches to the subject can be found in James A. Caporaso and David P. Levine, *Theories of Political Economy* (New York: Cambridge University Press, 1992).

[3] This discussion of the various meanings of political economy is based on Colin Wright, "Competing Conceptions of Political Economy," in James H. Nichols Jr. and Colin Wright, eds., *From Political Economy to Economics—And Back?* (San Francisco: Institute for Contemporary Studies, 1990).

nation as a whole and on the political as important. In his highly influential *Principles of Economics* (1890), Marshall substituted the present-day term "economics" for "political economy" and greatly restricted the domain of economic science. Following Marshall's precept that economics was an empirical and value-free science, his disciple Lionel Robbins in *The Nature and Significance of Economic Science* (1932) provided the definition to which most present-day economists subscribe: "Economics is the science which studies human behavior as a relationship between ends and scarce means which have alternative uses." In more modern terminology, economics is defined by economists as a universal science of decision-making under conditions of constraint and scarcity.

At the end of the twentieth century, the term "political economy" has come back into fashion even among economists, but there are important differences from earlier usages; also there is considerable controversy over the meaning of the term. For many professional economists, especially those identified with the Chicago School, political economy means a significant broadening of the *scope* or subject-matter that economists study.[4] These economists have greatly extended the social domain to which the methods or formal models of traditional economics are applicable. The underlying assumptions regarding motivation and the analytical tools of mainstream economics, they argue, are pertinent to the study of all (or at least almost all) aspects of human behavior. For such Chicago School economists as Gary Becker, Richard Posner, and Anthony Downs, the methodology of economics—that is, methodological individualism or the rational actor model of human behavior—is applicable to all types of human behavior from individuals choosing a sexual partner to voters choosing the American President. According to this interpretation, behavior can be explained by the efforts of individuals to maximize, satisfy, or optimize their self-interest.

Many economists and other social scientists enamored with economics attempt to use the individualistic or rational-choice methodology of economics to explain social institutions, public policy, and other forms of social activities that have traditionally been regarded as noneconomic in nature. Such "economic imperialism," identified most closely with the Chicago School, covers several scholarly areas that include neoinstitutionalism, public-choice theory, and what economists themselves call "political economy." The essence of this

[4] Warren J. Samuels, ed., *The Chicago School of Political Economy* (University Park, Pa.: Association of Evolutionary Economists, 1976).

approach to social institutions and other sociopolitical matters is to assume that individuals act alone or together to create social institutions and promote other social/political objectives to advance their private interests. Two fundamental positions may be discerned within this broad range of scholarly research. On the one hand, some scholars assume that individuals seek to create social institutions and advocate public policies that will promote overall economic efficiency. On the other hand, the term "political economy" is used by neoclassical economists to refer to rent-seeking behavior by individuals and groups.[5] Trade protectionism is an example of this approach. There is, however, a powerful normative bias among economists that economic institutions or structures are created to serve market efficiency.

The long-term objective of this body of scholarship is to make *endogenous* to economic science those variables or explanations of social phenomena that have traditionally been assumed to be *exogenous* and therefore the exclusive province of one of the other social sciences such as psychology, sociology, or political science. By "endogenous," economists mean that a particular human action can be fully explained as a self-conscious effort of an individual to maximize his or her economic interests; for example, according to the "endogenous growth theory," to be discussed in the next chapter, a firm invests in scientific research in order to increase its profits. By "exogenous," economists mean that a particular action can be explained best by a noneconomic motive; for example, Albert Einstein may be said to have been motivated in his work by curiosity or by the desire for fame rather than a desire to increase his income.

Economic imperialists assume that political and other forms of social behavior can be reduced to economic motives and explained by the formal methods of economic science. Government policies, social institutions including the state itself, and even whole economic systems, these economists claim, can be explained through application of formal economic models. For example, economist Edmund S. Phelps broadly defines political economy as the *choice* of the economic system itself.[6] Underlying this sweeping definition of political economy is the conviction, expressed by Jack Hirshleifer, that economics is the one and only true social science. The universality of economics, he argues, is due to the fact that its analytic abstractions such as scarcity,

[5] Rent-seeking refers to the use of a resource to obtain a surplus over the normal economic return to that resource. An example is a tariff that raises the cost of domestic goods.

[6] Edmund S. Phelps, *Political Economy: An Introductory Text* (New York: W. W. Norton, 1985), xiii-xiv.

cost, and opportunities are themselves universally applicable and can be used effectively to explain both individual behavior and social outcomes.[7] As we shall note many times in this book, the belief that there is only one universal social science, namely economics, is a powerful dogma embraced by many, if not most, economists.

