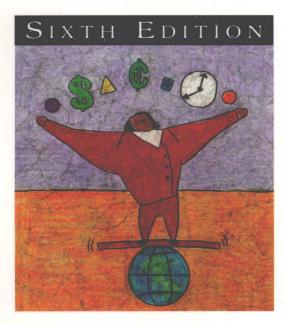
THE POLITICS OF INTERNATIONAL ECONOMIC RELATIONS



Joan E. Spero Jeffrey A. Hart

The Politics of International Economic Relations

Sixth Edition

JOAN EDELMAN SPERO

The Doris Duke Charitable Foundation

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To Samuel and Sylvia Edelman Michael, Jason, and Benjamin Spero JES

> To Joan and Zachary Hart JAH



Preface

he first edition of *The Politics of International Economic Relations*, published in 1977, was written to fill a void in the study of international relations—the gap between international politics and international economics. Since 1977, that gap has narrowed significantly. International political economy has emerged as a new and increasingly prominent field in political science. Theoretical and empirical analyses of the politics of international economic relations appear regularly in professional books and journals. Although the most important bridge building has come from political scientists, now economists are also including political variables in their analyses and applying economic theory to the study of political behavior. A new and diverse generation of students is being made aware of the interrelationship between economics and politics and is learning to use and integrate the tools of these disciplines.

Much has happened since 1977 to reinforce this academic evolution. Above all, turbulence in the world economy has heightened the political aspect of international economic relations. The persistent problems of the dollar and other international currencies, the many trade disputes between the United States and its major trading partners, crises in world oil markets, and the continuing debt crisis in the Third World have obliged scholars to reexamine the assumptions that separated the disciplines of economics and political science for over a century.

The focus and organization in this book has not changed much since the first edition was published. This edition of *The Politics of International Economic Relations* continues the previously established tradition of separating the discus-

X PREFACE

sion into problems faced by developing countries and former communist countries and problems that primarily affect industrialized capitalist countries. In the fifth edition, we added new material that reflected major changes in the international system since the end of the Cold War. Also in the fifth edition, we discussed and tried to explain the increasing pragmatism of domestic and foreign economic policies in many parts of the Third World, but especially in the faster–growing developing countries. Last, the fifth edition added material on the growing gap between the poorest regions of the world and the richest ones.

This sixth edition provides new information about the various monetary crises of the late 1990s, the early years of the World Trade Organization, the continuing rapid growth in foreign direct investment, the integration of the formerly communist countries into the capitalist world economy, and a rethinking of theories of economic development that followed the Asia Crisis of 1997–98. Finally, the sixth edition explores the relationship between globalization and governance in greater depth than in previous editions.

We owe a debt of gratitude to a number of colleagues for reading and providing comments on the sixth edition of *The Politics of International Economic Relations:* Mark Amen, University of South Florida; Mark Boyer, University of Connecticut; Steve Chan, University of Colorado; John Conybeare, University of Iowa; David D'Lugo, University of Southern California; Giullio Gallarotti, Wesleyan University; Michael Hiscox, University of California, San Diego; Layna Mosley, University of Notre Dame; Edward Morse, Hess Energy Trading; Aseem Prakash, University of Washington—Seattle; and Steve Roper, Eastern Illinois University. We would also like to thank the following individuals for their research assistance in preparing this sixth edition: Craig Ortsey, Sangbae Kim, Sangbum Shin, and Derekh Cornwell. Stacey Sims of Wadsworth was developmental editor for the sixth edition.



