International Political Economy

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Chapter One

1. The Evolution of International Political Economy

1.1. Introduction

The world is "globalized." Among developed countries, international trade now accounts for nearly 38% of gross domestic product (GDP). For developing economies, imports plus exports comprise nearly 49% of all national output. Over the last two decades, global flows of foreign direct investment have more than doubled relative to GDP. Globalization now allows individuals, corporations, and nation-states to reach around the world farther, faster, deeper and cheaper than ever before (Thomas Friedman 2000, 9). The field of international political economy (IPE) pre-dates the current era of globalization, it was created by scholars trying to grasp the fundamentals of this nascent age.

International Political Economy (IPE) is a relatively new field of inquiry, albeit one with an old pedigree. It emerged in the late 1960s and early 1970s, partly as a result of the inadequacy of the discipline of International Relations (IR) in dealing with global economic changes in that era, but its antecedents can be traced back to the classical political economy of Adam Smith (1723–1790), David Ricardo (1772–1823) and Karl Marx (1818–1883).

During the twentieth century, economics and political science were consolidated as autonomous areas in the academy, and each expressed little interest in the subject matter of the other. This process had a negative impact on the utility of both disciplines, and the division extended into the international realm.

According to Held and Leftwich (Hay and Marsh 1999: 13) 'politics is about power; about the forces which influence and reflect its distribution and use; and about the effect of this on resource use and distribution'. Economic agents 'act' politically, often attempting to influence and shape the policy process and the distribution of national resources. **The golden rule says "the one with the gold will make a rule".**

1.2.Early Evolution of IPE

As a distinct field, IPE focuses on the politics of international economic exchange. IPE is a substantive topic of enquiry, rather than a methodology in which economic models are applied to political phenomena. The field is primarily informed by two sets of key questions.

1. How, when, and why do states choose to open themselves to transborder flows of goods and services, capital, and people? In other words, what are the political determinants of what we now call globalization? In this first set of questions, openness is the dependent variable, or outcome to be explained, and politics is the independent or causal variable. Economic theory posits that free and unrestricted international commerce is, with limited exceptions, welfare improving; many politically naive analysts, in turn, expect countries to evolve toward free trade. By contrast, IPE begins with the reality that openness is historically rare, politically problematic, and a phenomenon that needs to be explained.
2. How does integration (or not) into the international economy affect the interests of individuals, sectors, factors of production, or countries and, in turn, national policies? Here, government policy is the dependent variable and how the actor is situated in the international economy is the independent variable.

IPE emerged as a new and distinct interdisciplinary field beginning in the late1960s and early1970s as a result of two contradictory, real-world developments.

- First, the success of the postwar international economic regime constructed at Bretton Woods, and embodied in the postwar institutions of the International Monetary Fund, World Bank, and General Agreements on Tariffs and Trade (GATT), ushered in an era of increasing economic interdependence. Trade as a percentage of all economic activity began to rise rapidly in all advanced countries, leading to a new focus on the political impact of deepening economic ties (Cooper1968; Keohane and Nye1972). The nation-state is just about through as an economic unit.
- Second, at nearly the same time that interdependence was "taking off," the political foundations of this open international economy began to crack. President Richard Nixon in 1971 formally ended the convertibility of the dollar into gold, closing the door on the

Bretton Woods regime[1] (Gowa 1983). Two years later, the postwar exchange rate regime collapsed when the major currencies began to float against one another. The Nixon created worldwide monetary instability.

The breakdown of the Bretton Woods system in the 1970s also contributed to the emergency of International Political Economy as a distinct field of study.

In response the Arab transformed oil into a coercive weapon; breathing through Organization of Petroleum Exporting Countries (OPEC) raising oil prices fifteen fold between 1973 and1980. Suffering under higher oil prices, the developing world called for a New International Economic Order through which other commodity producers hoped to exercise similar market power hopefully in support of Western consumers. In response to the growth of imports unleashed by liberalization and rising interdependence, American industry began clamoring for increased or renewed trade protection. Trying to satisfy industry without undermining its commitment to free trade, the United States adopted a series of innovative non-tariff barriers to trade.

The mutual astigmatism that hid International Politics and International Economics from each other cleared in the 1970s as a number of dramatic international events made plain how tightly the two fields were intertwined. The oil embargoes of the 1970s and the breakdown of the Bretton Woods monetary system are frequently cited as key events in IPE's development as a field of study. These events posed practical and theoretical problems that necessarily forced scholars and policy-makers to consider economics and politics together.

The rise of the Organization of Petroleum Exporting Countries (OPEC) and the Arab oil embargo of 1973-74 illustrated dramatically at least four key dimensions of IPE.

• First, it showed the power and influence of economic tools in foreign policy. After OPEC no state could dare make political policy without taking into account potential foreign economic retaliation or reaction.

• Second, the oil embargo showed that East-West issues were not always the state's most important concerns -- North-South political and economic problems could no longer be ignored

[1] It is a system generally interpreted as a system of economic governance constructed to support U.S. hegemony in the postwar era. Each of the main Bretton Woods institutions, the World Bank, the IMF, and the GATT, depended upon the United States to play a central leadership role.

or dealt with as ancillary to Cold War strategy. To the extent that economic issues were closer to the surface in North-South relations, this reinforced the notion that politics was really political economy.

• Third, the oil embargo revealed the complex interdependence between and among domestic politics, domestic economics, international politics, and international economics.

• Fourth, the oil embargo raised questions about the role of multinational corporations (MNCs) in international economics and politics. MNCs had previously been viewed by many scholars as agents of influence of their home country governments (this was especially true of US-based MNCs), but now their political allegiance appeared to be more ambiguous.

The rise of OPEC and the decline of US hegemony were just two events that broke down the artificial division of International Economics and International Politics that had in some respects characterized the Bretton Woods era. Other events such as the Third World debt crisis, the fall of communist regimes, the rise of the East Asian Newly Industrialized Countries (NICS), the expansion of the European Union, and the financial crises in Mexico, Russia, and East Asia all provided impetus for the growth and development of IPE studies. The simple divisions between state and market, domestic and international, and politics and economics were no longer applicable to a wide range of issues. An increasingly complex world required a complex approach to analysis, which IPE provided.

As international economic relations were politicized, it became apparent that inter-national exchange was not an autonomous sphere, a natural phenomenon beyond political machinations. As analysts struggled to understand the simultaneous growth and conflict in international markets, the field of IPE was born.

1.3.IPE: Definition

The growing prominence of IPE as a field of study is in part a result of the continuing breakdown of disciplinary boundaries between economics and politics in particular and among the social sciences generally. IPE is the study of a set of related problems. The traditional IPE includes analysis of the political economy of international trade, international finance, North-South relations, multinational corporations, and hegemony and globalization added recently.

It is hard to imagine a world without International Political Economy because the mutual interaction of International Politics (or International Relations) and International Economics is today widely appreciated. The political actions of nation-states clearly affect international trade and monetary flows, which in turn affect the environment in which nation-states make political choices and entrepreneurs make economic choices. It seems impossible to consider important questions of International Politics or International Economics without taking these mutual influences and effects into account. The dynamic interaction between market and state characterize IPE.

Eg. The mission of the WTO, and before that the General Agreement on Tariffs and Trade (the GATT), is to progressively reduce the barriers to free trade through multilateral negotiations. This movement towards global free trade, however, has not stopped states from using trade tools to further their own foreign policy goals when they can. Thus we live in an environment where the political and the economic viewpoints of international trade compete for attention.

Eg. Regional trade agreements like NAFTA[2] and the EU frequently use economic tools to achieve political goals. One of the political goals of European economic integration is to strengthen the western Cold War alliance. One of the political goals of NAFTA was to stabilize and strengthen Mexico's democratic system.

Political Economy is a science which treats of the Nature, the Production, and the Distribution of Wealth. Political Economy," says M. Storch, “is the Science of the natural laws which determine the prosperity of nations, that is to say, their wealth and their civilization." Mr. M'Culloch have defined Political Economy to be " the Science of the laws which regulate the production, accumulation, distribution, and consumption of those articles or products that are necessarily useful to man.

IPE is best defined as a problématique, a set of problems that bear some relationship to one another. The IPE problématique is the set of international and global problems that cannot

[2] North American Free Trade Agreement

usefully be understood or analyzed as just International politics or just International economics. These problems fall necessarily in the expanding domain of International Political Economy.

Its goal was to analyze the interaction of economics and politics in the international affairs of nation-states or, more narrowly, how economic factors influenced International relations. Although IPE research took many directions in this period, five sets of questions dominated the agenda: international trade, international finance, North-South relations, MNCs, and the problem of hegemony. A sixth concern -- globalization -- was soon added to the list.

- International Trade: Politics and Economics approach international trade from completely different points of view using completely different analytical frameworks. The borders of markets are dynamic, transparent, and porous; they rarely coincide exactly with the borders of states and a few markets today are even global in their reach. When trade within a market involves buyers and sellers in different nation-states, it becomes international trade and the object of political scrutiny.

  The political analysis of this subject treats international trade as fundamentally different from domestic economic activity (while economic theory sees no important distinction between the two). The international exchange of goods, services, or resources with another country raises many political questions of national interest, especially questions concerning the economic and military security of the nation.

  Although it is easy to oversimplify these security concerns (exports are desirable because they increase a nation's monetary reserves and create jobs whereas imports should be avoided because they create dependency, reduce national reserves, and threaten domestic business and labor interests) in practice the political analysis of international trade is far more complex. Exports create jobs, but their full impact on national security depends upon what is exported to whom and on what terms. An export of technology that has critical military or economic applications tends to weaken national security, not strengthen it. Nations have frequently imposed export controls for both economic and military reasons.

  Imports also raise complex security issues. Although imports may reduce or threaten domestic employment, create the potential for external dependency, and reduce domestic monetary reserves, there is more to the IPE of trade policy than simple protectionism.

Imports may be vital to domestic military and economic security, for example, so that national interest requires secure sources of specific imports. This is especially true regarding high technology military hardware. It may be impossible or impractical to avoid some foreign sourcing, so attention shifts from eliminating imports to establishing secure supply chains.

Willingness to permit imports from foreign nations can also be used as a foreign policy tool. During the Cold War, for example, the United States frequently used access to its domestic market as a bargaining chip in negotiations with other countries. Linking imports with political policies has continued since the Cold War, too, as illustrated by the US and European Union negotiations with China regarding entrance to the World Trade Organization.

Trade embargoes are another economic tool of foreign policy and a great deal of IPE research has focused upon the political economy of trade policies. The logic of an embargo is to shut off imports of many vital items and reduce export earning, thereby reducing domestic welfare and providing the state with an incentive to change its policies.

Eg. The multilateral economic embargo on South Africa linked that nation's policy of racial apartheid.

The U.S. trade embargo against Cuba

Saudi Arabia, Egypt and UAE trade embargo against Qatar

- International Finance: International Finance presents the second set of problems that have traditionally defined International Political Economy. The IPE of International Finance includes analysis of exchange rate policies, foreign exchange systems, international capital movements, particularly portfolio capital and debt flows, and the international and domestic institutions and political structures to which they relate. Three examples illustrate the types of issues that this problématique includes

Eg. 1. The architects of the Bretton Woods agreements designed an international monetary system built upon a dollar-gold standard. The values of international currencies were fixed in terms of the US dollar, which was then defined as a fixed quantity of gold. The responsibility for managing the international monetary system fell on the United States for the most part since its dollar was the key reserve currency. US was confronted with an inevitable choice between its domestic needs and its international responsibilities. The problem is this: at some point, the US was likely to feel the need to put its domestic political concerns ahead of its responsibility to the international monetary system. The Bretton Woods monetary system did in fact finally fail on August 15, 1971 when the U.S. formally removed the fixed link between the dollar and gold.

One lesson to be learned from the collapse of the Bretton Woods monetary system is that economic arrangements create political obligations and are subject to political manipulation. The combination of political and economic arrangements must be "incentive compatible" if it is to succeed in the long run.

Eg. 2. The second example is the IPE of the euro, the single currency adopted by many members of the European Union. It is clear that the euro is both political and it is economic and that the two sides cannot be separated.

The principal goal in creating the single currency was political: the euro would bind Germany forever to its European Union partners and prevent its focus from shifting towards Central and Eastern European relations. In a sense, the economic ties of the euro were meant to replace the political ties of Cold War alliance. A secondary goal was economic: to create a region of relative currency stability to encourage regional economic growth in a world of increasing financial instability.

Eg.3. The third example concerns the IPE of international financial crises. The breakdown of the Bretton Woods, technological change, financial deregulation, the end Cold War divisions, and the emergence of new economic centers all contributed to or accelerated the transformation of finance from an international economic structure, subject to regulation by national governments, to a global structure beyond the regulatory authority of any nation-state, had created a global financial system. In theory the International Monetary Fund could serve this role, but in practice this institution's power is intentionally restricted to limit its ability to undermine state autonomy.

One result of this asymmetry between political and economic structures has been the sequence of international financial crises that includes the Mexican peso crisis of 1994-5, the East Asian financial crisis of 1997, and the Russia crisis of 1999 among others.

The argument is that the range of financial markets has expanded beyond the reach of the regulatory structures that support them. Global markets require global systems of governance to match.

One reason why it is so difficult to agree to a new monetary system is that political and economy systems are complex so that economic changes can have unexpected political consequences. Another reason is that international agreements require that states sometimes sacrifice their domestic needs to honor their international responsibilities. It is difficult to design a system that creates an environment where states consistently honor international agreements. Finally, the strengthening of international or global authority threatens domestic autonomy -- the ability of the state to take action in the national interest.

International finance is viewed by some as less political and more purely economic than international trade, but these three examples give evidence to the contrary. Political scholars may hesitate to engage in this analysis because of the necessity to master difficult theories and arcane terminology, but there is no riper area for IPE analysis. As financial globalization has progressed, the IPE of International Finance has risen in importance as an IPE problématique.

- Globalization: Currently the research agenda in IPE is being driven by a number of factors and forces that are often collectively labeled globalization.

The globalization problématique begins with the global expansion of production and finance and asks questions about the causes and effects of increasingly global market structures. These questions concern politics, business, culture, technology, the environment, global migration, gender relations, and tourism, to name only the most obvious areas.

At the heart of the globalization problématique is the question of the state. International Relations theory puts the state at the center, but many scholars argue that a combination of events has weakened the state, either absolutely or through the relative strengthening of other forces and players. The nation-state, it is argued, is increasingly too small to deal effectively with global issues, and too large and removed to deal with local ones. The state exists in the "missing middle" of the emerging global/local geometry of human society.

Globalization is an example of Schumpeter's famous “creative destruction”. It creates opportunities for new forms of economic and social relations, but in so doing it destroys what came before.

1.4.Early Approaches of IPE

1.4.1. Dependency Theory

Perhaps the earliest approach to IPE was dependency theory, developed largely by Latin American scholars writing in the1960s. The many variants of dependency theory are unified by the idea that the economy and prospects for development in poor countries (the periphery) are conditioned by a global economy dominated by already developed states (the core). Today’s poor countries are not just undeveloped, as had been the case for the core centuries earlier, but are underdeveloped by an international economy that is forever biased against them (Andre Gunder Frank 1966). It follows that underdeveloped countries cannot follow the same path as the already industrialized states, as posited by modernization theory, but that they must pursue new and more autonomous strategies of development.