At least three different schools of economists employ an economic approach to human behavior: neoclassical institutionalism, the public-choice school, and what is sometimes called the "new political economy." Neoclassical institutionalism attempts to explain the origin, evolution, and functioning of all types of institutions (social, political, economic) as the result of the maximizing behavior of rational individuals. The public-choice school is also interested in applying the methods of formal economics to analysis of political behavior and institutions, especially to the *political* organization of free men.[8] The new political economy is interested primarily in the political determinants of economic policy. Although I shall make only occasional references to these schools of political economists, their insights have influenced the argument of this book.

The public-choice approach is most closely associated with Nobel Laureate James Buchanan and his co-author, Gordon Tullock.[9] Using the framework of conventional economics, Buchanan and Tullock in their highly influential *The Calculus of Consent* (1962) promoted the important subfield of public choice.[10] For most economists in the public-choice school, the subject matter is the same as that of political science; they believe that they are applying superior methods of economic science to political affairs.[11] What defines the public-choice school more than anything else, however, is its political coloration. With certain important exceptions, such as Nobel Laureates Kenneth Arrow and Paul Samuelson, both of whom have made important contributions to the subject of public choice, this school of political econ-

[7] Jack Hirshleifer, "The Expanding Domain of Economics," *American Economic Review* 75, no. 6 (December 1995): 53.

[8] Wright, "Competing Conceptions of Political Economy," 71.

[9] A useful overview of the public-choice literature is Dennis C. Mueller, *The Public Choice Approach to Politics* (London: Edward Elgar, 1993).

[10] James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962). The relevance of the public-choice approach to the international economy is set forth in Thomas D. Willett, *The Public Choice Approach to International Economic Relations* (Charlottesville: University of Virginia, Center for Study of Public Choice, 1996).

[11] The term "positive political economy" is frequently applied to this position. An example is James E. Alt and Kenneth A. Shepsle, *Perspectives on Positive Political Economy* (New York: Cambridge University Press, 1990).

omists, especially Buchanan and Tullock themselves, is distinguished by its explicitly normative commitment to unfettered markets and strong opposition to government intervention in the economy. While some economists emphasize *market failures* as a reason for government intervention in the economy, the more conservative branch of public-choice economics considers *government* failure—that is, economic distortions caused by the policies of governments—to be more of a threat to economic well-being. Politicians and government officials are not the disinterested public servants they are assumed to be by many economists and advocates of government interventionism; they have interests of their own that they seek to maximize in their public activities. This position asserts that politicians, liberal reformers, and others distort the efficient functioning of the market as they use the apparatus of government to further their own private interests.

Neoclassical institutionalism is one of the most interesting developments in contemporary economics. According to neoinstitutionalist economists, economic institutions (and other institutions, including the state) and their characteristics can be explained by the methods of neoclassical economics. Nobel Laureate Douglass C. North, one of the foremost representatives of this school, maintains that economic institutions (like all forms of economic activity) are the consequence of intentional actions by rational individuals to maximize their economic interests.[12] Economic actions may be motivated by the desire to increase economic efficiency or may be simply rent-seeking. However, there is a predilection among neoinstitutionalists and other economists to assume that economic institutions have been produced by rational efforts to increase efficiency.[13] This neoinstitutionalist school is weakened by the fact that it overlooks the noneconomic factors responsible for the creation of social institutions and the rules governing societies.

Most mainstream economists frequently use the term "political economy" pejoratively to refer to the self-serving behavior of individuals and groups in the determination of public policy. According to the "new political economy," national policy is most frequently the

[12] Douglass C. North, *Structure and Change in Economic History* (New York: W. W. Norton, 1981); also, North, *Institutions, Institutional Change, and Economic Performance* (New York: Cambridge University Press, 1990).

[13] A notable example is Richard A. Posner, *The Economics of Justice* (Cambridge: Harvard University Press, 1981). A valuable critique of neoclassical institutionalism is Alexander James Field, "On the Explanation of Rules Using Rational Choice Models," *Journal of Economic Issues* 13, no. 1 (March 1979): 49–72.

result of private groups' efforts to employ public means to further their own private interests rather than the result of selfless efforts to advance the commonweal. Economic policy, this positon argues, is the outcome of distributional politics and competition among powerful groups for private advantage. For example, the economics literature on trade protection (endogenous trade theory) exemplifies this approach as it argues that tariffs and other obstructions to free trade can best be understood as rent-seeking behavior by particular interest groups.

A very different concept of political economy is used by those critics (especially Marxists) who believe that the discipline of economics has become too formal, mathematical, and abstract. The study of economics as the development of formal models, many charge, has become largely irrelevant to the understanding and solving of real social and economic problems. A major reason for this isolation of economics from the real world, they argue, is that economics neglects the historical, political, and social settings in which economic behavior takes place. As a consequence, some assert that economics, at least as it is taught and practiced in traditional departments of economics, has little relevance to the larger society and its needs.

