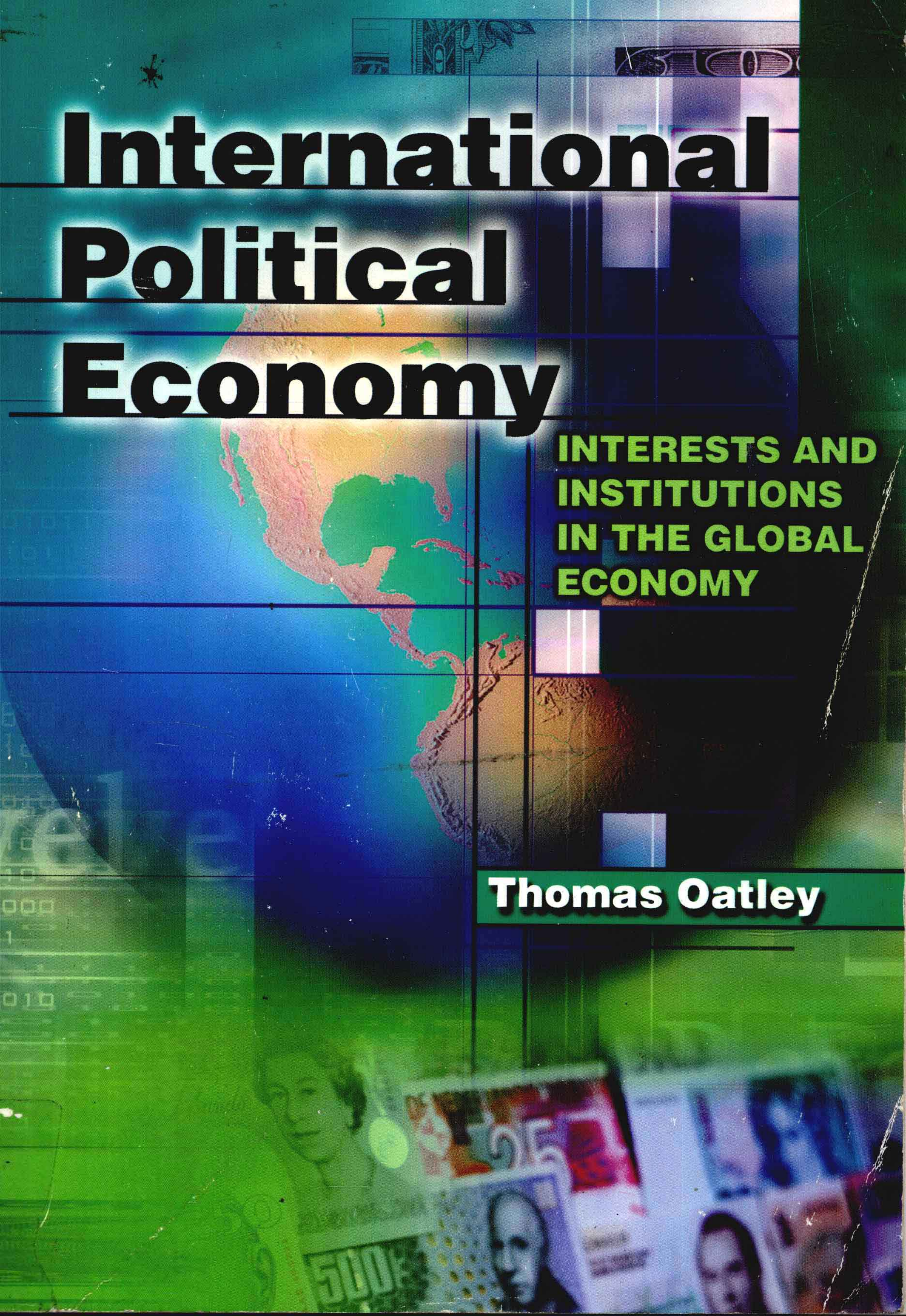
International Political Economy

INTERESTS AND INSTITUTIONS IN THE GLOBAL ECONOMY

Thomas Oatley



INTERNATIONAL POLITICAL ECONOMY

Interests and Institutions in the Global Economy

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PREFACE

This book emerged from a certain frustration that has arisen from my effort to find suitable material for use in teaching international political economy (IPE) to advanced undergraduates. I have found that available edited volumes assume that undergraduates have considerable background in economic theory, in the relationship between economic and political processes, and in the history of the international economic system. In my experience, few undergraduates taking their first course in international political economy have such a background. And while available texts do an excellent job providing the substantive context by describing the creation and evolution of the postwar international economic system, most texts do a much less thorough job presenting many of the theories used by contemporary scholars of international political economy. What was lacking, I believed, was a text that provided the historical and contemporary context of international economic system and explained the core theories of contemporary international political economy. As a result, I thought there was a considerable gap between the way available texts present IPE to undergraduates and how the field practices IPE as a scholarly endeavor.