About the Authors

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Joan E. Spero is President of the Doris Duke Charitable Foundation. Since 1997, she has been responsible for directing the activities of the \$1.4 billion foundation, which supports a variety of charitable causes, including the performing arts, environmental preservation, medical research, and prevention of child abuse. From 1993 to 1997, Ms. Spero served as Undersecretary of State for Economic, Business, and Agricultural Affairs in the Clinton Administration. She played a central role in the Clinton administration's foreign economic policy and has participated directly in many of the events discussed in this book: the reshaping of the Bretton Woods institutions such as the International Monetary Fund and World Bank; the completion of the Uruguay Round and the creation of the World Trade Organization; the launching of new regional economic initiatives through the Asia Pacific Economic Cooperation forum, the Summit of the Americas, and the New Transatlantic Agenda; and the transition of former communist countries into participants in the institutions and economic system of the West. As the senior economic official in the Department of State, she advised Secretary of State Warren Christopher on international economic policy and led the work of the State Department on issues ranging from investment and aviation negotiations to bilateral relations with key partners such as Japan and the European Union.

Ms. Spero received her doctorate in political science from Columbia University and taught international politics and economics there from 1973 to 1979. In 1980 she was named U.S. Ambassador to the United Nations Economic and

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Jeffrey A. Hart is Professor of Political Science at Indiana University, Bloomington, where he has taught international politics and international political economy since 1981. His first teaching position was at Princeton University from 1973 to 1980. He was a professional staff member of the President's Commission for a National Agenda for the Eighties from 1980 to 1981. Hart worked at the Office of Technology Assessment of the U.S. Congress in 1985–1986 as an internal contractor and helped write their 1987 report, *International Competition in Services*. He was a visiting scholar at the Berkeley Roundtable on the International Economy from 1987 to 1989. His major publications include *The New International Economic Order* (1983), *Interdependence in the Post Multilateral Era* (1985), *Rival Capitalists* (1992), *The Politics of International Economic Relations* (5th ed.; 1997; with Joan Spero), *Globalization and Governance* (1999; edited with Aseem Prakash), and scholarly articles in *World Politics, International Organization, British Journal of Political Science, New Political Economy*, and *Journal of Conflict Resolution*.

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From Management to Governance in International Economic Relations

Throughout history, governments have created international economic systems to regulate various aspects of their international economic interaction. These systems consist of rules, institutions, and procedures that are intended to control economic conflict and achieve common economic goals. The systems range from simple trade or financial agreements to complex arrangements such as colonial empires or international institutions. International economic systems are shaped by the nature and degree of international interaction among participants, that is, by their trade, investment, and financial flows. In addition, the systems are shaped by political factors such as the distribution of power among the players, the degree of shared goals and interests, and the nature of leadership within the system. In the half-century since the end of World War II, there have been three international economic systems: the Bretton Woods system, which prevailed from World War II until 1971; the period of interdependence from 1971 to 1989; and, from 1989 to the present, the contemporary era of globalization.

BRETTON WOODS

For nearly two decades, the Bretton Woods system was effective in controlling conflict and achieving the common goals of its members. The rules, institutions, and procedures of the system were embodied in three organizations created 2 CHAPTER ONE

during and immediately after World War II. Named for the New Hampshire town in which two of the organizations—the International Monetary Fund (IMF) and the World Bank—were negotiated, the Bretton Woods system consisted of those two organizations plus the General Agreement on Tariffs and Trade (GATT). These three institutions have evolved significantly over time but remain cornerstones of international economic governance to the current day.

During the Bretton Woods era, international economic interaction was limited but growing. During the early years of Bretton Woods, many countries were recovering from the devastation of the war and were in no position to compete internationally. Tariffs, quotas, and exchange controls protected national markets and hampered the international flow of goods and money. International investment was limited and concentrated heavily in raw materials and retailing, not in manufacturing.