Closely associated with this general criticism is what many critics regard as the pretension of economics to be a "science" modeled on physics and other natural sciences. Economics, they contend, cannot be value-free, and economists should not pretend that it is. According to Marxists and others, conventional economics reflects the values and interests of the dominant groups of a capitalist society. Rather than being value-free, economics is alleged to be infused with an implicit conservative social and political bias that emphasizes market and efficiency and neglects such social problems as inequality of income and chronic unemployment. In the opinion of Robert Heilbroner and William Milberg, contemporary economics is nothing but a handmaiden of modern Western capitalism, and its primary purpose is to make this troubled system work.[14]

By the end of the twentieth century, the term "political economy" had been given three broad and different meanings. For some scholars, especially economists, political economy referred to the application to all types of human behavior, including behaviors that would not be classified by others as economic, of the *methodology* of formal economics; that is, methodological individualism or the rational actor

[14] Robert L. Heilbroner and William Milberg, *The Crisis of Vision in Modern Economic Thought* (New York: Cambridge University Press, 1995).

model of human behavior. Other scholars used the term to mean employment of a specific economic *theory* or theories to explain social behavior; a good example is found in Ronald Rogowski's use of the Stopler-Samuelson theorem to explain political outcomes over time and space.[15] For those political scientists, including myself, who believe that social and political affairs cannot be reduced to a subfield of economics, political economy refers primarily to *questions* generated from the interactions of economic and political affairs. Proponents of this broad approach to the subject are eclectic in their choice of subject matter and methods (economic, historical, sociological, political, etc.).

What You Seek Is What You Find

Interpretations of economic affairs are highly dependent upon the analytic perspective of the observer and upon his or her assumptions as these determine what the observer looks for or emphasizes. Fundamental differences between economics and political economy are exemplified in their differing definitions of the economy to be studied, of the basic economic entities or actors, and of the forces responsible for economic and, more broadly, sociopolitical change. Members of each academic specialization differ in their perspectives on economic affairs, questions asked, and methods employed. The differences, illustrated in the coming paragraphs, are important because they profoundly influence the ways in which economists and political economists study economic affairs at both the domestic and international levels.

Definition of an Economy

In April 1992, the prestigious National Bureau of Economic Research (NBER) sponsored a conference to analyze whether or not Japan was deliberately creating an exclusive economic bloc in East and Southeast Asia. According to Martin Feldstein, NBER director, in his charge to conference participants, the conference was the first attempt by the Bureau to bring together a group of economists and political scientists (the latter included experts on Japanese and international politics) to address an issue of mutual concern. The results of the conference were published in *Regionalism and Rivalry: Japan and the United States in Pacific Asia* (1993), edited by Jeffrey Frankel (an

[15] Ronald Rogowski, *Commerce and Coalitions: How Trade Affects Domestic Political Alignments* (Princeton: Princeton University Press, 1989).

economist) and Miles Kahler (a political scientist).[16] The contributions to the book revealed that these two groups of specialists, as they attempted to answer Feldstein's questions, asked different questions, used different methods, and reached different conclusions regarding the nature of the evolving Pacific Asia economy.

The political scientists' analysis concentrated on the trade/investment behavior of Japanese firms and on official Japanese foreign aid to the region (Official Development Assistance). Evidence, they asserted, revealed that Japanese corporations, with the active support of the state, were attempting to incorporate the Pacific Asian economies into regional industrial and financial structures or networks organized, managed, and dominated by large Japanese corporations. Through their trade, investment, and other activities, these giant multinational firms working together with Japanese foreign aid agencies were consciously fashioning a regional division of labor composed of highly integrated production and distribution networks centered on the Japanese home economy. The political scientists concluded that the Japanese, as they had done in the 1930s, were again attempting to create and dominate an East Asian sphere of influence, albeit this time by peaceful economic means. The political scientists defined the Pacific Asian economy as a hierarchical structure increasingly determined and dominated by Japanese multinational corporations and the Japanese state.

The economists, on the other hand, concentrated their analysis on trade flows and other measurable economic quantities that could be formally modeled. Their analysis of the data led to the conclusion that the Japanese state and corporations were not attempting to create an exclusive economic sphere in Pacific Asia. On the contrary, they insisted that what was taking place in the region could be explained entirely in terms of market forces and the responses of individual firms to those forces. For example, the increasing Japanese investment in the region and growing trade with the region were considered responses to the substantial appreciation of the yen following the Plaza Agreement of September 1985 and to subsequent changes in Japanese comparative advantage. Moreover, analysis of gross trade statistics showed that, although intraregional trade in Pacific Asia was growing, it was growing less rapidly than trade between Pacific Asia and the rest of the world. Thus, economists found no

[16] Jeffrey A. Frankel and Miles Kahler, eds., *Regionalism and Rivalry: Japan and the United States in Pacific Asia* (Chicago: University of Chicago Press, 1993).

evidence either for the existence of a distinctive Pacific Asian economy or for any Japanese effort to create a regional sphere of influence.