Despite its early prominence, dependency theory waned by the1980s for two reasons.

- Its proponents failed to develop a unified, logically consistent, and empirically robust theory of underdevelopment.
- The theory was essentially falsified by the rise of the so-called newly industrializing economies, who took off in the1970s using an export-led growth strategy.

Nonetheless, dependency theory taps into issues of international inequality, uneven growth, and national control over international economic forces that remain central to contemporary debates about globalization.

1.4.2. Hegemonic[3] Stability Theory (HST)

The hegemon is a rich and powerful state that undertakes to supply public goods to the international system. These public goods include stable money, security (such as freedom of the seas), and a system of free trade that can be shared by all. If the world system prospers, the hegemon necessarily prospers as well. In fact, this provision of public goods may be a strategy to secure or extend the hegemon's dominant position.

The theory of hegemonic stability holds that the world system is most prosperous when a hegemon exists to organize the international political and economic system and coordinate the provision of international public goods. Periods of Dutch (1620-72), British (1815-73), and U.S. hegemony (1945-71) are commonly cited as evidence of this link between hegemony and prosperity (although there is disagreement about specific dates). When hegemony breaks down, however, the international system falls into disorder and conflict, with the resulting decline in peace and prosperity. The theory of hegemonic stability puts great weight on the existence of the hegemon and the maintenance of effective hegemonic policies.

Based largely on the experiences of Great Britain in the mid-nineteenth and the United States in the mid-twentieth centuries, the key intuition behind this approach is that a single hegemonic state is necessary and sufficient for international economic openness to arise. For the world economy to be stabilized there has to be a stabilizer, one stabilizer.

It posits that large dominant states possess strong preferences for free and open international exchange and, in turn, coerce, induce, or persuade other states into opening their markets to foreign trade and investment (Gilpin1975, 1977). Rather than focusing on collective action problems, hegemony theory posits that states have different preferences over international economic policy and outcomes are a result of strategic bargaining. Hegemony theorists argue that either states have more complex utility functions, including not just national wealth but power and stability.

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[3] Hegemony is a form of hierarchy necessary to enforce contracts and maintain international order so that international exchange and investment can occur.

As America's hegemony declined in the1970s and 1980s, HST expected the international economy to become more fragile and, ultimately, to collapse into renewed protectionism and exclusive economic blocks (Gilpin 1987). The rising problems and tensions in the international economy, and America's own slide into new forms of protectionism, gave backing to this view.

By the early 1990s, the Soviet Union had collapsed, the European and Japanese economies had slipped into a decade of stagnation, and the United States was once again hegemonic—but HST was nearly forgotten. Central to this approach, however, was the recognition that not all countries are "created equal," that some are more important to the openness of the world economy than others, and that large countries have particularly large effects on others.

This theory argues that hegemony is a self-limiting, self-defeating, and therefore temporary condition. The argument is that while the hegemonic state bears the burdens of organizing the international system and supplying public goods, free-rider states prosper, expand, and increase the burdens on the hegemon. At some point the hegemon finds itself over-committed and unable to bear the costs of the system it has created. Either the hegemon begins to put domestic interests over its international obligations or it becomes too weak to honors its widespread commitments. Either way hegemony collapses in on itself, the story goes, and chaos reigns until another hegemonic state arises to restore (temporary) order. Britain's decline in the 19th century (followed by World War I) is frequently cited as an example of hegemonic decline as is the collapse of the Bretton Woods system (viewed as the mechanism of US hegemony).

Hegemony is a state-centered concept that includes security as a critical element, but that draws upon the analysis of international trade and international finance to provide a richer and more complex explanation of the rise and fall of great powers.

1.4.3. Open Economy Politics

It dominates the study of IPE in the 1990s. OEP adopts the assumptions of neoclassical economics and international trade theory. It OEP provides a bridge between modern economics and political science.

In some OEP theories, individuals are primary but in most, firms, sectors, or factors of production are taken to be the relevant units. OEP begins with firms, sectors, or factors of production as the units of analysis, derives their interests over economic policy from each unit's position within the international economy, conceives of institutions as mechanisms that aggregate interests (with more or less bias) and condition the bargaining of competing societal interests, and, finally, introduces when necessary bargaining at the international level between states with different societally produced interests.

Interests[4]

The fundamental building block of OEP is interest, or how an individual or group is affected by a particular policy. Actors that benefit from a policy are expected to expend resources in the political arena to obtain that policy (as shorthand, to lobby) up to the point where the marginal cost of that effort equals the marginal benefit. Conversely, actors that lose from a policy are expected to lobby against it. In short, politics is fundamentally about winners and losers from alternative policies.

OEP uses economic theory to deduce what types of individuals can be reasonably assumed to share identical interests. A key divide within the approach is between the Ricardo–Viner or specific factors theory of international trade, which assumes that, typically, capital and labor are fixed in particular occupations and, thus, will tend to have similar interests over trade policy, and the Heckscher–Ohlin theory of international trade, which assumes that all factors are mobile across occupations and, therefore, capital, land, and labor will possess opposing interests.

OEP studies distributional implications of different economic policies and, in turn, how a group is located relative to others in the international economy. Deducing interests from economic theory was a fundamental innovation for OEP, one that makes the approach unique in political economy.

Institutions

Institutions aggregate conflicting societal interests, with varying degrees of bias, and condition the bargaining between opposing groups. In weakly institutionalized political systems, like the international system or "failed states," coercive strength is expected to determine political

[4] Preferences over alternative policies

outcomes. In highly institutionalized settings, like most domestic political systems, established rules and procedures generally reflect group strength.

At any moment, institutions serve to define what political power means in a particular society, whether the competition over policy will be conducted via votes, via contributions and bribes, or via ideas and argument. In short, institutions determine the rules of the political game.

International Bargaining

With domestic interests aggregated through institutions into a national policy states then bargain when necessary to influence one another's behavior and to determine the joint outcome of their actions. This is the third and final step in the OEP approach.

International bargaining commonly arises when the policies of one state create externalities for others. In many situations, externalities arise from the collective choices of many small economic actors. In these so-called market failures, individually optimal choices lead to collectively sub optimal results.

Two assumptions here: small country" assumption of traditional international trade theory, which holds that any individual state's production or consumption is sufficiently small relative to world supply and demand that its actions cannot affect world prices. Under this assumption, the unilateral actions of states do not affect the welfare of others and, it follows, unilateral free trade is the first-best policy. Large countries, on the other hand, unilateral actions can affect world prices (for at least some commodities) and, as Kyle Bagwelland Robert Staiger (2002) demonstrate, negotiated movements toward freer trade can be superior.

Although important, externalities are not a necessary condition for international bargaining to arise. Even when they are not directly affected by the actions of others, states may promote international norms and may be willing to pay some price to gain adherents or alter the behavior of possible violators. Most theories of IPE continue to assume that bargaining occurs mostly as a result of some material externality.

Chapter Two

2. Theories of International Political Economy

2.1.Mercantilists

Mercantilism represents, more than anything else, the economic strategies widely promulgated by the European nation states in the early capitalist era –1500 to 1850 – and arguably by a number of Asian states in the 20th and 21st centuries. Thus the mercantilist pre-economists writers were – commonly but not always businessmen – who lived in Europe during this era. Today the term "mercantilism", if recognised at all, is understood as "fallacious thinking in macroeconomics", and can be used as a way of tarring a one's doctrinal opponents.

The goal of economic activity, according to most mercantilists, was production - not consumption. For the mercantilists, the wealth of the nation was not defined in terms of the sum of individual wealth. They advocated increasing the nation's wealth by simultaneously encouraging production, increasing exports, and holding down domestic consumption. Thus, the wealth of the nation rested on the poverty of the many. Although the mercantilists laid great stress on production, a plentiful supply of goods within a country was considered undesirable. High levels of production along with low domestic consumption would permit increased exports, which would increase the nation's wealth and power. The mercantilists advocated low wages in order to give the domestic economy competitive advantages in international trade. Also, they believed that wages above a subsistence level would result in a reduced labor effort: higher wages would cause laborers to work fewer hours per year, and national output would fall. Thus, when the goal of economic activity is defined in terms of national output and not in terms of national consumption, poverty for the individual benefits the nation.

Thus mercantilists regarded liquid and internationally realisable financial claims (in the then form of gold or silver), rather than consumable goods and services, as national wealth. Keynes (1936, p.335) explicitly noted that their good ideas, of which there were many, generally promoted the well-being of the nation-state rather than the global economy as a whole. Hence the enduring label of mercantilists as economic nationalists. Mercantilism has been linked in the modern mind with the concepts of imperialism (O'Brien 1996), protectionism (Economist 1990), and rent-seeking (Ekelund and Tollison 1997). While mercantilist strategies may include all three, none grasps the essence of mercantilism. Certainly, in its internationalist context, mercantilism can be characterised as "economic nationalism" or, more extremely, "economic warfare".

Mercantilists analyzed how nations produce wealth, with the attention of credit balance of payment, a favorable trade of balance, manufacturing and fertile soil. The early mercantilists describe economic life in terms of circulation of commodities and social surplus products that will become evident with the growth in manufacturing and technology in agriculture. Assume wealth springs from trade and industry.

Mercantilism is economic nationalism for the purpose of building a wealthy and powerful state. Adam Smith coined the term “mercantile system” to describe the system of political economy that sought to enrich the country by restraining imports and encouraging exports. This system dominated Western European economic thought and policies from the sixteenth to the late eighteenth centuries. The goal of these policies was, supposedly, to achieve a “favorable” balance of trade that would bring gold and silver into the country and also to maintain domestic employment.

The most important economic rationale for mercantilism in the sixteenth century was the consolidation of the regional power centers of the feudal era by large, competitive nation-states. Other contributing factors were the establishment of colonies outside Europe; the growth of European commerce and industry relative to agriculture; the increase in the volume and breadth of trade; and the increase in the use of metallic monetary systems, particularly gold and silver, relative to barter transactions.

Most of the mercantilist policies were the outgrowth of the relationship between the governments of the nation-states and their mercantile classes. In exchange for paying levies and taxes to support the armies of the nation-states, the mercantile classes induced governments to enact policies that would protect their business interests against foreign competition.

These policies took many forms. Domestically, governments would provide capital to new industries, exempt new industries from guild rules and taxes, establish monopolies over local and colonial markets, and grant titles and **PENSIONS** to successful producers. In trade policy the government assisted local industry by imposing tariffs, quotas, and prohibitions on imports of goods that competed with local manufacturers. Governments also prohibited the export of tools and capital equipment and the emigration of skilled labor that would allow foreign countries, and even the colonies of the home country, to compete in the production of manufactured goods. At the same time, diplomats encouraged foreign manufacturers to move to the diplomats' own countries.

While the publication of *The Wealth of Nations* is generally considered to mark the end of the mercantilist era, The Napoleonic Wars in Europe and the Revolutionary War in the United States heralded the end of the period mercantilist policies. In addition, the variety of new products that were created during the industrial revolution made it difficult to enforce the industrial policies that were associated with mercantilist doctrine.

A number of factors led to the reemergence of mercantilist policies after World War II. The Great Depression created doubts about the efficacy and stability of free-market economies, and an emerging body of economic thought ranging from Keynesian countercyclical policies to Marxist centrally planned systems created a new role for governments in the control of economic affairs. In addition, the wartime partnership between government and industry in the United States created a relationship—the military-industrial complex, in Dwight D. Eisenhower's words—that also encouraged activist government policies. In Europe, the shortage of dollars after the war induced governments to restrict imports and negotiate bilateral trading agreements to economize on scarce foreign exchange resources. These policies severely restricted the volume of intra-Europe trade and impeded the recovery process in Europe in the immediate postwar period.

The economic strength of the United States, however, provided the stability that permitted the world to emerge from the postwar chaos into a new era of prosperity and growth. The Marshall Plan provided American resources that overcame the most acute dollar shortages. The Bretton Woods agreement established a new system of relatively stable exchange rates that encouraged the free flow of goods and capital. Finally, the signing of the GATT (General Agreement on

Tariffs and Trade) in 1947 marked the official recognition of the need to establish an international order of multilateral free trade.

The mercantilist era has passed. Modern economists accept Adam Smith's insight that free trade leads to international specialization of labor and, usually, to greater economic well-being for all nations. But some mercantilist policies continue to exist. Indeed, the surge of protectionist sentiment that began with the oil crisis in the mid-1970s and expanded with the global recession of the early 1980s has led some economists to label the modern pro-export, anti-import attitude "neo mercantilism." Since the GATT went into effect in 1948, eight rounds of multilateral trade negotiations have resulted in a significant liberalization of trade in manufactured goods, the signing of the General Agreement on Trade in Services (GATS) in 1994, and the establishment of the World Trade Organization (WTO) to enforce the agreed-on rules of international trade

2.1.1. Critics Against Mercantilism

Adam Smith refuted the idea that the wealth of a nation is measured by the size of the treasury in his famous treatise ***The Wealth of Nations***, a book considered to be the foundation of modern economic theory. Smith made a number of important criticisms of mercantilist doctrine. First, he demonstrated that trade, when freely initiated, benefits both parties. Second, he argued that specialization in production allows for economies of scale, which improves efficiency and growth. Finally, Smith argued that the collusive relationship between government and industry was harmful to the general population. While the mercantilist policies were designed to benefit the government and the commercial class, the doctrines of laissez-faire, or free markets, which originated with Smith, interpreted economic welfare in a far wider sense of encompassing the entire population.

Of the false tenets of mercantilism that remain today, the most pernicious is the idea that imports reduce domestic employment. Another mercantilist view that persists today is that a current account deficit is bad. When a country runs a current account deficit, it is either borrowing from or selling assets to the rest of the world to finance expenditure on imports in excess of export revenue. However, even when this results in an increase of net foreign indebtedness, and associated future debt servicing requirements, it will promote economic wealth if the spending is for productive purposes that yield a greater return than is forgone on the assets exchanged to finance the spending. Many developing countries with high rates of return on capital have run current account deficits for extremely long periods while enjoying rapid growth and solvency. The United States was one of these for a large part of the nineteenth century, borrowing from English investors to build railroads. Furthermore, persistent surpluses may primarily reflect a lack of viable investment opportunities at home or a growing demand for money in a rapidly developing country, and not a “mercantile” accumulation of international reserves at the expense of the trading partners.

2.2.Liberalism

Liberalism is a term rooted in the Latin word liber, which means free. Liberalism advocates liberty, another word linguistically related to liber. The theoretical roots of liberalism can be found in the seventeenth-century writings of John Locke and the eighteenth century works of Adam Smith. These early liberals are known as classical liberals. In the nineteenth century, liberalism was modified by theorists such as T. H. Green and Jane Addams. This later form of liberalism is termed modern liberalism.