This book is intended to fill this gap. It differs from existing textbooks in four principal ways. First, this book has more extensive discussion of economic concepts and theories than most IPE textbooks. This reflects my belief that it is impossible to understand how the international economic system operates without some background in economic principles and theories. In addition, I believe that it is impossible to understand why interest groups desire certain policies and why governments adopt specific policies without knowledge of how economic processes affect groups within society. Every chapter, therefore, contains an explicit discussion of some body of economic literature that has particular relevance to the issue under consideration. In presenting these theories, I emphasize the underlying intuition and make no attempt to describe the formal theoretical structure that supports these theories. In each instance, I stress the connections between the economic theory being discussed and the issue area under consideration. It is my hope that this will provide an introduction to international economics sufficient to allow students to make sense of the international economic system.

This book provides a more extensive discussion of domestic politics than most other IPE textbooks. The last 15 years have brought an explosion of studies that focus on the domestic politics of trade and exchange rate policy. Indeed, it is hard to find a scholarly work on any aspect of international political economy that does not acknowledge the importance of domestic politics. Few existing textbooks incorporate this literature, and most provide only a very cursory and rather unsystematic discussion of domestic politics. I dedicate two chapters entirely to domestic politics—one on the domestic politics of trade and one to the domestic politics of exchange rates. In addition, the two chapters on developing countries draw heavily on explanations based in domestic politics to make sense of the trade and development strategies adopted by developing countries in the postwar period.

Finally, but hardly least important, I place little emphasis on the three traditional schools of international political economy: mercantilism, liberalism, and Marxism, that structure many of the current textbooks. My decision to de-emphasize the traditional schools is based in part on two weaknesses in these schools. First, each school presents a coherent but largely self-contained interpretive framework that focuses on one aspect of the international political economy and neglects many others. As a consequence, these frameworks often force students to adopt an "either-or" mentality when studying the international political economy. Either global market-based capitalism is a good thing that raises global welfare, as liberals claim, or it is an exploitative system that benefits firms at the expense of workers, as Marxists claim. Either the international political economy is essentially cooperative, as the liberals emphasize, or it is essentially conflictual, as nationalists and Marxists emphasize. In most instances, however, the international political economy fails to fit wholly into any one of these three frameworks. International economic transactions can raise social welfare, but they also often promote an unequal distribution of these gains. Countries sometimes engage in economic cooperation, but also sometimes become embroiled in economic conflict. Thus, rather than using three traditional schools that offer self-contained perspectives on international political economy and that each focus on one aspect of the international political economy while neglecting others, this book develops an approach that can incorporate all of these aspects.

Second, these three traditional schools are often more useful for evaluating foreign economic policy outcomes than for explaining foreign economic policy decisions. Each traditional school offers an elaborate framework that tells us how governments should behave. Mercantilists argue that governments should intervene in markets while liberals argue that governments should not intervene in markets. Marxists argue that capitalism should be replaced by socialism. None are good at telling us why governments adopt one set of foreign economic policies rather than another. Governments do intervene in the market for reasons that have little to do with national security, and they liberalize trade in areas that mercantilists would question. Marxism is better at offering explanations. Yet, there are many instances in which simple class conflict between labor and capital fails to account for the policies that firms and labor pursue or the policies that governments adopt. For example, capitalist firms are important actors in the international economy and they play a large role in shaping government policy. Yet, not all firms have identical interests. In fact some firms clearly gain from globalization, but others clearly lose. Nor can workers be treated as an undifferentiated group. As is the case with firms, some workers do lose from globalization, but others clearly benefit. The complexities of international economic exchange cannot, therefore, be reduced to a simple Marxist framework that emphasizes class conflict between labor and capital. For these reasons, students of the international political economy have increasingly turned away from theoretical explanations based explicitly on the three traditional schools of political economy. These historical perspectives continue to shape public and scholarly debates about the role of the market, about the relative gains of labor and firms in a capitalist economy, and about the state's proper role in the economy. They have played a much less important role during the last 15 years, however, in shaping the explanatory theories that students of international political economy have developed to explain the foreign economic policies that governments adopt. I use an analytical framework based on the interaction between interests and institutions. This approach allows me to draw heavily on contemporary scholarship. In addition, the approach allows me to develop a number of distinct explanations covering a large number of countries all of which start from the same point: governments' foreign economic policies reflect the interaction between societal interests and political institutions.