Whereas the political scientists' analysis defined the Pacific Asian economy as composed of powerful economic and state actors, the economists defined the regional economy in terms of economic forces and quantities. The opposed conclusions of the two groups of specialists reflected the differences in their basic assumptions about the nature of economic reality, the evidence studied, and the methodology employed. I believe that the differing analytic approaches and conclusions of the economists and the political scientists are actually complementary rather than contradictory. Considered together, both intellectual approaches increase awareness of the role of both political and economic factors in shaping economic reality and thereby deepen our comprehension of developments in the world economy.

Nature of Economic Actors

In the late 1960s, a group of graduate students in public affairs at Princeton University's Woodrow Wilson School of Public and International Affairs asked a professor of economics to offer a course on the multinational corporation (MNC). During the 1960s the rapid overseas expansion and increasing importance of these giant firms (at that time mostly American) had captured public attention and become intensely controversial. Raymond Vernon and other commentators believed that these business firms would greatly facilitate efficient utilization of the world's scarce resources and speed economic development of the entire globe.[17] However, Stephen Hymer and other radical critics regarded such powerful corporations as nothing more than instruments of an expanding American capitalist imperialism that was exploiting countries throughout the world.[18] The students believed that the MNC was a novel and important phenomenon that should be the focus of at least one course in the School's substantial economics curriculum.

The students were firmly rebuffed with the professor's response that "the multinational corporation does not exist." Corporations exist, the economist granted, but there is no such thing as a distinctive *multinational* corporation that behaves differently from other corporations. Every corporation, whatever its nationality or scope of its

[17] Raymond Vernon, *Sovereignty at Bay* (New York: Basic Books, 1971).

[18] Stephen Hymer, *The International Operation of National Firms: A Study of Direct Foreign Investment* (New York: Cambridge University Press, 1976).

activities, behaves in the same way that all others behave. All corporate leaders make their decisions in response to market signals and in order to maximize their profits. (Or, as the economist told the students, the purpose of the postman is to deliver the mail regardless of the color of the uniform.) Economists in general believe that, whether the firm is American, European, or Japanese, it must optimize within given constraints and respond effectively to market opportunities in highly competitive markets or go out of business. The fact that a firm happens to be of a particular nationality and competes in a world market through establishment of overseas subsidiaries does not significantly change matters. In language that a Marxist or a realist would use, the ownership of the means of production and the national origins of a business firm are totally irrelevant.

This experience illustrates the view of neoclassical economics regarding the nature of economic actors. The world of the economist is populated solely by individuals (consumers and producers) pursuing their self-interest; firms, states, or other economic actors are assumed to be merely aggregates of such individual actors. Every individual (regardless of ethnicity, class, or national identity) is assumed to act rationally (employing a cost/benefit calculation) in pursuit of his or her self-interest. There are no fundamental differences among American, Japanese, or Bantu economic actors. Everyone is assumed to be seeking the same broad range of economic objectives. The only things that differ from one society to another are the external constraints on decision-making and the opportunities among which the individual must choose.

Within other intellectual perspectives, the nature of economic actors appears very different. A Marxist, for example, regards economic classes (defined by the ownership or nonownership of the basic means of production) or such representatives of class interests as politicians or interest groups as the fundamental actors in economic affairs. According to this view, all corporations (national or multinational) are representatives of the capitalist class that dominates every capitalist economy. For proponents of a state-centric approach, on the other hand, the primary economic actors are nation-states or other powerful political groups, and, therefore, the nationality of the MNC is of great importance because its behavior is strongly influenced by the policies and culture of its home society. Viewed from this perspective, a “multinational” corporation is, in its essence, a corporation of a particular nationality whose international activities are, on the whole, intended to promote the primary interests (economic, political, or even security) of its nation of origin.

Dynamics of the World Economy

In September 1992, an important and disturbing event occurred when, without warning, private investors suddenly transferred huge sums of money out of the British pound, the Italian lira, and other currencies into the German mark, thereby forcing an unwanted devaluation of the pound and other currencies. This devaluation significantly reshaped the economic and political landscape of Western Europe and tore apart the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS), whose purpose was to maintain the values of the European Community currencies within specified narrow bands. As a consequence of this financial crisis, Great Britain withdrew from the ERM and caused the movement toward European economic and monetary integration to divide into a "two-speed" process of European unification.