2.2.1. CLASSICAL LIBERALISM

John Locke (1632–1704) was an English philosopher who is often credited with being the originator of liberalism. Locke lived during a period of political turmoil. In his lifetime, one king was executed and the institution of the monarchy was, in turn, abolished, reinstituted, and restricted in its powers. Despite the disorder surrounding him, Locke’s personal life was one of accomplishment and success. He graduated from Oxford in 1656, taught philosophy, and published works on philosophy, politics, religion, and education. In his Two Treatises of Government (1690), Locke argues in favor of limited government and protection for individual rights. He builds a logical case for both propositions by extensively discussing human nature, the state of nature, laws of nature, and the origins of states. Locke’s discussion of these topics culminates in his rejection of the political theory of English writer Robert Filmer (1588–1653), a very popular theorist who supported the doctrine of the divine right of kings. According to Filmer, God gives monarchs absolute authority over citizens. As Filmer saw it, citizens were born into subjection to the monarchy and had the duty to be faithful subjects. By contrast, Locke believed that people created governments by freely consenting to those governments and that governments should serve citizens, not hold them in subjection. Locke begins his liberal theory by examining human nature. He writes of human nature in reference to what he calls a state of nature. The state of nature was a period of time prior to the creation of governments. It was a time in human history when women and men lived in small groups and communities, and for Locke it was a very revealing period of human history. What was so important about the state of nature? Individuals living in this state of nature had not been influenced or shaped by laws or political decrees because governments did not yet exist. Consequently, Locke contends, we can look to individuals living in this natural state to see what humans are like at their most natural level. We can look into the state of nature to observe human nature itself.

If you find it unusual that Locke would refer to a long-ago state of nature in his discussion of contemporary politics, recall that Locke was writing before the development of modern geology and evolutionary biology. For Locke, therefore, history did not consist of a very long timeline. In fact, all human history was assumed to consist of a few thousand years. Thus, it made sense to Locke to assume that one could trace back the existing generation to a not-so-remote state of nature. According to Locke, what we learn from a study of the state of nature is that human nature is characterized by freedom, equality, and reason. Humans are naturally free, born with the duty to submit to no one. That is, in the state of nature there are no natural rulers to whom we owe obedience. On the contrary, each person is naturally equal to all others, according to Locke. Each person is born equally free and equally in possession of certain natural rights (natural rights are rights we have just by virtue of being human). These rights are an element of our natural human nature. Locke believed that our natural rights include the right to life, liberty, and property. Insofar as each of us is equally human, each of us has an equal claim to enjoy these rights freely.

As you can see, the concepts of natural equality, natural right, and natural freedom are logically connected in Locke's theory. These ideas are also closely related to Locke's concept of natural reason. Humans possess a natural capacity to reason and can use this reason to deduce a set of ethical codes by which to live. Locke calls these ethical principles the laws of nature. Notice the logic of his terminology. He has told us that reason is rooted in human nature; therefore, that which is deducible by reason is natural. It is a reflection of and product of nature. Laws of nature are commonsensical codes, ones that are obviously correct to reasoning men and women. Locke identified three specific laws of nature:

• Preserve yourself. Take care of yourself and your needs. Work to promote your own survival.
•Do not harm others. Do not seek out trouble by starting conflicts and wars. If you seek to harm others, this will put you at risk of being harmed and will thus violate the first law of nature.

• Help others if possible. Help others if you can help them without putting yourself at risk.

According to Locke, each of these laws is self-evident to any thinking person. It makes sense to take care of yourself, to avoid creating dangerous situations in which you may die, and to help people who may later remember your good deeds and help you. Through his discussion of the laws of nature, Locke comes to a very important conclusion: People are capable of running their own lives because they have common sense. Government does not make people rational. Government does not make people fit for each other’s company. People have within their own natural makeup the capacity for rational existence.

Governments are formed because rational people see that they are useful. In the state of nature, certain annoyances may arise. Individuals pursuing their own preservation and betterment (consistent with the first law of nature) may act in self serving ways at times. In disputes, individuals may be biased in favor of their own positions. These biases may make it difficult to resolve disputes in an impartial manner that is fair to all parties. In addition, an individual may act contrary to reason. An individual may, on occasion, violate the laws of nature. Lockean theory, in positing that reason is a part of human nature itself, suggests that such acts of irrationality may not be so frequent as to become routine, but even if infrequent, such acts of irrationality create serious problems. If someone violates a law of nature—for example, if someone steals the property belonging to another—in the state of nature, individuals themselves must be the ones to enforce the laws of nature. In the case of the thief, individuals must find the thief, adjudicate any disputes over the thief’s actions, and then execute the laws of nature to discourage future theft. These tasks are cumbersome and time consuming. Would it not be nice to get rid of these annoyances? Would it not be nice to assign someone the task of enforcing the laws of nature so that those individuals who abide by the laws of nature need not do the enforcing? The desire for such a convenient arrangement is the motivation for creating government. Government can do the job of legislating, adjudicating, and enforcing rules in conformity with the laws of nature.

Government is created when individuals come together and give clear, direct, explicit consent to the formation of the state. Only those who freely give their direct consent to the state are considered citizens of this state. That is, no one is forced to leave the state of nature, so no one's natural freedom is violated. In creating the state, Locke explains, citizens give it power, but only limited power. The state has the limited tasks of making civil laws (human-made laws), which uphold the laws of nature. In this way, natural rights are protected and made more secure by the existence of an institution (the state) with the specific responsibility of making and enforcing laws to protect life, liberty, and property. If the state ever exceeds its appropriate authority, it violates these rights. Locke calls such a state tyrannical, authoritarian, and illegitimate. After all, such a state is making war against reason and the laws of nature. Such a state has lost its integrity and is not worthy of obedience.

In this discussion, Locke has made several points central to classical liberalism. First, he has established that the individual is more important than the state. The individual is the creator of the state and state authority. Without the explicit consent of individuals, states would not exist. Second, Locke has concluded that the individual is capable of independence and self-determination. Freedom is natural. Self-control and self-direction are natural to people because people can figure out the laws of nature. People are capable of making decisions for themselves and living their lives as they please and for the most part can do so without causing problems for others. Third, Locke has established an ideological basis for believing that progress is possible in human affairs. Because people are rational, they can take positive steps to improve and reform their societies. Change is not to be feared because rational humans can direct and steer change in ways that will promote well-being. Fourth, the logic of Locke's theory proposes that state power should be limited. States make our lives more convenient because they take on the burden of enforcing the laws of nature. This enforcement offers protection to us as we enjoy our natural rights. However, states are not in existence to make us moral, make us rational, or tell us how to live. Each individual, as long as he or she does not violate the laws of nature, should be left alone by the state so that the individual can decide how best to enjoy his or her natural freedom. Thus, classical liberals such as Locke side with Madison over Machiavelli on questions of state power and with Mill over the fundamentalists on issues involving morality and politics.

Classical liberalism was elaborated on by Adam Smith (1723–1790). Smith was a Scottish moral philosopher whose economic writings offer an elaborate justification of both classical liberalism and capitalism. Indeed, in Smith's theory, liberalism and capitalism are mutually reinforcing social arrangements. Liberalism and capitalism share a conceptual basis—both are founded on the premise of individual rationality. According to Smith, individuals pursue rational self-interest. In terms of economics, for example, individuals seek to satisfy their interests and needs by exchanging objects (money, goods, and services), and each party to the exchange seeks to better his or her position. If A desires object X and can obtain X on terms more favorable from B than from C, A's rational self-interest will incline A to exchange with B. B is rewarded and C is encouraged to improve his or her objects of exchange in order to benefit from future transactions. Capitalism—an economic arrangement in which individuals exchange their private properties according to their own self-interest with little or no state interference—is thus justified by Smith.

Consider the parallels with Locke. Both writers argue that individuals are rational enough to decide what is best for themselves. Think back to the preceding example: A can figure out how best to meet his or her needs—trade with B, not C. Government is not needed to direct A's decision. Individuals deduce for themselves how to live well. In short, both Smith and Locke agree that because individuals are so very rational, expansive regulatory governments are unnecessary. The departure from Filmer is a radical one; free individuals have no need of absolute monarchies. According to Smith, government's role should be restricted to providing security and public services such as public roads, bridges, and schools.

Under classical liberalism, natural equality does not lead to economic equality. Although Locke and Smith proclaim that individuals are naturally equal (that is, when individuals are born no one has any natural or preordained political authority over any other person), they conclude that individuals living in society will come to be divided into different economic groups. Locke asserts that economic classes of rich and poor will emerge as an economy develops. Locke attributes this class division to the use of money. He outlines his argument by explaining that in the early stages of economic development in any country, individuals tend to barter and exchange perishable objects. One person trades apples for beans, for instance. Because these objects of exchange are perishable, hoarding them for the purpose of stockpiling large quantities is very difficult. As a result, people's possessions remain relatively equal because no one can stockpile and acquire significantly more than anyone else. With economic development, however, societies begin to use money as a medium of exchange. Money does not spoil and can be hoarded. Some individuals can be expected to take advantage of the imperishable quality of money and start to store up increasingly large amounts. In this way, classes of rich and poor begin to appear.

According to Locke, this emergence of economic inequality does not create injustice or render the society illegitimate. Why? By using money, individuals imply that they are willingly consenting to the consequences of money. Economic inequality is consented to by rational individuals, whom Locke considers to be perfectly capable of deciding for themselves how to manage their own lives. Notice something very important in Locke's theory: The same logic that is used to justify limited government is used to justify economic inequality—namely, the notion that individuals know best, that individuals should be left alone to make their own choices.14 If individuals consent to having economic inequality within their communities, then so be it.

Smith also argues that natural equality is not sufficient to produce economic equality. Smith's discussion is very candid.15 He points out that, at birth, children are basically equal in terms of natural abilities. As children grow up, however, they enter different worlds. One pursues education, and the other does not. Consequently, as adults, they earn different returns on the labors they exchange. Physicians earn more than unskilled laborers. Like Locke, Smith accepts economic inequality. He sees society as making a rational trade-off when it embraces the capitalism in which the physician's and the unskilled laborer's lives are so very different. In return for economic inequality, society gains all the creative output from individuals producing goods and services as diverse as those created by physicians, unskilled laborers, and the other occupational groups comprising the economic sector.

Locke and Smith have arrived at some important conclusions, which go on to serve as basic precepts of classical liberalism's approach to economic policy. First, economic inequality is not necessarily unjust or unfair. Economic inequality is not a violation of natural equality. Instead, it arises from the free choices made by rational individuals sorting out the options available to them. Second, individual freedom is not to be sacrificed for the creation of economic equality. States are not to intrude into the economic interactions of individuals and mandate equal outcomes in terms of salaries, wages, prices, or property values. States are not to become "despotical" in order to give people equal incomes.

Over the years, classical liberalism has appealed to women and men who are drawn to its arguments in favor of keeping government small and limited. Classical liberalism has been praised by many for upholding individual liberty and freedom of choice in politics and economics.

Yet some writers have seen in classical liberalism something terribly flawed—even sinister. Is classical liberalism too comfortable with economic inequality, they ask? Does classical liberalism's concern with limiting state power turn it into an ideology that is insensitive to matters of social justice? Questions such as these led to critical disagreements among liberals. Out of the debate, modern liberalism emerged.

What most defines classical liberals is the priority they give to individual freedom. Believe that we should aim to maximise the freedom that individuals enjoy. Classical liberals maintain that people should be allowed to live their lives as they choose, with only the minimum necessary restraint from other individuals or authorities. They accept that freedom can never be absolute, since one person's freedom may conflict with another's: we may all have freedom of movement, but we still cannot all move onto the same spot at the same time. And freedom does not mean you are free to rob, threaten, coerce, attack or murder others, which would violate their freedom.

2.2.1.1.Ten principles of classical liberalism

1. The presumption of freedom

They have different grounds for this conclusion. To many, freedom is good in itself. Others say that freedom is something given to us by God or Nature and to avoid chaos and conflict. Many suggest that freedom is an essential requirement for progress. Some make a humanist point, that freedom is an essential part of what it means to be human: someone who is controlled by others is not a whole person, but a mere cipher. Lastly, utilitarian classical liberals value freedom as the best way to maximise the welfare of society as a whole.

2. **The primacy of the individual**

Classical liberals see the individual as more important than the collective. They would not sacrifice an individual's freedom for some collective benefit – at least, not without some very good justification. They have several different reasons for this:

- One view – called methodological individualism – is that a collective has no existence beyond the individuals that comprise it. Certainly, society is more than a collection of individuals, just as a house is more than a collection of bricks. But society has no independent mind of its own; it is individuals who think and value and choose and drive events. There is no collective 'public interest' beyond the interests of the individuals who comprise that community.
- Individuals disagree: the interest of one person may be against the interest of others.
- Experience: History explodes with examples of the horrors visited on populations when their freedom is sacrificed to some leader's misconceived notion of the collective good.
- Society is hugely complicated and in constant flux. No single authority could possibly know what is best for everyone in this complex, dynamic world. Individuals are far better placed to make decisions for themselves, and should be left free to do so.

3. **Minimising coercion**

Classical liberals give the monopoly on the use of force to the government and judicial authorities. But they want to keep even that to its necessary minimum; they know how easily power can be abused. Classical liberals maintain that any use of force to curb people's actions must be justified.

4. **Toleration**

Classical liberals believe that the main – or perhaps the only – good reason to interfere with people's freedom is to prevent them doing or threatening actual harm to others. They see toleration and mutual respect as essential foundations for peaceful cooperation and the creation of a beneficial, well-functioning society. Human differences are a fact of our social life, and always have been. Liberals do not believe that those differences can be eliminated, and are deeply sceptical of Utopian attempts to do so. Given that, toleration will always be a necessary part of functioning social life.

5. **Limited and representative government**

Classical liberals concede that some force may be needed to prevent people injuring others, and agree that only the authorities should have this power. They know that power tends to corrupt, and that politicians often cite the 'public interest' for policies that are actually in their own interests.

Social contract theorists such as the English philosopher John Locke (1632–1704) argue that government power comes from individuals, not the other way round. People give up some of their freedoms to the government in order to maximise their freedom in general. So government has no legitimate powers beyond the powers that individuals have themselves; and the whole purpose of government is to expand freedom, not to restrict it.

American revolutionary thinker Thomas Paine (1737–1809) argued, citizens would be within their rights to overthrow any government that broke this trust.

But revolution is a last resort. Classical liberals believe that representative and constitutional democracy is the best means yet discovered for keeping our legislators accountable to the people. Elections are not so much about choosing good leaders, but removing bad ones.

6. **The rule of law**

Another principle that restrains power and creates greater security for the public is the rule of law. This is the idea that we should be governed by known laws, not the arbitrary decisions of government officials.

Classical liberals insist that the law should apply equally to everyone, regardless of gender, race, religion, language, family or any other irrelevant characteristics. It should apply to government officers just as much as to ordinary people; nobody should be 'above the law'.

7. Spontaneous order

You may think that a large and complex society needs a large and powerful government to run it; but classical liberals dispute this. They believe that government is not the basis of social order.

The Austrian social theorist F. A. Hayek (1899–1992) called the result spontaneous order. Spontaneous orders can be hugely complex. They evolve through individuals following rules of conduct – like the rules of grammar – that they might not even realise they are following.