The Bretton Woods system rested on three political foundations: the concentration of power in a small number of states, the existence of a cluster of important interests shared by those states, and the presence of a dominant power willing and able to assume a leadership role. The concentration of both political and economic power in the developed countries of North America and Western Europe enabled these countries to dominate the Bretton Woods system. They faced no challenge from the communist states of Eastern Europe and Asia (including the Soviet Union), which were isolated from the rest of the international economy in a separate international economic system. Although the less-developed countries (LDCs) were integrated into the world economy, they had no voice in management because of their political and economic weakness. For much of this period, many developing countries in Africa and Asia were still subordinated within colonial empires. Finally, Japan, weakened by the war and lacking the level of development and the political power of North America and Western Europe, remained outside the management group for much of the Bretton Woods era. As a defeated power, Japan was not initially a member of the Bretton Woods institutions. It joined the IMF and World Bank in 1952 but did not become a member of the GATT until 1954. The concentration of power facilitated the economic system's management by confining the number of actors whose agreement was necessary to establish rules, institutions, and procedures and to carry out management within the agreedupon system.

Management also was made easier by a high level of agreement among the system's powerful members on the goals and means of the international economic system. The developed countries shared a belief in capitalism and liberalism and relied primarily on market mechanisms and private ownership. These countries also agreed that the liberal economic system required governmental intervention. In the era after World War II, national governments assumed responsibility for the economic well-being of their citizens, and employment, stability, and growth became important subjects of public policy. The welfare state grew out of the Great Depression, which created a popular demand for governmental intervention in the economy, and out of the theoretical contributions of the Keynesian school of economics, which prescribed governmental intervention to maintain adequate levels of employment.

The developed countries also favored a liberal international economic system, one that relied primarily on a free market with the minimum of barriers to the flow of private trade and capital. The experience of the Great Depression, in which proliferation of exchange controls and trade barriers led to economic disaster, remained fresh in the minds of public officials. Although these countries disagreed on the specific implementation of this liberal system, all agreed that an open system would maximize economic welfare. At the same time, governments recognized that international markets could be unstable and sought to design mechanisms to manage crises and control conflict.

Some governments also believed that a liberal international economic system would lead not only to economic prosperity and economic harmony but also to international peace.² One of those who saw such a security link was Cordell Hull, the U.S. secretary of state from 1933 to 1944. Hull argued that

unhampered trade dovetailed with peace; high tariffs, trade barriers, and unfair economic competition, with war . . . if we could get a freer flow of trade—freer in the sense of fewer discriminations and obstructions—so that one country would not be deadly jealous of another and the living standards of all countries might rise, thereby eliminating the economic dissatisfaction that breeds war, we might have a reasonable chance of lasting peace.³

The common interest in economic cooperation was enhanced by the outbreak of the Cold War at the end of the 1940s. The economic weakness of the West, some officials felt, would make it vulnerable to internal communist threats and external pressure from the Soviet Union. Economic cooperation became necessary not only to rebuild Western economies and to ensure their continuing vitality but also to provide for their political and military security. In addition, the perceived communist military threat led the developed countries to subordinate their economic conflict to their common security interests.

The developed market economies also agreed on the nature of international economic management, which would involve the creation and maintenance of a liberal system. This strategy would require the establishment of a stable international monetary system and the reduction of barriers to trade and capital flows so states would have a favorable environment for ensuring national stability and growth. The state, not the international system, bore the main responsibility for national stability and growth. Thus, the members of the system shared a very limited conception of international economic management: regulation of the liberal system by removing barriers to trade and capital flows and creating a stable monetary system.

Finally, international management relied on the dominant power to lead the system. As the world's foremost economic and political power, the United States clearly was in a position to assume that responsibility of leadership. The U.S. economy, undamaged by war and with its large market, great productive capability, financial facilities, and strong currency, was the dominant world economy. The ability to support a large military force plus the possession of nuclear weapons made the United States the world's strongest military power and the leader of the Western alliance. The European states, with their economies

in disarray due to the war, their production and markets divided by national boundaries, and their armies dismantled or weakened by the war, were not in a position to assume the leadership role. Japan, defeated and destroyed, was at that time not even considered part of the management system.