Interpretations of this episode illustrate the differences between an "economic" and a "political economic" analysis of the dynamics of the world economy. Economists were certainly aware that political developments like German reunification and the Danish rejection, in June 1992, of the Maastricht Treaty had important roles in generating the financial crisis of that fall. However, such political developments were treated by economists as factors external to the formal economic modeling of the crisis. Economists were interested in the dynamics of the crisis itself and not the political dynamics that led to the crisis. Therefore, the underlying political and other causes of this crisis were not closely examined by economists. Instead, analysis of the crisis by economists focused only on its economic aspects. For example, formulation of a general model of financial crises was a central purpose in one excellent study by economists.[19]

Political economists, on the other hand, were more interested in the political genesis of the crisis, its political resolution, and the longer-term economic/political consequences. That is to say, they were most interested in the external or exogenous political factors that lead to a crisis, contribute to its resolution, and determine its long-term effects. The point of this comparison is that economists and political economists were interested in different phenomena and asked different questions. The 1992 financial crisis illuminated the relationship and

[19] This is the case, for example, of an excellent study of the crisis by Willem H. Buiter, Giancarlo Corsetti, and Paolo A. Pesenti, *Financial Markets and European Monetary Cooperation: The Lessons of the 1992–93 Exchange Rate Mechanism Crisis* (New York: Cambridge University Press, 1998).

interaction of the economic and political forces that provide the dynamics of the international economy.

Since the mid-1970s, the size of international financial flows has grown to hundreds of billions of dollars a day. These immense capital flows can easily overwhelm national economies, as they did the Italian and British economies in 1992 and many other economies in the late 1990s. Increasing integration of global financial markets has caused national governments to surrender a portion of their economic autonomy to global market forces. Although a government may pursue inappropriately expansionary economic policies for a time, powerful market forces will eventually overturn these policies. The huge outflow of capital from Italy and Great Britain in 1992 and subsequent devaluations of their currencies forced both nations to withdraw from the Exchange Rate Mechanism (ERM), although Italy eventually returned.

Many observers believe that the September 1992 financial crisis demonstrated the triumph of transnational economic forces and economic globalization over the nation-state. In this popular and influential interpretation, the integration of global financial markets and the resulting huge flows of capital across national boundaries have led, in the words of one enthusiastic writer, to "the end of geography."[20] Some commentators allege that national governments are rapidly losing their economic autonomy and have even become hostage to global market forces and the whims of international speculators. Some argue that if a national government fails to heed the interests of the controllers of international capital, the errant government will not be able to obtain the capital required to carry out its economic and political plans. International capital markets are alleged to have created a web of economic interdependence that has transformed the nature of international affairs and destroyed the economic and political independence of nation-states. Hence, many have concluded that markets are firmly in control of the world economy. Some believe that the 1997 East Asian financial crisis supports this conclusion.

An alternative interpretation of the earlier 1992 crisis emphasizes the role of government decisions and political developments in convincing international investors that the currency situation in Western Europe was highly unstable. The July 1990 decision to eliminate intra-European barriers to capital flows had increased the risk of currency speculation that could cause exchange rate disequilibria. This

[20] Richard O'Brien, *Global Financial Integration: The End of Geography* (London: Pinter Publishers, 1992). Published for the Royal Institute of International Affairs.

potentially risky situation was exacerbated when additional restrictions were placed on exchange rate flexibility within the ERM. These economic developments laid the groundwork for the crisis. Political developments that raised questions about the movement toward European monetary unity included the Danish rejection in June 1992 of the Maastricht Treaty. This startling action was followed in September by the narrow (51 percent) passage in France of a national referendum on the Treaty. However, the most important developments leading to the financial crisis were the several decisions of the German Central Bank (Bundesbank), from November 1990 on, to raise German interest rates substantially in order to offset the inflationary consequences of German reunification. Then the American Federal Reserve lowered interest rates in early 1992 to stimulate the stagnant American economy. Also, in order to stay within the ERM currency bands, the British government had attempted to maintain an overvalued pound and thereby caused the worst British recession in the postwar era. These political developments raised serious doubts that the British could continue to maintain the value of the pound.

The large gap between Germany's excessively high and America's excessively low interest rates, plus the economic troubles of Italy and Great Britain, created a disequilibrium in exchange rates. Hedge-fund managers like George Soros of the Quantum Fund saw an opportunity for a huge windfall and fled from the overvalued lira and pound to the mark. Others followed suit in what economists have called a "speculative overreaction." Thus, although it is correct to say, at one level of analysis, that Italy and Great Britain were overwhelmed by market forces, at a deeper level of analysis it is equally correct to say that the financial crisis was due to policy decisions taken by American, German, and British financial authorities. Government decisions and the actions of individual economic actors were responsible for that crisis. Indeed, French government officials, economic nationalists to the core, denounced the financial crisis as an "Anglo-Saxon plot" to destroy the movement toward European unity.

The 1992 financial crisis illustrates that both impersonal market forces and the deliberate actions of a few powerful states can determine the dynamics of the world economy. While Italy and Great Britain were overwhelmed by market forces, deliberate policy decisions by American and German central banks produced such economic fundamentals as the differentials in interest rates. Interactions of impersonal markets and state policies constitute the driving forces in the world economy and the subject matter of the study of international political economy. Whereas market forces are the domain of eco-

nomic analysis, the explanation of economic policies is primarily the province of political economy. Because each mode of analysis is limited by its assumptions, both should be utilized to improve understanding of the dynamics of the world economy.