8. Property, trade and markets

Classical liberals believe that wealth is not created by governments, but by the mutual cooperation of individuals in the spontaneous order of the marketplace. Prosperity comes through free individuals inventing, creating, saving, investing and, ultimately, exchanging goods and services voluntarily, for mutual gain – the spontaneous order of the free-market economy. This wealth-creating social order grows out of a simple rule: respect for private property and contract, which allows specialisation and trade.

Classical liberals do not allow property to be acquired by force. In fact, most property is created – crops are raised, houses are built, innovations are developed. Property clearly benefits the owner. But, in fact, it benefits everyone because it promotes wider prosperity.

9. Civil society

Classical liberals believe that voluntary associations are better at providing individuals' needs than are governments. While they emphasise the priority of individuals, they recognise that people are not isolated, atomistic, self-centred beings. On the contrary, they are social animals and live in families and groups and communities that partly shape their values – clubs, associations, unions, religions, schools, online communities, campaigns, self help groups, charities and all the other institutions that we call civil society.

These institutions are an important part of how people relate to each other. They provide the basis of mutual understanding on which cooperation can be built. Indeed, cooperation would be impossible without the freedom to associate like this.

Civil society also provides a buffer between individuals and governments. If we really were all isolated individuals, our freedoms would be easily suppressed by a despotic government.

2.2.2. Modern Liberalism

English philosopher T. H. Green (1836–1882) was an advocate of modern liberalism. Modern liberals make the following revisions to liberal theory: They argue in favor of interventionist government and expansive liberty. Interventionist government is government that takes a role in regulating economic and social interactions. Expansive liberty is the objective sought by the interventionist government.

Green justifies his revised form of liberalism by pointing to what he considers to be the unacceptable implications of classical liberalism. Classical liberalism, he writes, views freedom in terms of freedom from state intervention. Someone is free, as the classical liberals see it, if he or she is not being regulated by or dictated to by government. For Green, this definition of freedom is too narrow. He prefers to define freedom as broader, more expansive, and more inclusive. Green's liberty is freedom to expand the boundaries of human potential and make a creative contribution to society. Modern liberalism's expanded outlook conceptualizes liberty as maximizing individual potential and using that potential to be a contributing member of a society. It is a liberty involving living fully and actively, using one's talents and fulfilling one's potential.

Consider the ramifications of this revised definition of freedom. Think about hypothetical person Mary Smith. Let's say that she is unemployed and living in a homeless shelter. She is free to make personal choices in terms of where to look for a job, what kind of job to seek out, and how many hours to spend at the shelter or looking for employment. Of course, she is also free to make choices on private matters of conscience—whether to believe in God or not, whether to support capital punishment or not, and so on. Despite her freedom of thought and opinion, however, let's say she is demoralized by her poverty and feels defeated and hopeless.

Is person Mary Smith free? From a classical liberal standpoint, because she is not having choices dictated by an intrusive government and is not being interfered with, she is free. She is not happy, but she is free, and classical liberals would expect her to use her rationality to find a path out of this desperate, unhappy existence. From Green's perspective, however, Mary Smith is not free. Her potential to participate as a contributing member of society is being wasted. How very different her life appears, depending on how one defines liberty. If one moves from a classical liberal definition to a modern one, hypothetical person Mary Smith is transformed from a free person into an un free (oppressed) one.

Green argues that an interventionist state is needed to promote the cause of this new expansive liberty, which is often called "positive liberty." States should not be limited to the protection of individualism (Locke and Smith are incorrect) but should intervene in society on behalf of those whose positive liberty is violated. Modern liberals such as Green supported government action to help those who lacked the resources needed to develop their own potential. Modern liberals have called for government assistance to working women and men who could not, in the absence of laws supporting them, demand that employers provide safe working conditions and increased wages. Modern liberals have also proposed that laws be enacted to regulate the amount of hours that employees could be required to work and that laws be passed to promote regulations to further public health. Did such laws interfere with negative liberty? Of course they did, Green argued. It was government's job to intervene in society and restrict the liberty of one person or group if that person or group happened to be carrying out actions that denied others the opportunities of pursuing the fullest realization of human potential (expansive liberty).

Green's theory provides insights on the logic of modern liberal ideology. First, we can see from Green's writings that modern liberals believe that state intervention can promote and enhance individual freedom. Defining freedom as expansive liberty, modern liberals assert that state regulations protecting health, education, and workplace conditions and generally promoting the well-being of the less powerful sectors of society prevent exploitation and the denial of (positive) liberty. Increased state intervention in society can lead to increased levels of expansive liberty. Second, modern liberals are not as willing as are classical liberals to accept economic inequality. According to modern liberals, someone who is poor may have a difficult time realizing his or her potential; therefore, poverty is an impediment to expansive liberty and should be remedied by laws enacted by the interventionist state. In other words, modern liberals believe in both natural equality and economic equality. Third, modern liberalism promotes the social welfare of society. Indeed, we can see the parallels between Green's ideology and the logic of welfare policies designed to help the marginalized to achieve their potential.

Jane Addams (1860–1935) advanced the cause of modern liberalism in the United States. Addams was a founder of Hull House in Chicago. Hull House was a community center that offered assistance to immigrants, workers, young women, and others in need of social services. In addition, Addams campaigned for legislation to support social welfare programs, women's rights, consumer protection, and economic equality. Specifically, she worked on behalf of the 8-hour workday, the prohibition of child labor, and the right of workers to strike. Addams viewed these reforms in quintessentially modern liberal terms: If the state intervened to help those in need, this would take away the freedom of the powerful to exploit the weak and would therefore replace exploitation with expansive liberty. Thus, when Hull House and/ or the state intervened to help the needy, this intervention advanced the welfare and freedom of the powerless.18 If classical liberals were correct in saying that individual freedom is a wonderful thing, shouldn't the powerless enjoy it as well and thus become empowered? To Addams, the answer was obvious, and the state was needed to act as advocate and enforcer of expansive liberty.

Chapter Three

3. International Trade

3.1.Introduction

International trade is the inter-country flow of goods and financial resources. It is considered to be part of the production structure (a set of relationships that determine what is produced, where, by whom, how, for whom and at what price) of political economy. When elements of this structure cross international boundaries the result is international trade, which assumes forms of interaction between states and other actors such as international business.

Trade is always political and the economics of trade cannot be separated from its political aspect. Not only does trade continue to gain an importance for national officials but also a number political actors and institutions outside the nation states that shape developments in this area has grown significantly since the end of the Cold War. Trade ties countries together and in so doing generates a good deal of political and economic interdependence. Partly because of this, states, today, are compelled more than ever to regulate international trade so as to capture its benefits and limit its costs to their economies.

3.2. Why States Trade?

3.2.1 The Absolute Advantage (Adam Smith Model)

Adam Smith (father of liberalism and economical science) brought the argument in his book "The Wealth of Nations", published in 1776, about absolute advantage. Adam Smith's theory starts with the idea that export is profitable if you can import goods that could satisfy better the necessities of consumers instead of producing them on the internal market. The essence of Adam Smith theory is that the rule that leads the exchanges from any market, internal or external, is to determine the value of goods by measuring the labour incorporated in them.

In order to demonstrate his theory, Adam Smith analyzed using one country (say A), using one factor of production, the productivity of labour (evaluated in the necessary of hours needed to produce a unit of measure of the products X and Y). Because all the economies have limited resources, there are limits in the level of production, and if a country wants to produce much of one product it has to give up producing another goods, existing in this case renounce of trade.

Country	**Products** **Units of product/units of time**			
	Without Trade		**After Specialization and Trade**	
	X	Y	X	Y
A	6	3	12	_____
B	3	6	_____	12
Total	9	9	12	12

Country A is more productive than B in the production of X and it has an absolute advantage in this product and country B is more productive in producing product Y. It is reasonable and in the benefit of the two countries to concentrate all resources of labour to the product for which they have an absolute advantage. After specialization, exchanging products, both countries can gain from trade.

3.2.2 The Comparative Advantage (David Ricardo model)

The main distinguishing feature of international trade singled out by Ricardo was the international immobility of factors of production. Factors were regarded as perfectly mobile within countries and completely immobile among countries, whereas goods were perfectly mobile within and among countries (at zero transport cost).

Ricardo rather glossed over the question of the interdependence of industries, treating them as integrated, producing one output and using one primary input (labor). The latter being mobile internally, the unit cost of each good was constant, depending only on the amount of labor required to produce it.

In his celebrated example of trade in cloth and wine between England and Portugal, he says "England may be so circumstanced, that to produce the cloth may require the labour of 100 men for one year; and if she attempts to make the wine, it might require the labour of 120 men for the same time. England would therefore find it her interest to import wine, and to purchase it by the exportation of cloth."

Country	**Productivity** **Hours/Monetary Units**		**Opportunity Cost**	
	X	**Y**	**X**	**Y**
A	1	2	0.5	2.0
B	6	3	2.0	0.5

Country A is more productive in X than Y. and country B is more productive in Y than in X. each country should specialize in the production in which it has less opportunity cost.

3.2.3. THE H-O MODEL

One of the most popular model advanced in explaining the concept of comparative advantage was provided by two Swedish economists Eli Heckscher and Bertil Ohlin is known as the Heckscher-Ohlin model or the factor endowments or factor proportions model. Since its development in the early 1930s this model has been accepted as the standard explanation of international trade.

Heckscher-Ohlin (or H-O) model of comparative costs or advantage postulates that a country will specialize in the production and export of those products in which it has a cost advantage over other countries. This model suggests that a country will have a comparative advantage in, and therefore will tend to export, those goods whose production requires the intensive use of a factor of production with which that country is well endowed. This theory implies that:

(1) A country will export those products that are intensive in its abundant factor; that is, a capital-rich country will export capital- intensive goods.

(2) Trade will benefit the owners of locally abundant factors and harm owners of the scarce factors. Thus, although all countries will benefit in absolute terms, there will be important distributive consequences that will favor either capital or labor in trading countries.

(3) Trade in factors (capital or labor) and trade in goods will have the same effect and can fully substitute for one another.

(4) Under certain circumstances, trade in goods will over time equalize the return (wages to labor and profits to capital) for each factor of production.

The basic problem with the H-O model or theory is that actual trading patterns frequently differ from what the theory predicts. A notable example is found in intra-industry trade among countries with similar factor endowments. Indeed, most trade among industrialized countries takes place largely in the same product sectors; for example, the United States both exports to and imports from other industrialized countries.

Another important intellectual development that has undermined the H-O theory of international trade is a shift among economists from emphasizing "comparative" to emphasizing "competitive" advantage, especially in high-tech sectors. International competitiveness and trade patterns frequently result from arbitrary specialization based on increasing returns rather than from efforts to take advantage of fundamental national differences in resources or factor endowment. This new thinking about the arbitrary or accidental nature of international specialization and competitiveness emphasizes the increasing importance of technology in determining trade patterns.

Mainstream economists have been hesitant to acknowledge the increased importance of such factors as technology and learning by doing in the determination of trade patterns. Nevertheless, the fundamental idea that comparative or competitive advantage is largely arbitrary and a product of human intervention rather than a fixed gift of nature is accepted by growing numbers of mainstream economists.

Some economists regard actual trade patterns as resulting from many factors other than natural endowments, factors including historical accidents, government policies, and cumulative causation. Moreover, the standard H-O theory itself has been modified and expanded to include such important factors as human capital (skilled labor), "learning by doing," technological innovation, and especially economies of scale. Revisions have so transformed the original H-O model that some economists now argue that the theory of international trade is not much more than an eclectic enumeration of the many factors that determine comparative advantage and trade flows.

However, it is very difficult to incorporate these newly recognized factors into a formal model, and because there is no satisfactory alternative model, economists continue to support the standard H-O theory of trade based on factor endowments. As Richard Caves and Ronald Jones have argued, the Heckscher-Ohlin theory, with its emphasis on factor endowments, is still largely valid. Moreover, as economists argue national specialization and the benefits of a territorial division of labor remain valid concepts that are of overwhelming importance for the efficient use of the world's scarce resources. True! But this generalization does not explain or determine which country will produce what, and nation-states will always be very reluctant to leave that decision entirely up to the market.

These important considerations that "international comparative advantage in the production of and sale of high-technology goods must be struggled for and earned through superior technological innovativeness" has significantly intensified what F. M. Scherer has labeled "international high-technological competition." The drive for technological superiority has notably increased the receptivity of governments to the "new trade theory."

3.2.4 New Trade Theory or Strategic Trade Theory

The most important and certainly the most controversial development challenging the conventional theory of international trade is the "new trade theory," more commonly known as "strategic trade theory" (STT).

Strategic trade theory is the culmination of earlier challenges to conventional trade theory because it incorporates a growing appreciation of imperfect competition, economies of scale, economies of scope, learning by doing, the importance of R & D, and the role of technological spillovers. STT is significant because it challenges the theoretical foundations of the economics profession's unequivocal commitment to free trade. In fact, STT originated with the development of new analytical tools and growing dissatisfaction with conventional trade theory and its inability to explain the increasing trade problems of the United States, especially with respect to Japan in the 1980s.

Before we consider the theory, however, we will discuss oligopolistic competition briefly. Under conditions of perfect competition, strategic behavior is not possible because the behavior of one or just a few firms cannot significantly change market conditions for other firms. However, if unit costs in certain industries do continue to fall as output increases (economies of scale), the total output of firms will expand but the number of firms will decrease. Economies of scale in an industry mean that the market will support only one or just a few large firms; that is, the industry will become oligopolistic, and the market will eventually be dominated by a few firms. This would permit the behavior of one firm to make a difference and to alter the decisions of other firms.

If imperfect or oligopolistic competition exists, then monopoly rents or abnormally high profits can exist in that economic sector; the resultant rents or super-profits could then be captured by a small number of firms or even by one firm. Individual firms, then, may well pursue corporate strategies to increase their profits or economic rents.

Oligopolistic firms can and do consciously choose a course of action that anticipates the behavior of their competitors. If successful, such action enables them to capture a much larger share of the market than would be the case under conditions of perfect competition. For example, oligopolistic firms can and do follow strategies in which they adjust their own prices and output in order to alter the prices and output of competitor firms.

Two of the most important strategies used to increase a firm's long-term domination of an oligopolistic market are dumping (selling below cost to drive out competitors in the product area) and preemption (through huge investment in productive capacity to deter other entrants into the market). Imperfect or oligopolistic competition is most likely found in certain high-tech industries characterized by economies of scale and learning by doing. The sectors most likely to become oligopolistic include computers, semiconductors, and biotechnology; these technologies, of course, are identified by most governments as the "commanding heights" of the information economy. Many are dual technologies, because they are very important to both military weaponry and to economic competitiveness. Many countries consider it essential for both commercial and security reasons to take actions that will ensure a strong presence in some or all of these sectors. The importance of a head start in these industries encourages firms to pursue a "first-mover" strategy so that cumulative processes and path dependence will strengthen their market position.

The theory of strategic trade takes the existence of imperfect or oligopolistic competition one step further and suggests that a government can take specific actions to help its own oligopolistic firms. Government policies can assist national firms to generate positive externalities (e.g., technological spillovers) and to shift profits from foreign firms to national firms. Economists have long appreciated that a nation with sufficient market power could enact an optimum tariff and thereby shift the terms of trade in its favor. By restricting imports and decreasing the demand for a product, a large economy may be able to cause the price of the imported good to fall. Strategic trade theory, however, goes much farther than optimum trade theory in recognizing the capacity of a nation to intervene effectively in trade matters and thus to gain disproportionately.