The United States was both willing and able to assume the leadership role. U.S. policymakers had learned an important lesson from the interwar period. The failure of U.S. leadership and the country's withdrawal into isolationism after World War I were viewed as major factors in the collapse of the economic system and of the peace. U.S. policymakers believed that after World War II the United States could no longer isolate itself. As the strongest power in the postwar world, the United States would have to assume primary responsibility for establishing political and economic order. With the outbreak of the Cold War, yet another dimension was added to the need for U.S. leadership. Without such leadership, the U.S. government and its allies abroad believed, the economic weakness in Europe and Japan would lead to communist political victories.

Furthermore, the Europeans and the Japanese—economically exhausted by the war—actively encouraged this U.S. leadership role. They needed assistance from the United States to rebuild their domestic production and to finance their international trade. The political implications of U.S. leadership, therefore, were viewed as positive, because political elites in these countries felt that U.S. economic assistance would alleviate domestic economic and political problems and encourage international stability. What the Europeans feared was not U.S. domination but U.S. isolation: the late entry of the United States into both world wars was fresh in their minds.

Throughout the Bretton Woods period, the United States mobilized the other developed countries for management and, in some cases, managed the system alone. The United States acted as the world's central banker, provided the major initiatives in international trade negotiations, and dominated international investment.

This coincidence of a limited degree of international economic interaction combined with favorable political conditions—the concentration of power, the cluster of shared interests, and the leadership of the United States—provided the political capability equal to the tasks of managing the international economy. The Bretton Woods system enabled Europe and Japan to recover from the devastation of the war, established a stable monetary system, encouraged more open trade, finance, and investment, and in turn led to a period of rapid economic growth.

INTERDEPENDENCE

By the 1970s, however, the Bretton Woods system was replaced by a new international economic system characterized by **interdependence**. Changes in the nature of international economic interaction and a shift in the balance of power among the key players led to a restructuring of the international economic order.

Important economic changes increased the management challenges facing the system. Ironically, it was the very success of Bretton Woods that led to these challenges. Economic growth and ongoing international liberalization combined with innovations in computing and telecommunications technologies led to higher volumes of international economic interaction and growing penetration of national economies by international trade, investment, and monetary flows. The reduction of barriers to trade and capital as well as the revolution in information technologies enabled an expansion in international economic interaction among the developed market economies: larger international capital flows, the growth of international trade, and the development of international systems of production. As a result, national economies became more interdependent and more sensitive to economic policy and events outside the national economy. The problem was heightened because this sensitivity grew at a time when, more than ever, states were expected to ensure domestic economic well-being. Because of the influence of external events, states found it increasingly difficult to manage their national economies. The greatest disruptions were caused by periodic monetary crises that forced dramatic revaluations of currencies and disrupted trade.

Interdependence led to two reactions and two different challenges to the underlying liberal consensus on which the system was based. One reaction was to erect new barriers to limit economic interaction and, with it, interdependence. An open international system, in this view, no longer maximized economic welfare and most certainly undermined national sovereignty and autonomy. Some critics argued that a continued focus on tariff reductions was no longer appropriate in an increasingly tariff-free world economy. Nontariff barriers (NTBs) had become deeply embedded in national economic policy, partly as a response to reduced tariffs. Pressures grew for new forms of protection and managed trade, but also for efforts to strengthen regional free-trade groupings such as the European Economic Community (EEC). These regional groupings were not on the whole protectionist, although the possibility always existed that new barriers to extraregional trade and investment flows would be erected even as internal ones were being dismantled.

Another reaction was to go beyond Bretton Woods and the idea of a limited management to new forms of international economic cooperation that would manage interdependence. An open system, according to this viewpoint, maximized welfare but required, in turn, new forms of international management that would assume responsibilities and prerogatives formerly undertaken by the state. These views led to efforts to establish a regular series of international economic summits and attempts (mostly unsuccessful) to coordinate national macroeconomic policies. In the 1980s, new initiatives were taken to upgrade the multilateral trade regime with a new and more ambitious multilateral trade negotiation—the Uruguay Round.

During the period of interdependence, changes in power and leadership also altered political management of the international economic system. Although the developed countries remained the dominant political and economic powers, states outside the group challenged their right to manage the system.