The Nature of an Economy

Whereas economists regard an economy as a market composed of impersonal economic forces, specialists in political economy interpret it as a sociopolitical system populated by powerful actors. Such conceptual differences distinguish the study of economics from that of international political economy (IPE).

The *neoclassical economic interpretation* is that the economy is a market or a collection of markets composed of impersonal economic forces over which individual actors, including states and corporations, have little or no control. As former *New York Times* economic commentator Leonard Silk has described it, for economists the economy is nothing more than a collection of flexible wages, prices, interest rates, and similar forces that move up and down allocating resources to their profitable use as buyers and sellers rationally pursue their own interests.[21] Such an economic universe is a self-regulating and self-contained system composed solely of changing prices and quantities to which individual economic actors respond. Economic actors are assumed to be "price-takers" who seek to maximize, or at least satisfy, their private interests as they respond to changes in relative prices or to changes in economic constraints and opportunities.

The *political economy interpretation* used in this book defines the economy as a sociopolitical system composed of powerful economic actors or institutions such as giant firms, powerful labor unions, and large agribusinesses that are competing with one another to formulate government policies on taxes, tariffs, and other matters in ways that advance their own interests.[22] And the most important of these powerful actors are national governments. In this interpretation, there are many social, political, or economic actors whose behavior has a powerful impact on the nature and functioning of markets. This conception of the economy as an identifiable social and political structure composed of powerful actors is held by many citizens and by most social scientists other than professional economists.

[21] *New York Times*, 26 March 1980, D2.
[22] Ibid.

The role of institutions in determining economic behavior and outcomes is of particular interest in the political economy interpretation. Social, political, and economic institutions are significant in that they determine, or at least influence, the incentives that shape the interaction of individuals and groups as political and economic actors. In economics the two principal explanations for the creation of institutions are neoclassical institutionalism and the theory of public choice. Both of these theories assume that institutions can be explained as resulting from conscious action by economic actors to further their economic interests. These two positions differ, however, regarding the purpose of institutions. Neoclassical institutionalism is based on the belief that institutions are created primarily to solve economic problems and will result in increased economic efficiency; for example, neoinstitutionalists believe that business corporations are created to reduce transaction costs. The public-choice position, on the other hand, believes that government institutions are created by powerful groups, public officials, and politicians to promote their own self-interest and that they decrease efficiency; for example, tariffs are essentially rent-seeking devices to shift income from consumers to domestic producers. Both positions, however, explain the creation of institutions as resulting from rational intentions.

Political economists, on the other hand, believe that institutions are created for a variety of rational, irrational, and even capricious motives. Moreover, in contrast to economists' emphasis on efficiency or rent-seeking, the political economists argue that institutions are built on the idea of path dependence and that economic and other institutions are the result of accidents, random choices, and chance events that frequently cannot be explained as the result of rational economic processes. Institutions are sometimes the consequence of historical accident and self-reinforcing and cumulative processes. (One of my favorite examples is the constitutional prohibition against foreign-born Americans becoming President; its purpose was to bar the detested Alexander Hamilton from the presidency.) As a consequence, many institutions are neither efficient nor do they necessarily represent the economic interests of the individuals who brought them into existence. However, once these institutions are created, for whatever chance or irrational reason, they have a powerful advantage over new and more efficient institutions that could otherwise displace them.

Institutions are even more tenacious than neoinstitutionalism and public-choice theory suggest, and it is frequently difficult to replace an inefficient institution with a more efficient one. Neoclassical institutionalism, for example, is based on the assumption of constant re-

turns to scale in which economic actors who desire to replace an older and less efficient institution or business firm with a newer and more efficient one can do so without any overwhelming difficulty. However, the established institution or business firm may enjoy economies of scale (and hence lower costs) merely as a consequence of having established itself in the market ahead of potential rivals. An existing institution may also have gained a legitimacy and a powerful constituency whose interests it serves. Thus, even though the potential efficiency of the new institution or business firm may be much greater than the efficiency of the existing institution or business firm, the "barriers to entry" are too great to accomplish a change. In the economic universe of political economists there are many inefficient economic institutions and oligopolistic businesses that result from random events and irrational decisions.

The study of political economy requires integration of these two fundamentally different meanings of "economy." Both the neoclassical and the political economy interpretations of economic activities are necessary and important ingredients in the effort to understand how the economy functions. Impersonal markets and powerful actors interact to produce those economic and political outcomes of interest to students of political economy. The study of political economy requires an understanding of how markets work and how market forces affect economic outcomes as well as an understanding of how powerful actors, of which the nation-state is by far the most important, attempt to manipulate market forces to advance their private interests. The science of economics, as it has been developed by generations of professional economists, possesses highly useful analytical tools and a rich body of theoretical insights (or as economists prefer, models) for understanding markets. The scope of economic science, however, is too limited and its theories much too abstract for the purposes of international political economy. The strength of political science lies in its broad emphasis on the "realities" of the universal struggle among human beings, groups, and states for power and position. Its weakness lies in the intuitive nature of its methods and its limited theoretical foundations.