A government's decision to support a domestic firm's plans to increase its productive capabilities (preemption) or even to signal intention to build excess productive capacity exemplifies a strategic trade policy. Through use of a direct subsidy to a firm or outright protection of a domestic industry, the government might deter foreign firms from entering a particular industrial sector. Since a minimum scale of production is necessary to achieve efficiency, especially in many high-tech industries, the advantage of being first ("first-mover advantage") encourages a strategy of preemptive investment.

Strategic trade theory departs from conventional trade theory in its assumption that certain economic sectors are more important than others for the overall economy and therefore warrant government support. Manufacturing industries, for example, are considered more valuable than service industries because manufacturing has traditionally been characterized by higher rates of productivity growth and has produced higher profits, higher value-added, and higher wages.

Some economic sectors, especially such high-tech industries as computers, semiconductors, and information processing, are particularly important because they generate spillovers and positive externalities that benefit the entire economy. Because a new technology in one sector may have indirect benefits for firms in another sector, firms that do extensive research and development are valuable to many others.

However, because firms may not be able to capture or appropriate the results of their research and development activities, many will under-invest in these activities. Proponents of strategic trade theory argue that such a market failure indicates that firms should be assisted through direct subsidy or import protection, particularly in high-tech industries, which frequently raise the skill level of the labor force and thus increase human capital.

If, as the proponents of strategic trade believe, such special industries do exist, then free trade is not optimal, and government intervention in trade matters can increase national welfare. Strategic trade theory has become a highly controversial subject within the economics profession. Some critics argue that strategic trade theory is a clever, flawed, and pernicious idea that gives aid and comfort to proponents of trade protectionism. Other opponents of the theory agree with this negative assessment and maintain that the theory itself adds nothing really new to dubious arguments favoring trade protection. Perhaps in response to the severe denunciations of strategic trade theory by leading mainstream economists, some of its earliest and strongest proponents have moderated their initial enthusiasm.

3.3. Perspectives in International Trade: Free Trade versus Protectionism

The different perspectives on IPE provide different motivations for trade to take place. The system of international trade pulls in three directions at once. There is a large but far from universal consensus that a liberal international trading system is desirable. Within that liberal structure, however, individual nation states try to pursue mercantilist policies while worrying about becoming dependent and being exploited by other nations. Thus, it is possible for national leaders apparently to believe in all three perspectives at once: a global system of free trade (liberal), but protection for domestic firms and workers (mercantilist) by promoting high wage or high technology industrialization (structuralist). No wonder, international trade policy is so controversial. In the coming sections, an attempt will be made to shade light on the three perspectives of international political economy and their respective positions on international trade.

As noted in the foregone sections one of the significant perspective on international trade is liberalism, formalized through the theory of absolute / comparative advantage by Adam Smith and David Ricardo.

The liberal doctrine of free trade is based on the principles of the market system formulated by classical economists. Adam Smith and David Ricardo argued that removing the impediments to the free movement of goods would permit national specialization and facilitate optimal utilization of the world's scarce resources.

Trade liberalization would lead to efficient trade patterns determined by the principle of comparative advantage; that is, by relative factor prices (of land, capital, and labor). Adoption of the principle of "comparative advantage" or "comparative cost" would ensure that a country would achieve greater economic welfare through participation in foreign trade than through trade protection. Underlying this liberal commitment to free trade is the belief that the purpose of economic activity is to benefit the consumer and maximize global wealth. Free trade also maximizes consumer choice, reduces prices, and facilitates efficient use of the world's scarce resources. From this perspective, the primary purpose of exports is to pay for imports rather than to enhance the power of the state.

According to its advocates, trade liberalization produces a number of specific benefits. In the first place, trade liberalization increases competition in domestic markets, and thereby undermines anticompetitive practices, lowers prices, increases consumer choice, and increases national efficiency. In addition, free trade increases both national and global wealth by enabling countries to specialize and to export those goods and services in which they have a comparative advantage while importing those goods and services in which they lack comparative advantage. Free trade also encourages the international spread of technology and know-how around the globe and thus provides developing economies with the opportunity to catch up in income and productivity with more advanced economies. Last, but not least, free trade and the international cooperation that it entails increase the prospects of world peace. Trade protection also has a negative impact on income distribution. A tariff or other restrictive measure creates economic or monopoly rents and shifts income from consumers and non-protected sectors to the protected sectors of the. Finally, one of the most serious dangers of trade restrictions is that they tend to protect declining noncompetitive industries.

The one important exception to economists' universal belief in the superiority of free trade over trade protection is the protection of infant industries. Many economists accept the argument first set forth by Alexander Hamilton (a mercantilist) that nourishing infant industries can provide an acceptable rationale for trade protection. An infant industry is one that, if protected from international competition, will become sufficiently strong and competitive to enable it to survive when protection is eventually removed. A major problem with infant industry protection, however, is that protection too frequently becomes permanent.

From eighteenth-century mercantilists to present-day protectionists, advocates of trade protection have desired to achieve certain political, economic, and other objectives more than the economic benefits for the entire society of free trade. However, the specific objectives sought by protectionists have varied over time and space. Economic nationalists regard trade protection as a tool of state creation and statecraft; for example, a trade surplus is considered beneficial for national security. Many representatives' of less developed countries believe that trade with industrialized countries is a form of imperialism; they fear that free trade benefits only the developed economy and leads to dependence of the less developed countries on the developed ones.

Opponents of free trade in developing economies also include advocates of the "developmental state" who believe that the state rather than free markets should have the principal role in the process of economic development. In developed economies, proponents of trade protection reject free trade and other forms of globalization as threats to jobs, wages, and domestic social welfare; organized labor in industrialized countries increasingly advocates protection against imports from low-wage economies with inadequate labor standards. In recent decades, more and more environmentalists have denounced trade as a threat to the environment.

The most systematic economic rationale for economic nationalism and trade protection was provided by Friedrich List. Strongly influenced by Alexander Hamilton's protectionist ideas, List argued in his National System of Political Economy (1841) that every industrial nation has pursued and should pursue protectionist policies in order to safeguard its infant industries. List maintained that once their industries were strong enough to withstand international competition, these countries lowered their trade barriers, proclaimed the virtues of free trade, and then sought to get other countries to lower their barriers. Free trade, List believed, was the policy of the strong. If one were to translate List's ideas into modern parlance, one would say that every successful industrial power at some point in its history has carried out an activist industrial policy.

At the beginning of the twenty-first century, many trade protectionists advocate promotion through national industrial policies of high tech and certain other favored sectors in order to build the nation's industrial strength and increase its competitiveness. They believe that the state should guide and shape the overall industrial and technological structure of the society through trade protection, industrial policy, and other forms of government intervention. In addition to such high tech industries as computers and electronics, economic nationalists also favor support for more traditional manufacturing industries such as the automobile and other mass-production industries characterized by high value-added and high wages. Although in its efforts to catch up with the West, Japan has conspicuously and aggressively pursued an industrial policy, industrial policies have also been employed by the United States, Western Europe, and many developing economies to promote industries believed important for national security and economic development.

Economists have strongly disputed the alleged benefits of trade protection. Trade protection, they point out, reduces both national and international economic efficiency by preventing countries from exporting those goods and services in which they have a comparative advantage and from importing those goods and services in which they lack comparative advantage. Protection also decreases the incentive of firms to innovate and thus climb the technological ladder; it also discourages shifting national resources to their most profitable use.

Despite economists' arguments supporting trade liberalization, trade protectionism persists, and its advocates too frequently succeed. Endogenous trade theory explains the success of protectionism by calling attention to the fact that the political process generally favors special interests desiring protection rather than general consumer interests. Whereas the benefits of free trade diffuse across a society, the benefits of protection are concentrated in a few groups of producers.

3.4 Instruments of Trade Policy

Contemporary trade policy is deeply conditioned by all the four IPE perspective on trade. As noted earlier, there seems to be a consensus on the liberal international trade system whose most important justification is contained in the H-O model. However, states tend to behave as mercantilist when national interests are threatened.

(A)Tariffs: a tariff is a tax on an import that is usually a percentage of the price of that import. They are used as a way of raising revenue for the government and can also be used to raise the price of an imported good up to a certain level to prevent foreign competition for domestic producers of that good. There are different kinds of tariffs.

(B)Non-tariff Barriers to Trade

There are many forms of non tariff barriers to trade and some of these barriers will be discussed as follows.

- Import Quotas: a government agency allocates the rights to import by limiting the number of goods (not the price) for a given time period. It is a limit imposed up on the amount of a particular good that can be imported in to a country. Quotas may be imposed or can be achieved through Voluntary export restraints [VER]: foreign suppliers agree to "voluntarily" refrain from sending some exports.
- Exchange controls: there are a number of different ways in which to control foreign exchange. These includes limits on the amount of foreign exchange made available to importers or citizens travelling abroad or limits on the amount of foreign exchange to be for investment purposes and also charges made when purchasing foreign currency.

- Import licensing: this occurs when importers obtain licenses so that the government can better enforce restrictions.
- Embargos: an embargo is imposed when a government decides to completely ban imports or exports to certain country.
- Domestic content provisions and Administrative barriers- Domestic content provisions require a given percentage of the value of a good must consist of domestic components or labour. Administrative barriers may take different forms different Domestic policies affecting trade: health, environment and safety standards; packaging and labeling requirements; inconsistent treatment of intellectual property rights; subsidies to domestic firms, etc.

3.5. Postwar Trade Regime: The GATT and WTO

Despite the different regions' experience of the dramatically uneven patterns of economic growth throughout the world, the pace and size of international economic transactions has risen steadily. New institutions have developed to promote and manage the world's trade. From 1948 to 1995, nations negotiated a series of treaties through the General Agreement on Tariffs and Trade (GATT), which gradually lowered tariffs for most manufactured goods. In the 1990s the GATT transformed itself into the World Trade Organization (WTO), with more powers of enforcement and a broader mandate to promote trade.

3.5.1. The General Agreement on Tariffs and Trade (GATT)

As we have seen above, the Bretton Woods institutions are the result of attempt of the allied power, led by USA and UK; to restructure the world political economy in the post war era in such a way to prevent potential economic conflicts like those led to the outbreak of the WWII. But, it is not commonly known that the conference also advocated the formation of 'International Trade Organization' [ITO]. In his original concept, John M. Keynes thought that this organization would be responsible for stabilization of the prices of primary products by employing different mechanisms. At the time, ITO was proposed to oversee the new liberal trade rules as it applies to tariffs, subsidies, and other protectionist measures that states may utilize.

The whole idea was that ITO would serve as an international counterbalance against domestic tendencies of protectionism. However, ITO did not take the ground for the U.S. congress soon forced the government to withdraw the negotiation. The H. Truman's government soon proposed a temporary alternative structure of multilateral trade negotiations, called **rounds**, under the General Agreement on Tariff and Trade [GATT]. GATT was signed by 23 nations at a trade conference in 1947 and became effective in January 1948.

Upon its establishment, GATT was not more than what its title suggested: a forum for bringing the countries together and to reach agreement on trade and tariff issues. GATT also originated as a "charter" for the proposed International Trade Organization (ITO), which was to be a specialized agency of the United Nations. Although the ITO failed to win ratification by the United States Congress in 1950 and never came into being, the GATT remained in use to govern international trade. Hence, GATT was both treaty and organization of international trade in existence from 1948 to 1995. GATT members, known as 'contracting parties', worked to minimize tariffs, quotas, preferential trade agreements between countries, and other barriers to international trade. The major objective of GATT was to augment trade by removing its barriers in various forms. More specifically, this aim targeted at what is known as "tariffication", i.e. converting non-tariff barriers [NTBs] to be followed by lowering the existing tariff levels. The other objective of GATT was the "universalization" of trade relations. This was to be materialized in a way of extending the scope of most favoured nations [MFN] concept. The simple definition of this concept is that, the trade concessions agreed upon between any two countries would automatically be extended to other member countries of GATT.

GATT was founded on three principles. These principles are (i) "non-discrimination", "multilateralism" and the application of "most-favoured-nation" [MFN], (ii) the expansion of trade by reducing barriers, and (iii) unconditional reciprocity to all member nations bound by the treaty, which required members to treat one another in the same manner if not equally. Once a member reduced a tariff for another member country, that reduction applied to all member countries. However, an escape clause allowed a nation to withdraw its tariff reduction if it seriously harmed the country's domestic producers.

Accordingly, both the industrialized and non- industrializing economies have taken a number of initiatives, under American leadership, to lower trade and investment barriers. GATT members sponsored eight specially organized rounds of trade negotiations: Geneva round 1947, Annecy (France) round 1949, Torquay (UK) round 1951, Geneva (for the second time) round 1956, Dillon round 1960-61, Kennedy round 1964-67, Tokyo round 1973-79, and Uruguay round 1986-93.

By the mid-1980s, the GATT trade regime was no longer adequate to deal with a highly integrated world economy characterized by oligopolistic competition, economies of scale, and dynamic comparative advantage. In addition, the "new protectionism" of the 1970s had led to the erection of numerous nontariff barriers, such as quotas and government subsidies. The "new protectionism", as distinct from the "old" protectionism, was particularly characterized by hidden trade barriers, a shift from rules to discretion, and a return to bilateralism. Moreover, the character of trade itself has changed and outgrown the rules and trading regime of the early postwar era. Trade became closely intertwined with the global activities of multinational firms, and trade in both services and manufactures expanded rapidly. Trade among industrialized countries became the most prominent feature of the trading system.

Nevertheless, all the eight rounds of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT), the principal forum for trade liberalization, have significantly decreased trade barriers. However, another development in the 1980s was the so-called "new regionalism". Especially the acceleration of the movement toward European integration was recognized as a threat to the multilateral trading system.

From the mentioned time onwards, the U.S.A. pressured its West European and other trading partners for a new round of trade negotiations to strengthen the multilateral trading system. Eventually, this American pressure overcame European and other resistance, and the Uruguay Round of trade negotiations was launched at Punta del Este, Uruguay, in 1986, resulting in intense negotiations until it ended in 1994. The Uruguay Round was crucial as it came out of the dynamic nature of world economic development and the accompanying debates that lasted for over four decades. Why is the Uruguay round regarded as the most important in the development of the post-war trade regime? The treaty produced by the Uruguay Round, which came into force on January 1, 1995, reduced tariffs on manufactured goods and lowered trade barriers in a number of important areas. At the same time, the formal tariffs on merchandise goods were reduced to the lowest level. The Uruguay Round decreased or eliminated many import quotas and subsidies. The agreement's twenty-nine separate accords also reduced trade barriers and for the first time extended trade rules to a number of areas that included agriculture, textiles, services, intellectual property rights, and foreign investment.

In doing this, the Round took an important step toward completion of the framework of international institutions that had originally been proposed at Bretton Woods (1944). At the end of the negotiations, the members of GATT, as well as representatives from seven other nations, signed a trade pact that will eventually cut tariffs overall by about one-third and reduce or eliminate other obstacles to trade. The pact also took steps toward opening trade in investments and services among member nations and strengthening protection for intellectual property—that is, creative works that can be protected legally.