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

Numerous reviewers provided detailed comments that vastly improved the book in so many ways. It is no light burden to write a thoughtful and constructive review of a book, and I thank them all for taking the time to do so. My thanks, therefore, go to: Ali R. Abootalebi, University of Wisconsin, Eau Claire; Francis Adams, Old Dominion University; Katherine Barbieri, Vanderbilt University; Charles H. Blake, James Madison University; Terry D. Clark, Creighton University; Linda Cornett, University of North Carolina–Asheville; Charles R. Dannehl, Bradley University; Robert A. Dayley, Albertson College of Idaho; Mark Elder, Michigan State University; Richard Ganzel, University of Nevada; Alan Kessler, The University of Texas at Austin; Douglas Lemke, University of Michigan; Michael Mastanduno, Dartmouth College; Sean M. McDonald, Bentley College; Philip Meeks, Creighton University; Jeffrey S. Morton, Florida Atlantic University; Gene Mumy, The Ohio State University; Jim Pletcher, Denison University; Herman Schwartz, University of Virginia; Cliff Staten, Indiana University Southeast; and Christianne Hardy Wohlforth, Fordham University. Frank Boyd read an early version of Chapter 4 and pointed me to literature that greatly strengthened it. Zia Cromer, who patiently read two versions of the complete manuscript, also helped improve the text in important ways. Milada Vachudova was a seemingly tireless reader who greatly improved the book.

Finally, I owe a large debt of gratitude to all of those scholars whose research made this book possible. You have taught me much, and I only hope that in writing this book I have treated your work accurately and fairly. Of course, in spite of all of this support, I alone am responsible for any errors of fact or interpretation.

Thomas Oatley

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CHAPTER 1

INTERNATIONAL POLITICAL ECONOMY

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

In the second case, a vocal opposition to globalization has begun to emerge in many advanced industrialized countries since the mid-1990s. Organized opposition to globalization first emerged in 1997 in response to efforts by governments in the United States, Western Europe, and other advanced industrialized countries to negotiate an international agreement called the Multilateral Agreement on Investment, which would establish rules governing foreign investment. Fearing that such an agreement would be too oriented toward business interests and would ultimately lead to a weakening of environmental protection regulations, opponents of globalization organized protests, rallies, and other activities designed to convey their opposition to governments. In 1998, governments abandoned the proposed agreement, in part because of public opposition. Opponents of globalization claimed victory and pushed their campaign forward in late November and early December of 1999. The occasion was a meeting of representatives of more than 100 countries in Seattle, Washington. The goal of the meeting was to establish an agenda for the Millenium Round of trade negotiations that were to be held under the aegis of the World Trade Organization (WTO). The effort to establish an agenda failed, however, because the Clinton Administration's efforts to incorporate discussion of international labor standards in the WTO—one of the demands of the protesters in Seattle—met strong resistance from developing countries' governments. International trade, and globalization more generally, are issues that have rarely been high on the list of public concerns. Why have they suddenly become flashpoints sparking angry and sometimes violent protests?

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

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

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

What Is International Political Economy?

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

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

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

The international trade system is centered upon an international institution called the World Trade Organization (WTO). Some 144 countries belong to the WTO, and through this international institution they have created a nondiscriminatory international trade system. This means that in the international trade system, each country gains access to all other WTO members' markets on equal terms. In addition, the WTO and its predecessor, the General Agreements on Tariffs and Trade (GATT), have enabled governments to progressively eliminate tariffs and other barriers to the cross-border flow of goods and services. As these barriers have been dismantled, world trade has grown steadily. Today, goods and services worth about $7.6 trillion flow across national borders each year. During the last ten years, however, regional trading arrangements have arisen to pose a potential challenge to the WTO-centered trade system. These regional trade arrangements, such as the North American Free Trade Agreement (NAFTA), are trading blocs comprised of a small number of countries who offer each other preferential access to their markets. Scholars who study the international trade system investigate the creation, operation, and consequences of the WTO-centered system and the emerging regional trading frameworks.

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

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