The study of political economy and international political economy requires an analytic approach that takes into account economics, political science, and other social sciences. It must incorporate the many economic, political, and technological factors that determine, or at least influence, the nature and dynamics of the international economy. Yet, such an approach will undoubtedly always be limited in its explanatory, and certainly in its predictive, powers. There is simply

too much that we do not know and perhaps never will know. As international economist Robert Baldwin has commented, an adequate theory of international political economy would have to be built upon a theory of how governments reach decisions, and, of course, there is no such theory.[23] Achievement of our goal of comprehending how the international political economy functions will probably always be elusive no matter how hard we work to improve the study of the international economy.

Embeddedness of the Economy

The central idea that markets are embedded in larger sociopolitical systems underlies my interpretation of both political economy and international political economy. The government, powerful domestic interests, and historical experiences determine the purpose of the economy and establish the parameters within which the market (price mechanism) functions. Contrary to economists' belief that economic activities are universal in character and essentially the same everywhere, the specific goals of economic activities are in actuality socially determined and differ widely over the face of the earth. For example, although neoclassical economists assert that the primary purpose of economic activities is to satisfy the desires of individual consumers, this characterization applies to the United States but not to every other economy. Japan and many Asian societies, for example, place a high priority on the welfare of the community and on social cohesion. In fact, the idea that markets should be free to promote the private interests of individuals is a rather recent belief, and the strength of the welfare state in Western Europe indicates that even in the West this idea is not universally accepted.

In addition to determining the purpose of economic activity, the sociopolitical system and a society's values determine the role that the market or price mechanism in a particular society legitimately plays and the socially approved ways in which economic objectives may be pursued. Every society has values and beliefs that circumscribe the ways in which the market is permitted to function; societies establish rules and set boundaries that govern the range of activities in which the price mechanism is considered legitimate; what is considered to be "fair" economic behavior in one society may not be considered fair in another. For example, bribery is a serious offense in the United

[23] Robert Baldwin, in Jaime De Melo and Arvind Panagariya, eds., *New Dimensions in Regional Integration* (New York: Cambridge University Press, 1993).

States, but what Westerners would call "bribery" has long been a normal and accepted business practice in China. Many Americans complain that competition from low-wage Asian labor is unfair; many Asians retort that the American criticism is unfair because low wages constitute their only important comparative advantage. Such national differences have been a major source of misunderstandings and even of political conflict as national economies have become more closely linked to one another through trade and investment.

The international economy is also embedded in a sociopolitical system, although not as deeply as are national economies; the international economy is embedded in an international system of regimes, public and private organizations, and, most important of all, nation-states. As I shall argue in greater detail below, the dominant power/s in the international system plays/play a major role in defining the purpose of the international economy and the principal rules governing international economic activities. For example, during the Cold War, the Western international economic system, under American leadership, was intended to strengthen security ties against the Soviet Union.

Economists in general believe that an international economy easily and automatically emerges because, in the words of Adam Smith, it is natural for mankind to "truck, barter, and trade." However, it is in fact politically very difficult to create an open world economy. As Mancur Olson has pointed out, the decision of a government to open its economy to imports and other commercial activities constitutes a politically risky action because it immediately results in many resentful losers and, at least initially, produces just a few winners.[24] Necessarily then, Olson argues, the creation of an international economy is the result of costly actions taken by powerful states (hegemons) for economic, political, and especially security reasons. Private economic interests, especially those of powerful business groups, also obviously play an important role in the efforts of powerful states to create an international economy. However, the political and security interests of states themselves play the central role in its creation.[25]

The primacy of the national economic and political interests of dominant powers is illustrated in the nature of successive international economies since the mid-seventeenth century. During the mercantilist age of the seventeenth and eighteenth centuries, the major

[24] Mancur Olson provides an illuminating discussion of this subject in De Melo and Panagariya, eds., *New Dimensions in Regional Integration.*

[25] The nexus of economic and security affairs is discussed by Edward D. Mansfield in his *Power, Trade, and War* (Princeton: Princeton University Press, 1994).

powers of Western Europe fought on land and sea to create empires that would support their political rivalries. Although companies of merchant-adventurers such as the British and Dutch East India Companies benefited from these commercial conflicts, the primary concern of states was to acquire a favorable balance of trade/payments to finance their external military and political ambitions. Great Britain's victory in the Napoleonic Wars resulted in a new and differently ordered international economy. Formal imperialism and possession of colonies were deemphasized and what historians called "the imperialism of free trade" emerged. Or, in the words of Stanley Jevons, one of England's foremost economists in the late nineteenth century, "Unfettered commerce . . . has made the several quarters of the globe our willing tributaries."[26] The Pax Britannica and Britain's dominant global position were thus built on economic foundations.