While the first round [Geneva 1947-48] with its 23 participants took only few months, the last round i.e. Uruguay round, with 108 members lasted for more than six years. The Dunkel draft, on which the Marrakesh agreement was made in April 1994, was a bulky document that contained in itself 28 proposed accords. Thus, the Marrakesh Treaty happened to be one of the most ambitious international trade agreements to be signed by such a large number of nations.

Many of the supporters of the agreement said it would create jobs and improve business. On the other hand, opponents claimed that the new GATT treaty would lead to massive losses of jobs in manufacturing and that the powerful WTO would threaten independence nations. A number of groups, including environmentalists, human-rights activists, and labour organizations in liberal democratic states and other countries, argued against the treaty, claiming that it failed to link trade preferences to protections for the environment and workers' rights.

The ultimate goal of GATT, i.e. "establishing a world trade regime or universal rules for the conduct of commercial policy" seemed real, when the 1994 trade agreement officially took effect and fully implemented in January 1995. As such, this pact, while providing for the establishment of the World Trade Organization (WTO), facilitated the takeover of GATT's functions by the WTO, an international body that administers trade laws and provides a forum for settling trade disputes among nations. In addition, more and more nations have been pursuing neoliberal economic policies. These developments have resulted in an increasingly market-oriented global economy. Despite the impressive achievements, however, of the Uruguay Round in reducing trade barriers, many vexing issues were left unresolved.

3.5.2. World Trade Organization (WTO)

The World Trade Organization was created to replace GATT, when the members of the latter signed a new trade pact established in 1994, and began operation on 1st January of 1995. After the transition period, GATT ceased to exist. All of the 128 nations that were contracting parties to the new GATT pact at the end of 1994 became members of the WTO upon ratifying the GATT pact. A number of other nations have joined the WTO since then.

World Trade Organization [WTO], based in Geneva, is an international body that promotes and enforces the provisions of trade laws and regulations. It has the authority to administer and police new and existing free trade agreements, to oversee world trade practices, and to settle trade disputes among member states.

As far as the organizational leadership is concerned, the WTO is controlled by a General Council made up of member states' ambassadors who also serve on various subsidiary and specialist committees. The ministerial conference, which meets every two years and appoints the WTO's director-general, oversees the General Council. The World Trade Organization (WTO) is, in essence, an American creation. The WTO's predecessor, the General Agreement on Tariffs and Trade (GATT) had served well America's fading mass production economy, but it did not serve the emerging economy equally well. In effect, WTO has the primary responsibility to facilitate international economic cooperation in trade liberalization. The agreement that established the WTO expanded and entrenched the GATT principle that trade should be governed by multilateral rules rather than by unilateral actions or bilateral negotiations.

Although the WTO incorporated the GATT along with many of its rules and practices, the legal mandate and institutional structure of the WTO were designed to enable it to play a much more important role than the GATT had played in governance of international commerce. The WTO has more extensive and more binding rules. It has also created a trade-policy-review mechanism to monitor member countries.

It is true that WTO was not given as extensive rule-making authority, as some desired. However, it does have much more authority than the GATT. The GATT dispute-settlement mechanism was incorporated in the WTO, reformed, and greatly strengthened by elimination of such basic flaws as long delays in the proceedings of dispute panels, the ability of disputants to block proceedings, and the frequent failure of members to implement decisions. The agreement also established a new appellate body to oversee the work of the dispute panels.

Most importantly, and perhaps controversially, the WTO was empowered to levy fines on countries that refused to accept a decision of the dispute panel. Although the WTO operates a dispute settlement process similar to the one under GATT, it has stronger power to enforce agreements, including authority to issue trade sanctions against a country that refuses to revoke an offending law or practice. WTO has also a significantly broader scope than that of GATT. GATT regulated trade in merchandise goods. The WTO expanded the GATT agreement to include trade in services, such as international telephone service, and protections for intellectual property, i.e. creative works that can be protected legally, such as sound recordings and computer programs.

The institutional structure of the trade regime also changed significantly. Whereas the GATT had been a trade accord supported by a secretariat, the WTO is a membership organization that increases the legal coherence among its wide-ranging rights and obligations and establishes a permanent forum for negotiations. Periodic ministerial meetings increase political guidance to the institution. The WTO is also a formally structured organization whose rules are legally binding on its member states. The organization provides a framework for international trade law. Members can refer trade disputes to the WTO where a dispute panel composed of WTO officials serves as arbitrator. Members can appeal this panel's rulings to a WTO appellate body whose decisions are final. Disputes must be resolved within the time limits set by WTO rules.

Since its creation, the WTO has attracted criticism from those concerned about free trade and economic globalization. While the advocates of the WTO argue that it plays a critical role in helping expand world trade and raise living standards around the world, the opponents of the WTO have forwarded several arguments some of which are outlined below.

WTO as an organization is "too powerful" and it can declare the laws and regulations of sovereign nations in violation of trade rules, in effect pressuring nations to change these laws. Critiques of WTO also argue that trade rules do not sufficiently protect workers' rights, the environment, human rights or human health. It is also accused of the widespread democratic deficit. Claims argue that the Organization lacks democratic accountability, because its hearings on trade disputes are closed to the public and press. However, the WTO officials have tended to reject this argument, claiming that its member nations, most of which are democracies, wrote the WTO rules and selected its leadership.

Trade in certain areas such as agriculture, textiles, and shipping continues to be highly protected. The failure to reduce tariffs on agriculture and textiles was and continues to be especially vexing because lower tariffs would greatly benefit LDCs. Trade barriers are still high in most developing countries, especially with respect to services, and developed countries continue to restrict imports of automobiles, steel, textiles, consumer electronics, and agricultural products. Even more menacing, in most cases, public opinion has become more skeptical of the costs and benefits of trade, and by the late 1990s the WTO and trade liberalization were clearly on the defensive. Scholars criticize the WTO's propagation of free trade within an overall neoliberal conception of economic growth, justified through the universalistic belief that everyone benefits (mainly as consumers) from trade and growth. This has not in fact produced economic growth and higher incomes for poor countries and people.

Doubts are also arising due to the fact that with over 130 members, the WTO's ability to carry out its assigned responsibilities is subject to doubt. Criticism of the WTO reached an apex in late 1999, when more than 30,000 protesters disrupted a WTO summit in Seattle, Washington. The protesters called for reforms that would make the organization more responsive to consumers, workers, and environmentalists. The summit failed in its goal to set an agenda for a new round of global trade talks, largely because of disagreements between industrialized and developing nations in areas like the agricultural subsidies provided by the former nations, notably the support of EU and U.S.A. to their farmers. Developing countries objected to the extent of the subsidies, which amount to about $300 billion annually, arguing that such generous support artificially lowered world crop prices and made it difficult, if not impossible, for farmers in developing countries to compete. The failure of the richer nations to reach agreement on lowering agricultural subsidies continued to derail trade talks in the early 2000s.

In addition, the volume of world trade expanded and trade penetrated more and more deeply into national societies. And, it became increasingly entwined with politically sensitive matters and came into conflict with powerful domestic interests, especially in the United States. This development has produced the “new trade agenda,” which includes such highly controversial issues as labor standards, human rights, the environment, and national sovereignty. Although some proponents of the new trade agenda are unalterably opposed to free trade and are even outright protectionists, most advocates of one or another of the issues on the new trade agenda want radical changes in the WTO that would, most experts believe, greatly weaken the trade regime.

Examination of the new trade agenda and the intense political controversy surrounding various items reveals serious threats to the trade regime that will be difficult to overcome. On the other hand, most economists, governments, and business groups are strongly opposed to integrating several issues into international trade negotiations, fearing that, however well some groups intended are, the important issues of labor standards, human rights, and environmental protection will be and are being exploited by outright protectionists.

Chapter Four

4. International Financial Relations

4.1. Introduction

International monetary and financial relations are at the center of today's international political economy. Currency values, short- and long-term capital movements, debtor-creditor relations, and related issues are crucial to the private sector, to intergovernmental relations, and to private-public sector interaction around the world. A fundamental analytical and practical question for those concerned about the future of the world economy is indeed the extent to which growing international financial ties will lead toward more cooperation among national policy makers, and among nationally-based businesses, or more conflict among them. This section is your visa to the complex world of international money and finance.

4.2. Meaning and Scope

Financial structure comprises the set of relationships, institutions, and practices that bind together creditors and debtors, borrowers and lenders. These relationships exist within the framework provided by the international monetary system. The finance structure creates a pattern of rights and obligations that conditions the behaviour of nations, businesses and individuals. The finance structure is both local and international in its scope.

International finance is a major force in integrating world economy. Since the period of renaissance and the development of modern banking private capital has nourished the international political economy in the form of loans and portfolio investment (stocks and bonds). In the contemporary period, foreign directed investment by multinational corporations has augmented these traditional means of capital flow. Government and international organizations have also become important sources of capital through the making of loans and official aid particularly to the less developed countries.

From the perspective of liberal economics, the primary function of international finance to transfer accumulated capital to the location where its marginal rate of return is highest and where it can therefore be employed most efficiently. International finance links the international economy and also contributes to its dynamic nature. In a world divided among competitive states, however, international finance has also ahs significant political consequences. It creates dependency relationships and is a major source of national power.

Both foreign investment and official aid involve extensive penetration of an economy and in many cases lead to continuing external influence over domestic activities. Although trade and monetary relations may impinge up on an economy, foreign investment, loan and aid have a greater tendency to create superior subordinate relationships. Stockholders and creditors have been known to call up on their own governments to intervene in other societies to protect their investment; foreign investment and international finance have always aroused political and nationalistic passions.

4.3.Definition of Terms

4.3.1. Foreign Exchange

Before we go deep in to the discussion of the political economy of international monetary relations, let us first define some of the most frequently used terminologies in international monetary systems. We will begin our discussion with exchange rate. The foreign exchange system organizes the terms and conditions for international payments and set the method for determining the exchange rate between different countries' currencies. Exchange rate refers to the ratio of exchange between the currencies of different countries. At a very general level, the foreign exchange rate is simply the price of foreign currency which clears the market for foreign exchange, or the rate at which one currency is exchanged for another.

In the contemporary world, a nation's money is like a ticket which can be exchanged for goods and services in the country that issues it. The behavior of exchange rate is so vital to any state as it links a country's macro and micro economies to the rest of the world through the asset market and goods market. In macro- economic terms, this happens in two ways. First, in the goods market, the higher the exchange rate, the higher the prices of the imported goods in the home currency will be. For a given level of domestic costs and prices, a higher exchange rare will make foreign goods less attractive to domestic consumers whilst domestic goods will become attractive to consumers in the rest of the world. Second, in the asset market the exchange rate is an important variable when decisions are being made by domestic wealth holders over how that wealth is to be held. Such choices are dependent up on the trade-off between risk and return. The higher the return on foreign assets compared to domestic assets in the home currency- provided there is no increase in the level of risk- the more chance there is that domestic residents will move their wealth in to foreign asset.

In micro-economics terms, the exchange links a country to the rest of the world in ways that are vital to resource allocation. In goods market, when an exchange rate change makes an economy more competitive, the number of tradable goods increases. More goods then become exportable, and fewer goods are imported as a result. On the other hand, when a change in the exchange rate makes an economy less competitive, resources are largely utilized in the domestic market. More goods are imported and fewer exported. Exchange rate changes, therefore, affect the resource allocation in an economy because the distribution of income between different groups or sectors is often dependent up on the level of competitiveness.

The three main types of foreign exchange systems (which will be examined in greater detail in the coming sections) are:

• Fixed or pegged FX- where FX rate is most heavily influenced by states actions;

• Flexible or floating FX- where international FX markets (demand and supply) are the principal determinants of exchange rate and;

• Managed or coordinated FX- where states and markets are important determinants.

Special vocabularies used in discussing changes of FX rate are depreciation and appreciation. When a currency becomes more valuable relative to other currencies it is said to be appreciated and when it becomes less valuable relative to other currencies it is said to be depreciated. While many economic forces affect exchange rate two of the most important are the inflation rate and interest rate. All else being equal, a nation's currency tends to depreciate when that nations experiences higher inflation rates. Inflation, a rising of overall prices, means that the currency has less real purchasing power within its home country. This makes the currency less attractive to foreign buyers. In the same way, if a nation has lower inflation rate, its currency tends to appreciate reflecting the relatively higher power of its money,

Interest rate also affect exchange rate because they influence the value and desirability of the investment that a particular currency can purchase. For lenders, the rate of interest measures the rate of return which will be received when their wealth is invested. Consequently, the higher the return, the more wealth those lenders will wish to invest.

4.4.The Era of the Specie Money

In the pre modern period, precious metals, principally silver, served as a basis of the international monetary system. Local and international trade tended to be separated from each other. Whereas local trade tended to dependent up on barterer and locally recognized money, international trade was, served by great currencies minted from gold and silver. Thus the solidus of the Constantine, the dinar of the Arabs or the ducat of the Venice were universally accepted and held their values for centuries. Whether minted in to coin or left in the form of bullion, gold and silver constituted a neutral medium of international exchange; one states gold and silver are as good as the other ones and in effect international currencies enjoyed political and economic autonomy.

The nature and role of the system began to change in the sixteen century with the discovery of gold in the Americas and the expansion of international trade. The separation of local and international money begun to break down as the consequence of great influx in to Europe of precious metals of the new world, the growing monetization of national economies, and the increasing interdependence. In time gold and silver drove out local currencies leading to the increasing intertwining of local and international money and consequently governments were unable to manipulate local economic activities as domestic economic activity and price levels had become subject to international changes.

This has led to the development of the science of economics which subsequently become the basis for the development of the liberal economics. In his price-specie flow theory, David Hume responded to the growing obsession of the mercantilist state to accumulate precious metals through a trade surplus and their fear that trade deficit would result in the loss of precious metals. He demonstrated that, if a country gained precious metals in payment for an excess export over imports would cause its domestic and then its export price to rise. This would in turn discourage others from buying its products. At the same time its citizens would be able to import more because of the relative value of it's their currency had risen and foreign prices would fallen because of the decrease money supply abroad. As a result a nation's export would decline and its imports would increase.

Although Hume's price-specie flow mechanism continued to characterize international monetary relations in to the twenty first century, the nature of the monetary system was revolutionized in the modern world due to a number of economic and political reasons. Stated simply money had been transformed from a gift of nature to the creation of a state. State controls over the supply and demand for money become a principal determinant of the level of international and national economic activity. To understand the significance of this transformation, it is first necessary to comprehend what is known as the financial revolution.

During the18th and 19th century states begun to issues paper money, modern banking arose, and public and private credit instruments proliferated. For the first time in history governments acquired the extensive control over money supply; at least in theory could influence the level of economic activity through the creation of money. The change in the nature of money brought about a serious clash between domestic economic autonomy and international monetary order. And hence bringing with itself the political economy of international monetary relations and the questions of who gets what, when and how. Monetary stability and the efficient operation of the international monetary system require the subordination of domestic policies to international rules and conventions. If individual governments create too much money, the resulting inflation can destabilize international monetary relations. The conflict between domestic economic autonomy and international economic stability has become the fundamental dilemma of monetary relations. The manner in which this dilemma has or has not been resolved defines the phases in history of international monetary relations.