Following World War II, the United States launched a concerted effort to create an open world economy. The origins of this effort can be traced to the Reciprocal Trade Act of 1934 and the Tripartite Monetary Agreement a few years later. In addition, American postwar planners working mainly with their British counterparts began to lay the foundations for an open world economy following the war; this cooperative effort culminated in the Bretton Woods Conference (1944) that created the institutional framework for the postwar international economy. However, strong assertion of American postwar economic leadership occurred *only* after the emergence of a clear Soviet threat. With the outbreak of the Cold War, the United States undertook a number of important initiatives to strengthen the wartorn economies of its allies, to forge a powerful anti-Soviet alliance, and subsequently, to fasten these allied economies firmly to the United States. The most important American action was, of course, the Marshall Plan that transferred billions of dollars to Western Europe; this extraordinary transfer of wealth would not have taken place if not for the Cold War. In effect, the United States used its political, economic, and other resources to create an open world economy embracing its political allies and much of the Third World.

This analysis suggests that the creation and maintenance of an open and unified world economy requires a powerful leader or "hegemon" that possesses both the political interest and the resources to pay the high costs associated with such a task. It is highly unlikely that an open and unified world market economy could be created and maintained unless there were a dominant power able and willing to use its

[26] Stanley Jevons, *The Coal Question* (London: Macmillan, 1906), 411.

political, economic, and other resources to encourage other states to lower trade and other economic barriers, to prevent free-riding, and to apply sanctions to states that failed to obey the rules or regimes governing the liberal world economy. If there were no such strong leader, international cooperation among egocentric states would be exceedingly difficult, and there is a likelihood that the open, unified world economy would fragment into national protectionism and regional blocs.

The emphasis in this book on the role of political actors using their power to influence market outcomes has some similarities to the position of the public-choice school that argues that all political behavior, including that of public officials, can be explained as the pursuit of private interests by self-centered individuals and groups. However, my position differs from this perspective in important respects. The public-choice school implies that politics and markets can, at least in theory, be separated; it argues that if there were no state intervention in the economy, the price system by itself would determine all outcomes. I believe, on the other hand, that the market is inherently political. For example, the distributive effects of markets are determined primarily by the nature and distribution of property rights, and property rights themselves and their distribution are inevitably affected by political developments. Further, whereas the public-choice position believes that public officials are motivated primarily by economic interests, I myself believe that national security and prestige play an equal and frequently an even greater role in motivating the behavior of national governments.

Another difference between the public-choice position and my own is based on different concepts of the nature of the state and the national interest. The public-choice position believes that the state is simply a collection of those individuals who comprise the government at a particular moment; the national interest is the combined interests of the individual members of the society or of those members who dominate the government. On the other hand, I believe that the state is more than the sum of its component parts, that it has some autonomy from society, and that the national interest is distinct from the combined interests of its parts. The state and the national interest cannot be reduced, as the public-choice position asserts, to the individuals who happen to be in power at any particular moment.[27] Most

[27] Willett, I believe, concedes this point when he acknowledges that foreign policy cannot be reduced to interest group politics. Willett, *The Public Choice Approach to International Economic Relations,* 14.

adherents of the public-choice position believe in free trade, as do I. However, the commitment to free trade must be based on a concept of a national interest and the belief that free trade will benefit that national interest and not just the interests of those in power at the time.

A state or national government must fulfill several social, economic, and political functions to retain the loyalty of its citizens. Provision of security for its citizens both at home and abroad is the primary function of the state; no other institution can relieve it of this responsibility. Another function is to promote the social and economic welfare of its citizens and to guarantee minimal standards of individual justice; although the social welfare function has long existed, as James Mayall has emphasized in discussing what he calls "the new economic nationalism," economic welfare has become intimately joined to national citizenship in the modern world.[28] Without a state of their own, individuals have no access to welfare programs. The state also provides an identity for its citizens; it appears to be inherent in human nature that individuals need to be part of some larger social grouping. In many societies there is growing concern that globalization is leading to loss of a separate identity for individual citizens and individual states. This situation reinforces my belief that political economy's concept of an economy as markets embedded in a sociopolitical system is not only accurate but that it also provides a very useful tool of analysis.

Conclusion

This book defines political economy as the interaction of the market and powerful actors. Both components are necessary, and one cannot comprehend how either domestic or international economies function unless he or she understands both how markets work and how states and other actors attempt to manipulate markets to their own advantage. As I stated above, markets have an inherent logic of their own as they respond to changes in relative prices, constraints, and opportunities. Therefore, to analyze the functioning of an economy, one must begin with at least a rudimentary knowledge of how the discipline of economics understands the economy as a market or price mechanism, and this is the focus of the next chapter.

[28] James Mayall, *Nationalism and International Society* (New York: Cambridge University Press, 1990), chap. 6.