4.5.The Classic Gold Standard

The international gold standard, which reached its zenith in the late nineteen century, was the classic resolution of the aforementioned dilemma. Gold is a monetary arrangement under which the basic unit of currency of is defined by stated quantity of gold. This monetary system prevailed between 1875 and 1914. Participating countries were committee to fixing the prices of their domestic currencies in terms a specified amount of gold.

The countries maintained this fixed prices by being willing to buy and sell gold to anyone at that price. These feature provided a fixed exchange rate mechanism for adjusting the international balance of payments as trade and payment imbalances among nations were brought back in to equilibrium through the flow of gold.

During its reign the classic gold standard provided an effective foundation for the 19th century international and economic order. It was not, however, as liberal economists would like us to believe, an automatic, impersonal and politically symmetrical political order. It was not automatic as banks manipulated the buying and selling of gold in a manner that reduces the effect of the flow of gold on domestic economy. The system did not operate impersonally as it was organized and managed by Britain and the city of London through its hegemonic position in the world commodity, money and capital market, enforced the rules of the system up on world economies. The monetary system was not politically symmetrical in its effects on various economies as the balance of payment adjustment had very different consequences on advanced economies and less developed once.

The clash between domestic autonomy and international order achieved under the gold standard provides an example of a dominant hegemonic power enforcing the rules of the game and managing world economic affairs. As the world's preeminent industrial, trading and capital exporting country in the nineteen century Britain performed this task in an interest of a stable and smoothly functioning international monetary system; as it has the power and the will to do so.

Near the end of the nineteenth century, the rise of the new industrial powers and the relative decline of the British hegemony began to undermine the basis of the British global economic leadership. France, Germany and other nations disliked a monetary order that benefited Britain and most importantly the less developed countries grew frustrated with paying the costs of the adjustment. Raising social discontent and the revolt against laissez faire begun to shake the system. The force of economic inertia, however, continued British dominance in money and finance long after the British dominance in manufacturing vanished. The First World War destroyed the political foundation of this economic era and plunged the world in to monetary and economic chaos for the next three decades.

4.6.The Interwar Period (1914-1944)

A major consequence of the First World War was the nationalization of the world's monetary system. Upon the outbreak of hostilities, the belligerents acted quickly to safeguard their gold supplies and disengage from the system of fixed exchange rates to facilitate the freeing and mobilization of their economy for war. The gold standard collapsed and its place was taken by a makeshift of arrangement of floating (freely exchangeable) currencies. With the end of British leadership and collapse of economic interdependence, the determination of currency values became the responsibility of national authorities. Domestic economic autonomy triumphed over international monetary order due to the requirements of war.

The implication of the collapse of the international monetary order and the states acquisition of control over domestic activity was viewed differently by economists. On the one hand, those who subscribe to Keynesian economics focused on the opportunity that this transformation provided for the elimination of the evils of the free market such as unemployment, and recession. Through manipulation of few monetary variables like government spending, interest rate and money supply public spirited economics and their science could achieve social justice and economic progress.

On the other hand, conservative liberal economists considered the undisciplined monetary power of the modern state to be an invitation to political irresponsibility because it eliminated economic safeguards against inflation and other evils. They feared that the state would use its new taxing and borrowing powers to shift the distribution of national income from the producer and saver to the non producer. In a world without restraints and the gold standard and other international norms, democratic governments seeking to court popularity and appease special interests through the expansion of costly government programs would subject to ever increasing inflationary pressure; this could undermine both capitalism and democracy.

In the immediate aftermath of the war there was an attempt to return back to the gold standard. However, it survived for just few years and its collapse was the major factor in precipitating the great depression of the 1930s. There were many reasons for the collapse, and these are: first, governments begun to value domestic welfare objectives like full employment and stability than an international monetary order. Second, Britain has no longer the power to manage international monetary order due its industrial decline and the rise of new economic powers.

The ensuing economic chaos led to fragmentation of the international monetary systems in to several competing monetary blocs. At the Ottawa conference in 1932, the British and its trading partners created the sterling bloc. Soon after the dollar bloc was created around the United States and gold bloc around France.

Finally Germany, Japan and Italy taking the advantage of the world economic crisis attempted to create autarchic empires. The world economy entered an era of unprecedented economic warfare, with competitive devaluations and fluctuating currencies as each economic bloc attempted to solve its payments and employment problems at the expense of the other. Pound

The event of the interwar period meant the end of an automatic equilibrium that on the whole, characterized the era of gold standard. The simultaneous achievement of internal and external balance through the achievement of Hume's price-specie flow mechanism was decreasingly applicable to a world where central banks tried to counter the effects and prices/wages were not permitted to fall automatically in response to tight monetary policies; the era of government intervention and management of the economy had arrived.

4.7.The Bretton Woods System (1944-1976)

Following the trauma of the great depression and the scarifies imposed on the citizenry during the Second World War, the western powers established two sets of economic priorities, namely the achievement of economic growth and full employment at the domestic scene and the creation of a stable international economic order that would prevent a return of destructive economic nationalism of the 1930s, which is often called the Bretton wood system. The Bretton wood system had several key features. It envisions a world in which governments could have considerable freedom to pursue national economic objectives, yet the monetary order would be based on fixed exchange rates in order to prevent the destructive competitive depreciation and policies of the 1930s. Another principle adopted was currency convertibility for current account transactions. The international monetary fund was created to supervise the operation of the monetary system and provide medium term lending to countries experiencing temporary balance of payment difficulties. And finally in the event of fundamental disequilibrium the system allowed a nation to change its exchange rate with international consent.

The Bretton woods systems reflected fundamental in social purposes and political objectives. Whereas the nineteen century gold standard and the ideology of laissez faire had subordinated domestic stability to international norms and the interwar period had reversed these objectives, the post regime tried to achieve both. Under this system the American economy became the principal engine world economic growth; American monetary policy became world monetary policy. United sates assumed primarily responsibility for the management of the world monetary systems beginning with the marshal plan. The Federal Reserve became the world's banker and the dollar became the basis of international monetary system. The classic Bretton woods system was quickly replaced by what the French call the dollar hegemony.

Several key elements characterize what in effect become a gold exchange standard based the dollar. As other nations pegged their currency to the dollar, a system of fixed exchange rate; the adjustment process involved simply taking actions that changed the par value of a currency against the dollar. The basis of the system was the pledge of the united to keep the dollar convertible in to gold at $ 35 per ounce and because of this the dollar become the principal medium of exchange, unit of account and store value.

Nevertheless, there was a fundamental contradiction at the heart of this dollar-based system. While the huge outflow of American dollars to finance the rebuilding of Western Europe and Japan and the American military buildup during both the Korean and Vietnam Wars helped solve certain problems, this outflow of dollars meant that the United States would one day be unable to redeem in gold, and at the agreed price of $35 per ounce, those dollars held by private investors and foreign governments. Robert Triffin, in a series of writings, predicted that confidence in the dollar would be undermined as the American balance of payments shifted from a surplus to a deficit. This problem did become acute late in the 1960s when escalation of the Vietnam War and its inflationary consequences caused deterioration in international confidence in the value of the dollar. As that confidence declined, the foundations of the Bretton Woods System of fixed rates began to erode.

Decreased confidence in the dollar also led to intensifying speculation in gold, and this was followed by futile attempts to find ways to recreate confidence in the system. For example, in the late 1960s, Special Drawing Rights (SDRs) were created by the IMF as a new reserve asset, although they were never utilized extensively. However, as Benjamin Cohen has convincingly argued, it was only when a political solution was devised that maintenance of the dominant position of the dollar was ensured. America's Cold War allies, notably Western Europe and Japan, fearing that collapse of the dollar would force the United States to withdraw its forces from overseas and to retreat into political isolation, agreed to continue to hold overvalued dollars. The dollar was also bolstered for a period of time because such export-oriented economies as West Germany and, at a later date, Japan, wanted to retain access to the lucrative American market and therefore supported the high dollar. However, as soaring inflation undercut the value of the dollar, a more fundamental economic solution was needed

4.8.The End of Fixed Exchange Rates

In the early 1970s, the deteriorating position of the dollar became the central issue in the world economy. Escalation of the Vietnam War and the simultaneous launching of the Great Society Program by the Johnson Administration (1963–1969) had caused the global rate of inflation to accelerate and to threaten the value of the dollar. The U.S. government, attempting to hide the financial cost of the Vietnam War from the American people, refused to increase taxes and chose instead to pay for its warfare and welfare policies through inflationary macroeconomic policies. The succeeding Nixon Administration (1969–1974) compounded the problem of inflation. In addition, the Federal Reserve threw caution to the wind as it stimulated the economy, a move that critics labeled a blatant attempt to reelect Nixon. Subsequent intensification of speculative attacks on the overvalued dollar and ballooning of the American trade/payments deficit resulted in the Nixon Administration's decision on August 15, 1971, to force devaluation of the dollar.

The international monetary system was thus changed, at least de facto, from one based on fixed exchange rates to one based on flexible rates. Subsequent efforts of an international committee to develop a new system of stable exchange rates failed. The overwhelming problems posed by increased capital mobility, along with fundamental differences between the United States and Western Europe over any new system, made agreement impossible. Moreover, the huge OPEC monetary surplus following the first oil crisis, and the need to recycle those funds, proved important in the development of the international financial market. Before the end of the 1970s, the scale and velocity of international financial flows had expanded enormously and had truly transformed the international economic system. As a consequence of this impasse, the major industrial powers accepted economic reality at the Jamaica Conference (1976) and instituted flexible rates. This situation was described by some as a "non-system", because there were no generally recognized rules to guide the flexible rates or any other decisions on international monetary affairs.

4.9.Foreign Directed Investment and MNCs

The importance of the multinational corporation (MNC) is a key feature of globalization of the world economy. However, opinions differ greatly over the significance for domestic and international economic affairs of the development of multinational corporations. Some commentators believe that the multinational corporation has broken free from its home economy and has become a powerful independent force determining both international economic and political affairs. Others reject this position and believe that the multinational corporation remains a creature of its home economy. This section is devoted to the discussion of MNC role in IPE and most notably in the area of foreign directed investment.

4.9.1. The Nature and Significance of MNC

Although there are many more technical definitions of a multinational firm, a MNC refers simply to a firm or corporation of a particular nationality with partially or wholly owned subsidiaries within at least one other national economy. Tens of thousands of MNCs with numerous subsidiaries conduct business around the world.

Such firms expand overseas primarily through foreign direct investment (FDI), whose purpose is to achieve partial or complete control over marketing, production, or other facilities in another economy; such investments may be in services, manufacturing, or commodities. FDI can entail either the purchase of existing businesses or the building of new facilities (called "greenfield" investment). Whereas the purpose of portfolio investment is to obtain a financial return on the investment, FDI, as well as alliances, mergers, and similar ventures, are usually part of an international corporate strategy to establish a permanent position in another economy.

In one sense, multinational firms have existed for a very long time. The Dutch East India Company, the Massachusetts Bay Company, and other companies of merchant-adventurers were forerunners of today's MNCs like IBM, Sony, and Daimler-Chrysler. These earlier transnational firms, however, were far more powerful than contemporary MNCs are; they commanded armies and fleets, had their own foreign policies, and controlled vast expanses of territory: the sub-Asian continent (India, Pakistan, and Bangladesh), the East Indies (Indonesia), and South Africa. Modern MNCs are much more modest. Another major difference between those early transnational firms and today's is that the former were principally interested in agricultural products and extractive industries in particular regions of the world, whereas major firms in the early twenty-first century are principally involved in manufacturing, retailing, and services, tend to operate on a regional or worldwide basis, and usually pursue an international corporate strategy

4.9.2. The Multinationals and the International Economy

The world's largest MNCs account for approximately four-fifths of world industrial output while typically employing two-thirds of their work force at home; they are not nearly as footloose as many critics charge. Foreign direct investment (FDI) has been growing at a rapid rate. Between 1985 and 1990, FDI grew at an average rate of 30 percent a year, an amount four times the growth of world output and three times the growth rate of trade. FDI has in fact become a major determinant of trade patterns. The annual flow of FDI has doubled since 1992 to nearly $350 billion. Intra firm trade—that is, trade among subsidiaries of the same firm—accounted for one-third of American exports and two-fifths of U.S. imported goods in 1994.

About one-half of the trade between Japan and the United States is actually intra firm trade. This intra firm trade takes place at transfer prices set by the firms themselves and within a global corporate strategy that does not necessarily conform to the conventional trade theory based on traditional concepts of comparative advantage. Evidence suggests that these trends will continue and could even accelerate.

The gross statistics, however, hide noteworthy aspects of FDI and of other activities of MNCs. Despite much talk of corporate globalization, FDI is actually highly concentrated and is distributed unevenly around the world. Although FDI has grown rapidly in developing countries, most FDI has been placed in the United States and Europe, while only a small percentage of U.S. foreign direct investment has gone to developing countries.

This concentration of FDI is due to the simple fact that the United States and Europe are at present the world's largest markets. Nevertheless, throughout most of the 1990s, FDI in less developed countries (LDCs) grew at about 15 percent annually. However, FDI in LDCs has been highly uneven and concentrated in a small number of countries, including a few in The increasing importance of MNCs has profoundly altered the structure and functioning of the global economy. These giant firms and their global strategies have become major determinants of trade flows and of the location of industries and other economic activities. Most FDI is in capital and technology-intensive sectors. These firms have become central in the expansion of technology flows to both industrialized and industrializing economies and therefore are important in determining the economic, political, and social welfare of many nations.

Controlling much of the world's investment capital, technology, and access to global markets, such firms have become major players not only in international economic but in international political affairs as well, and this has triggered a backlash in many countries. According to DeAnne Julius, one of the world's most knowledgeable experts on the MNC, the huge expansion of FDI, inter-corporate alliances, and intra-firm trade throughout the 1980s and 1990s reached a level where "a qualitatively different set of linkages" among advanced economies was created; some have estimated that more than twenty thousand corporate alliances were formed in the years 1996–1998. The growing importance of FDI and inter-corporate cooperation means that the world economy has reached a "takeoff" point comparable to that wrought by the great expansion of international trade in the late 1940s and the subsequent emergence of the highly interdependent international trading system. The growth in FDI and in the activities of multinational corporations of many nationalities has linked nations more tightly to one another, and this has further affected the global economy.

The role of MNCs in the world economy remains highly controversial. Critics charge that foreign direct investment and the internationalization of production are transforming the nature of international economic and political affairs in ways that undermine the nation-state and integrate national economies. Impersonal market forces and corporate strategies are believed to dominate the nature and dynamics of the international economic and political system.

While many believe such a development to be highly beneficial for mankind, others regard the MNC as exploiters. These critics believe that giant firms, answerable only to themselves, are integrating societies into an amorphous mass in which individuals and groups lose control over their own lives and are subjugated to firms' exploitative activities. The world, these critics charge, is coming under the sway of a ruthless capitalist imperialism where the only concern is the bottom line.

Many and perhaps most professional economists (with the important exception of business economists), on the other hand, discount the significance of multinational firms in the functioning of the world economy. The neoclassical interpretation acknowledges that large oligopolistic firms may be politically important and may also affect the distribution of income within national economies. However, these economists deny that the investment, marketing, and other economic activities of these firms around the world have any great impact on the "real" economy of international trade, location of economic activities, or national rates of economic or productivity growth. In neoclassical economics, the global location of economic activities and patterns of international trade are determined according to location theory and the principle of comparative advantage.

Both extreme positions are exaggerations. Critics exaggerate the evils of the MNCs and their role in the world economy. Although some MNCs do exploit and damage the world, the MNC as an institution is beneficial to many people worldwide; it is, for example, a major source of capital and technology for economic development. On the other hand, the proponents of the MNCs exaggerate their importance and overstate the internationalization of services and production.

The nation-state remains the predominant actor in international economic affairs, and domestic economies are still the most important feature of the world economy. Although some convergence has been occurring, national societies retain their essential characteristics and are not becoming part of any homogenized amorphous mass. In an era of oligopolistic competition and rapid technological innovation, location theory and the conventional theory of comparative advantage cannot tell the whole story of what is happening in the world economy.

One of the most important recent developments in the world economy has been the internationalization of services and of industrial production, a development facilitated by falling costs for communication and transportation that have enabled firms to integrate production and other activities around the globe. Continuing restructuring of services and manufacturing was extremely important in the nature of the world economy as it entered the new millennium. Nevertheless, the importance of this development is frequently misunderstood and exaggerated. FDI in the year 2000 is only a small part of the total domestic investment of the rich countries. Furthermore, contrary to the often stated opinion that MNCs have "globalized" technology and put their own firms everywhere on an equal footing for reasons internal to the firms themselves, and because of conditions prevailing in many developing countries, technology tends to diffuse from industrialized to industrializing countries relatively slowly.

Moreover, internationalization of services and production is highly concentrated among the major powers and within particular regions notably Japan in southeast Asia, the euro zone in Eastern Europe, and the US in the NAFTA area. Evidence thus suggests that regionalism as well as globalism characterizes the strategies of multinational firms. While economic competition and financial markets have become increasingly global, production and services are increasingly regional. The increased importance of regionalization in the world economy raises some disturbing possibilities. The trend toward regionalization could lead to weakening of the post–World War II movement toward trade liberalization. While the MNCs of the major economic powers continue to pursue global strategies and to invest in one another's economies (with the exception caused by Japan's relatively low level of inward FDI), they are also concentrating their own FDI in neighboring countries. Creation of regional rather than global production and sourcing networks has become a notable trend.

Chapter Five

5. International Debt Crisis and Foreign Aid

5.1. Accumulation of Debt and Emergence of the Debt Crisis

The accumulation of external debt is a common phenomenon of developing countries at the stage of economic development where the supply of domestic savings is low, current account payments deficits are high, and imports of capital are needed to augment domestic resources. Prior to the early 1970s, the external debt of developing countries was relatively small and primarily an official phenomenon, the majority of creditors being foreign governments and international financial institutions such as the IMF, the World Bank, and regional development banks. Most loans were on concessional (low-interest) terms and were extended for purposes of implementing development projects and expanding imports of capital goods. However, during the late 1970s and early 1980s, commercial banks began playing a large role in international lending by recycling surplus OPEC "petrodollars" and issuing general-purpose loans to developing countries to provide balance of payments support and expansion of export sectors.

Although foreign borrowing can be highly beneficial, providing the resources necessary to promote economic growth and development, when poorly managed, it can be very costly. In recent years, these costs have greatly outweighed the benefits for many developing nations. The main cost associated with the accumulation of a large external debt is debt service. Debt service is the payment of amortization (liquidation of the principal) and accumulated interest; it is a contractually fixed charge on domestic real income and savings. As the size of the debt grows or as interest rates rise, debt service charges increase. Debt service payments must be made with foreign exchange. In other words, debt service obligations can be met only through export earnings, curtailed imports, or further external borrowing. Under normal circumstances, most of a country's debt service obligations are met by its export earnings.

5.2. Tactics for Debt Financing

1. Repudiate debts by forming a debtors' cartel[5]
2. Extension of maturity of payments
3. Printing of Currency
4. Borrowing
5. Selling of Assets

5.3. Foreign Aid

In addition to export earnings and private foreign direct and portfolio investment, developing countries receive two other major sources of foreign exchange: public (official) bilateral and multilateral development assistance and private (unofficial) assistance provided by nongovernmental organizations. Both of these activities are forms of **foreign aid**, although only public aid is usually measured in official statistics. In principle, all governmental resource transfers from one country to another should be included in the definition of foreign aid. Even this simple definition, however, raises a number of problems. For one thing, many resource transfers can take disguised forms, such as the granting of preferential tariffs by developed countries to exports of manufactured goods, particularly from the least developed countries. This permits developing countries to earn more foreign exchange from selling their industrial products in developed-country markets at higher prices than would otherwise be possible. There is consequently a net gain for developing countries and a net loss for developed countries, which amounts to a real resource transfer to the developing world. Such implicit capital transfers, or disguised flows, should be counted in qualifying foreign-aid flows. Normally, however, they are not. However, we should not include *all* transfers of capital to developing countries, particularly the capital flows of private foreign investors. Private flows represent normal commercial transactions, prompted by commercial considerations of profits and rates of return, and therefore should not be viewed as foreign aid. Commercial flows of private capital are *not* a form of foreign assistance, even though they may benefit the developing country in which they take place.

[5] A group of developing-country debtors who join together to bargain as a group with creditors.

Economists have defined foreign aid, therefore, as any flow of capital to a developing country that meets two criteria: (1) Its objective should be non-commercial from the point of view of the donor, and (2) it should be characterized by **concessional terms**; that is, the interest rate and repayment period for borrowed capital should be softer (less stringent) than commercial terms. Even this definition can be inappropriate, for it could include military aid, which is both noncommercial and concessional. Normally, however, military aid is excluded from international economic measurements of foreign-aid flows. The concept of foreign aid that is now widely used and accepted, therefore, is one that encompasses all official grants and concessional loans, in currency or in kind, that are broadly aimed at transferring resources from developed to less developed nations on development, poverty, or income distribution grounds. Unfortunately, there often is a thin line separating purely developmental grants and loans from sources ultimately motivated by security or commercial interests. Just as there are conceptual problems associated with the definition of foreign aid, there are measurement and conceptual problems in the calculation of actual development assistance flows. In particular, three major problems arise in measuring aid.

1. First, we cannot simply add up the dollar values of grants and loans; each has a different significance to both donor and recipient countries. Loans must be repaid and therefore cost the donor and benefit the recipient less than the nominal value of the loan itself.
2. Second, aid can be tied either by *source* (loans or grants have to be spent on the purchase of donor-country goods and services) or by *project* (funds can only be used for a specific project, such as a road or a steel mill). In either case, the real value of the aid is reduced because the specified source is likely to be an expensive supplier or the project is not of the highest priority otherwise, there would be no need to tie the aid). Furthermore, aid may be tied to the importation of capital-intensive equipment, which may impose an additional real resource cost, in the form of higher unemployment on the recipient nation. Or the project itself may require the purchase of new machinery and equipment from monopolistic suppliers while existing productive equipment in the same industry is being operated at very low levels of capacity.
3. Finally, we always need to distinguish between the nominal and real value of foreign assistance. Aid flows are usually calculated at nominal levels and tend to show a steady rise over time.

5.4.Why Donors Give Aid?

Donor-country governments give aid because it is in their political, strategic, or economic self-interest to do so. Some development assistance may be motivated by moral and humanitarian desires to assist the less fortunate (e.g., emergency food relief and medical programs) and certainly this has been the international rhetoric in the increases in aid in the first decade of the twenty-first century.

Still, there is no historical evidence to suggest that over longer periods of time, donor nations assist others without expecting some corresponding benefits (political, economic, military, counterterrorism, etc.) in return. We focus here on the foreign-aid motivations of donor nations in two broad but often interrelated categories: political and economic.

1. **Political Motivations:** Political motivations have been by far the more important for aid-granting nations, especially for the largest donor country, the United States. The United States has viewed foreign aid from its beginnings in the late 1940s under the Marshall Plan, which aimed at reconstructing the war-torn economies of western Europe, as a means of containing the international spread of communism. When the balance of Cold War interests shifted from Europe to the developing world in the mid-1950s, the policy of containment embodied in the U.S. aid program dictated a shift in emphasis toward political, economic, and military support for "friendly" less developed nations, especially those considered geographically strategic. Most aid programs to developing countries were therefore oriented more toward purchasing their security and propping up their sometimes shaky regimes than promoting long-term social and economic development. The successive shifts in emphasis from South Asia to Southeast Asia to Latin America to the Middle East and back to Southeast Asia during the 1950s and 1960s and then toward Africa and the Persian Gulf in the late 1970s, the Caribbean and Central America in the 1980s, and the Russian Federation, Bosnia, Ukraine, and the Middle East in the 1990s, with a renewed focus on the Islamic nations after 2001, reflect changes in U.S. strategic, political, security, and economic interests more than changing evaluations of poverty problems and economic need. Recent increases in aid to African countries with public health crises including HIV assistance may be due in part to concerns that

disease may spread internationally or lead to destabilizing state collapse and possible havens for terrorists.

Even the Alliance for Progress, inaugurated in the early 1960s with great fanfare and noble rhetoric about promoting Latin American economic development, was formulated primarily as a direct response to the rise of Fidel Castro in Cuba and the perceived threat of communist takeovers in other Latin American countries. As soon as the security issue lost its urgency and other more pressing problems came to the fore (the war in Vietnam, the rise in U.S. violence, etc.), the Alliance for Progress stagnated and began to fizzle out.

Our point is simply that where aid is seen primarily as a means of furthering donor-country interests, the flow of funds tends to vary with the donor's political assessment of changing international situations and not the relative need of potential recipients. The behavior of other major donor countries such as Japan, Great Britain, and France has been similar to that of the United States. Although exceptions can be cited (Sweden, Denmark, the Netherlands, Norway, and perhaps Canada), by and large these Western donor countries have used foreign aid as a political lever to prop up or underpin friendly political regimes in developing countries, regimes whose continued existence they perceived as being in their own national security interests.

Economic Motivations: Two-Gap Models and Other Criteria Within the broad context of political and strategic priorities, foreign-aid programs of the developed nations have had a strong economic rationale. This is especially true for Japan, which directs most of its aid to neighboring Asian countries where it has substantial private investments and expanding trade. Even though political motivation may have been of paramount importance for other donors, the economic rationale was at least given lip service as the overriding motivation for assistance.

Let us examine the principal economic arguments advanced in support of foreign aid.

Foreign-Exchange Constraints: External finance (both loans and grants) can play a critical role in supplementing domestic resources in order to relieve savings or foreign-exchange bottlenecks. This is the so-called two-gap analysis of foreign assistance. The basic argument of the **two-gap model** is that most developing countries face either a shortage of domestic savings to match investment opportunities or a shortage of foreign exchange to finance needed imports of capital and intermediate goods. Basic two-gap and similar models assume that the **savings gap** (domestic real resources) and the **foreign-exchange gap** are unequal in magnitude and that they are essentially independent. The implication is that one of the two gaps will be “binding” for any developing economy at a given point in time. If, for example, the savings gap is dominant, this would indicate that growth is constrained by domestic investment. Foreign savings may be used as a supplement to domestic savings. (However, decision-makers in a country with a shortage of savings may be unable or unwilling to divert purchasing power from consumption goods to capital goods, either bought domestically or from abroad. As a result, “excess” foreign exchange, including foreign aid, might be spent on the importation of luxury consumption goods.) An outstanding example of savings-gap nations would be the Arab oil exporters during the 1970s. When the foreign-exchange gap is binding, a developing economy has excess productive resources (mostly labor), and all available foreign exchange is being used for imports. The existence of complementary domestic resources would permit them to undertake new investment projects if they had the external finance to import new capital goods and associated technical assistance. Foreign aid can therefore play a critical role in overcoming the foreign exchange constraint and raising the real rate of economic growth.

Growth and Savings External assistance is also assumed to facilitate and accelerate the process of development by generating additional domestic savings as a result of the higher growth rates that it is presumed to induce. Eventually, it is hoped, the need for concessional aid will disappear as local resources become sufficient to make development self-sustaining. In reality, much aid is not invested, and if it is, the productivity of that investment is often very low. However, among the main reasons for this are the very “strings” attached to foreign aid.

Technical Assistance Financial assistance needs to be supplemented by **technical assistance** in the form of high-level worker transfers to ensure that aid funds are used most efficiently to generate economic growth. This skill gap-filling process is thus analogous to the financial-gap-filling process mentioned earlier. Sustainable development impact requires a focus on training in recipient countries.

Absorptive Capacity Finally, the amount of aid is considered in relation to the recipient country’s **absorptive capacity**, its ability to use aid funds wisely and productively (often meaning as donors want them to be used). Typically, the donor countries decide which developing countries are to receive aid, how much, in what form (loans or grants, financial or technical assistance), for what purpose, and under what conditions on the basis of the donor countries' assessment of domestic absorptive capacities (particularly for the least developed countries). But many types of assistance, such as resources for building infrastructure or for training (e.g., of government officials or health or education workers) itself increases absorptive capacity. It has been said that what one donor sees as a constraint on the ability of a country to use conventional aid, another sees as an opportunity to have more leveraged impact with new forms of assistance. In any case, in practice the total amount of aid rarely has much to do with developing-country absorptive capacities because typically, foreign aid is a residual and low-priority element in donor-country expenditures. In most instances, the recipient countries have little say in the matter.

Economic Motivations and Self-Interest The arguments on behalf of foreign aid as a crucial ingredient for successful development should not mask the fact that even at the strictly economic level, definite benefits accrue to donor countries as a result of their aid programs. The strong tendency toward providing interest-bearing loans instead of outright grants and toward tying aid to the exports of donor countries has saddled many countries, often among the least developed, with substantial debt repayment burdens. It has also increased their import costs because aid tied to donor-country exports limits the receiving nation's freedom to shop around for low-cost and suitable capital and intermediate goods. **Tied aid** in this sense is clearly a second-best option to untied aid (and perhaps also to freer trade through a reduction of developed-country import barriers). For example, a large fraction of U.S. aid has been spent on American consultants and other U.S. businesses.

5.5.Why Recipient Countries Accept Aid

The reasons why developing nations have usually been eager to accept aid, even in its most stringent and restrictive forms, have been given much less attention than the reasons why donors provide aid. The major reason is probably economic. Developing countries have often tended to accept the proposition—typically advanced by developed-country economists and supported by reference to success stories such as Taiwan and South Korea to the exclusion of many more failures—that aid is a crucial and essential ingredient in the development process. It supplements scarce domestic resources, it helps transform the economy structurally, and it contributes to economic growth. Thus the economic rationale for aid is based in part on their acceptance of the donor's perceptions of what the poor countries require to promote economic development.

Second, in some countries, aid is seen by both donor and recipient as providing greater political leverage to the existing leadership to suppress opposition and maintain itself in power. In such instances, assistance takes the form not only of financial-resource transfers but of military and internal security reinforcement as well.